Internal Revenue cumulative bulletin

1989-1

January-June

Department of the Treasury
Internal Revenue Service

In This Issue

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Mission of the Service

The purpose of the Internal Revenue Service is to collect the proper amount of tax revenues at the least cost to the public, and in a manner that warrants the highest degree of public confidence in our integrity, efficiency and fairness. To achieve that purpose, we will:

—Encourage and achieve the highest possible degree of voluntary compliance in accordance with the tax law and regulations;

—Advise the public of their rights and responsibilities;

—Determine the extent of compliance and the causes of noncompliance;

—Do all things needed for the proper administration and enforcement of the tax laws;

—Continually search for and implement new, more efficient and effective ways of accomplishing our Mission.

Statement of Principles of Internal Revenue Tax Administration

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

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

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

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

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

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

Introduction

The Internal Revenue Bulletin is the authoritative instrument of the Commissioner of Internal Revenue for announcing official rulings and procedures of the Internal Revenue Service and for publishing Treasury Decisions, Executive Orders, Tax Conventions, legislation, court decisions, and other items of general interest.

It is 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 1989-1 is a consolidation of all items of permanent nature published in the weekly Bulletins 1989-1 through 1989-26 for the period of January 1 through June 30, 1989.

The Internal Revenue Cumulative Bulletin is prepared in three parts as follows:

Part I.—1986 Code.
This part includes rulings and decisions based on provisions of the Internal Revenue Code of 1986. Arrangement is sequential according to Code and regulations sections. The code section is shown at the top of each page.

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. Included in this Part is a list of persons disbarred or suspended from practice before the Internal Revenue Service.

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.

The Bulletin Index-Digest System, a research and reference service supplementing the Bulletin, may be obtained from the Superintendent of Documents on a subscription basis. It consists of four Services: Service No. 1, Income Tax; Service No. 2, Estate and Gift Taxes; Service No. 3, Employment Taxes; Service No. 4, Excise Taxes. Each Service consists of a basic volume and a cumulative supplement that provides (1) finding lists of items published in the Bulletin, (2) digests of revenue rulings, revenue procedures, and other published items, and (3) topical indexes of Public Laws, Treasury Decisions, and Tax Conventions.

Definition of Terms

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

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

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

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

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

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

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

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

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

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

Abbreviations

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

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

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Cumulative List of Announcements Relating to Decisions of the Tax Court Published in the Internal Revenue Bulletin from January 1, 1989 thru June 30, 1989

It is the policy of the Internal Revenue Service to announce in the Internal Revenue Bulletin at the earliest practicable date the determination of the Commissioner to acquiesce or not acquiesce in a decision of the Tax Court which disallows a deficiency in tax determined by the Commissioner to be due.

Notice that the Commissioner has acquiesced or nonacquiesced in a decision of the Tax Court relates only to the issue or issues decided adversely to the Government.

Actions of acquiescences in adverse decisions shall be relied on by Revenue officers and others concerned as conclusions of the Service only to the application of the law to the facts in the particular case. Caution should be exercised in extending the application of the decision to a similar case unless the facts and circumstances are substantially the same, and consideration should be given to the effect of new legislation, regulations, and rulings as well as subsequent court decisions and actions thereon.

Acquiescence in a decision means acceptance by the Service of the conclusion reached, and does not necessarily mean acceptance and approval of any or all of the reasons assigned by the Court for its conclusions.

No announcements are made in the Bulletin with respect to memorandum opinions of the Tax Court.

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:

Taxpayer	Docket No.	Report Volume	Report Page
Bailey, James[1]	21107-85	88	1293
Follender, David B., et ux[2]	14625-85	89	943
Givens, Donald[3]	4951-85	90	1145
Longue Vue Foundation, Transferee[4]	4440-85	90	150
Schirmer, Dolphus E., et ux[5]	32772-85	89	277
Standard Oil Co. (Indiana)[6]	5319-76	77	349
Winokur, James[7]	143-85	90	733

The Commissioner does NOT ACQUIESCE in the following decision:

Taxpayer	Docket No.	Report Volume	Report Page
Givens, Donald[8]	4951-85	90	1145

[1]Acquiescence relating to whether the payments made by the Urban Redevelopment Authority under an easement to rehabilitate the historic facade of petitioner's property are includable in petitioner's gross income.

[2]Acquiescence in the issues relating to (1) what extent petitioner, a limited partner in Brooke Associates, a New York limited partnership, increased his amount at risk by assuming a primary obligation to pay the principal, but not the interest, of a partnership recourse purchase note bearing nonrecourse interest, (2) whether nonrecourse interest due on a recourse purchase note payable solely from gross receipts is "contingent interest" under section 843 of the Code, and (3) whether petitioners are liable for the increased rate of interest under section 6621(c), formerly section 6621(d).

[3]Acquiescence relating to whether the Tax Court correctly held that the Service failed to meet its burden of proof as to whether the taxpayer had unreported income.

[4]Acquiescence in result relating to whether a forced heir's state-law created right to set aside a portion of a charitable transfer renders that portion contingent within the meaning of section 20.2055-2(b) of the regulations. Acquiescence "in result" means acceptance of the Court but disagreement with some or all the reasons assigned for the decision.

[5]Acquiescence relating to whether a taxpayer who fails to come within the protection of a revenue procedure issued in accordance with section 1.6666-4(c) of the regulations and who fails to make specific reference to section 6661 of the Code can nonetheless satisfy the requirement of section 6661(b)(2)(B)(ii) by providing on the return information sufficient for the Commissioner to identify the potential controversy involved.

[6]Acquiescence in result relating to whether the nonmaterial costs related to the fabrication of dual purpose jacket-type offshore drilling and production platforms may be deducted as expenses under section 263(c) of the Code and section 1.612-4 of the regulations. Acquiescence "in result" means acceptance of the Court but disagreement with some or all the reasons assigned for the decision.

[7]Acquiescence relating to whether a charitable contribution deduction is allowable under section 170 of the Code and section 1.170A-5(a)(2) of the regulations for the donation of an undivided interest in tangible personal property, if the donee is given the immediate right to possession of the property for a portion of every year equal to its interest, but does not take actual possession within one year of delivery of the deed of gift.

[8]Nonacquiescence relating to whether amounts designated as "sick pay" and received under a county statute by an employee who is injured in the course of employment are fully excludable from gross income under section 104(a)(1) of the Code.

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

Subpart A.—Income Taxes
Chapter 1.—Normal Taxes and Surtaxes
Subchapter A.—Determination of Tax Liability
Part IV.—Credits Against Tax
Subpart A.—Nonrefundable Personal Credits

Section 25.—Interest on Certain Home Mortgages

26 CFR 1.25-1T: Credit for interest paid on certain home mortgages.

Average area purchase price safe harbor limitations for Guam and Puerto Rico are added to the list in Rev. Proc. 88-48, 1988-2 C.B. 635. See Rev. Proc. 89-27, page 892.

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

The median gross income for the United States and the average purchase prices for the United States are set forth for use in computing the income limitation under section 143(f)(5) of the Code. See Rev. Proc. 89-32, page 904.

Subpart D.—Business Related Credits

Section 38.—General Business Credit

When, pursuant to a single integrated transaction, a corporation transfers section 38 property to a newly formed subsidiary in year one and distributes its stock in the subsidiary to its shareholders in year two, the disposition of the section 38 property triggering investment credit recapture under section 47(a) of the Code occurs in year one. See Rev. Rul. 89-18, page 14.

Section 41.—Credit for Increasing Research Activities

26 CFR 1.41-0: Table of contents.

T.D. 8251

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

Credit for Increasing Research Activity

AGENCY: Internal Revenue Service, Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final amendments to the income tax regulations to provide rules for the credit for increasing research activities. The research credit was added to the law by the Economic Recovery Tax Act of 1981. The research credit was subsequently amended by the Tax Reform Act of 1984, the Tax Reform Act of 1986, and the Technical and Miscellaneous Revenue Act of 1988. The regulations provide the public with guidance needed to comply with the applicable tax law.

EFFECTIVE DATE: These regulations are effective for amounts paid or incurred after June 30, 1981, and before January 1, 1990.

SUPPLEMENTARY INFORMATION:

Background

On January 21, 1983, the Federal Register published (48 FR 2790) [LR-236-81, 1983-1 C.B. 1003] proposed amendments to the Income Tax Regulations (26 CFR Part 1) relating to the credit for increasing research activities. A large number of comments were received and a public hearing was held on April 14, 1983. The credit for increasing research activities was originally provided by section 44F of the Internal Revenue Code, as added by section 221 of the Economic Recovery Tax Act of 1981 [Pub. L. 97-34, 1981-2 C.B. 256, 293]. Section 471(c) of the Tax Reform Act of 1984 [Pub. L. 98-369, 1984-3 C.B. (Vol. 1) 1, 334] redesignated section 44F as section 30. The Tax Reform Act of 1984 did not amend the research credit provisions substantively. Section 231 of the Tax Reform Act of 1986 [Pub. L. 99-514, 1986-3 C.B. (Vol. 1) 1, 90] redesignated section 30 as section 41. The Tax Reform Act of 1986 extended the credit to amounts paid or incurred before January 1, 1989; amended the definition of qualified research for taxable years beginning after December 31, 1985; provided a separate credit with respect to certain payments to qualified organizations for basic research; and amended the credit provisions in certain other aspects. The Technical and Miscellaneous Revenue Act of 1988 extended the credit to amounts paid or incurred before January 1, 1990.

The regulations provided in this document are promulgated under section 41 for conformity purposes. Where the law has changed the regulations contain separate provisions with their own effective dates. In general, those portions of the regulations relating to the Tax Reform Act of 1986 have been reserved.

Explanation of Provisions

Joint Ventures

Section 41(b)(1) defines the term "qualified research expenses" as the sum of the taxpayer's in-house research expenses and the taxpayer's contract research expenses, that are paid or incurred by the taxpayer during the taxable year in carrying on any trade or business of the taxpayer. If the taxpayer is not carrying on the trade or business for section 162 purposes to which the research relates, then the taxpayer is not entitled to the research credit for such expenditures. In the case of partnerships the carrying on a trade or business requirement must be satisfied at the partnership level without regard to the trade or business of any partner.

Section 1.44F-2(a)(4)(ii) of the proposed regulations provided an exception to the carrying on a trade or business requirement at the partnership level in the case of certain joint ventures if all the partners are entitled to the results of the research and the following is true with respect to each partner. If the partner had carried on the research that was in fact carried on by the partnership, all the research expense paid or incurred in carrying on the research would have been paid or incurred by the partner in carrying on a trade or business of the partner. Several commentators suggested that the regulations should not require each member of the joint venture to satisfy the "carrying on" test for the particular research being performed by the joint venture. They suggested that the regulations be modified to deny the credit only to those joint venturers who do not satisfy the "carrying on" test. Section 1.41-2(a)(4)(ii) of the final regulations removes the requirement that all partners must satisfy the "carrying on" test. However, to ensure that the removal of that requirement does not lead to abuse, the final regulations add certain limitations similar to those in section 168(h)(6) relating to tax-exempt use property.

Funded Research

Section 41(d)(4)(H) provides that the term qualified research does not include any research to the extent funded by any grant, contract, or otherwise by another person (or governmental entity). Section 1.44F-4(d)(1) of the proposed regulations provided that amounts paid under any agreement that are contingent on the success of the research and thus considered to be paid for the product or result of the research are not treated as funding. Section 1.44F-4(d)(2) of the proposed regulations provided that, if a taxpayer performing research for another person retains no substantial rights in the research under the agreement providing for the research, the research is treated as fully funded, and none of the expenses paid or incurred by the taxpayer in performing the research is treated as paid or incurred for qualified research. One commentator stated that, in a case where the researcher does not retain substantial rights in the results of the research and the funder's payments are contingent on the success of the research, neither the researcher nor the funder is entitled to treat any of the expenditures as paid or incurred for qualified research. The commentator's reading of the interaction of the contingent payment and the substantial rights rules is the correct reading of the two provisions. The proposed regulations are finalized as proposed on this matter. Section 1.44F-4(d)(4) of the proposed regulations provided that independent research and development payments under certain government contracts are treated as funding the research to which the payments relate. Several commentators suggested that such payments are analogous to the recovery of overhead costs through the sale of products. The final regulations provide that such payments are not to be treated as funding except where they are properly severable from the underlying contract.

Definition of Research and Experimental Expenditures

Section 41(d)(1) provides, in part, that the term "qualified research" means research with respect to which expenditures may be treated as expenses under section 174. Section 1.174-2 of the proposed regulations that was originally proposed on January 21, 1983, included extensive clarifications of the regulations under section 174, including a clarification of the treatment of computer software.

This portion of the proposed regulations is not being finalized by this document. The proposed amendments to §1.174-2 have been revised and superseded by a separate notice of proposed rulemaking [PS-002-89, page 1058, this Bulletin].

Special Analyses

The amendment of the regulations proposed by notice of proposed rulemaking on January 21, 1983, and adopted by this Treasury decision is interpretative. Accordingly, the Regulatory Flexibility Act (5 U.S.C. chapter 6) did not apply to the notice of proposed rulemaking and no Regulatory Flexibility Analysis was required. The Commissioner of Internal Revenue has determined that this rule is not a major rule as defined in Executive Order 12291 and that a Regulatory Impact Analysis is therefore not required.

* * * * * *

Adoption of Amendments to the Regulations

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

PART 602—[AMENDED]

Paragraph 1. The authority for Part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 2. In the table of control numbers in §602.101, the language "§1.41-4(b) and (c) .... 1541-0074" is removed and the language "§1.41-4A(b) and (c) .... 1545-0074" is added in its place.

PART 1—[AMENDED]

Par. 3. The authority for Part 1 continues to read in part:

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

PART 1—INCOME TAX; TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1953

Par. 4. Sections 1.41-0 through 1.41-8 are redesignated §§1.41-0A through 1.41-8A, respectively.

Par. 5. In §1.41-0A as redesignated, the language "1.41-1 through -8" is removed and the language "1.41-1A through -8A" is added in its place.

Par. 6. In §1.41-1A(a) as redesignated, the language "§1.41-3(a)" is removed and the language "§1.41-3A(a)" is added in its place.

Par. 7. In §1.218-0, the language "1.41-0 through -8" is removed and the language "12.41-0A through -8A" is added in its place.

PART 1—INCOME TAX; TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1986

Par. 8. The following new §§1.41-0 through 1.41-9 are added in the appropriate places.

§1.41-0 Table of Contents.

This section lists the paragraphs contained in sections 1.41-0 through 1.41-9.

(2) Short base period year.

(3) Years overlapping the effective dates of section 41 (section 44F).

(i) Determination years.

(ii) Base period years.

(4) Number of months in a short taxable year.

(e) Examples.

§1.41-4 Qualified research for taxable years beginning after December 31, 1985. [Reserved]

§1.41-5 Qualified research for taxable years beginning before January 1, 1986.

(a) General rule.

(b) Activities outside the United States.

(1) In-house research.

(2) Contract research.

(c) Social sciences arts or humanities.

(d) Research funded by any grant, contract, or otherwise.

(1) In general.

(2) Research in which taxpayer retains no rights.

(3) Research in which the taxpayer retains substantial rights.

(i) In general.

(ii) Pro rata allocation.

(iii) Project-by-project determination.

(4) Independent research and development under the Federal Acquisition Regulations System and similar provisions.

(5) Funding determinable only in subsequent taxable year.

(6) Examples.

§1.41-6 Basic research for taxable years beginning after December 31, 1985. [Reserved]

§1.41-7 Basic research for taxable years beginning before January 1, 1986.

(a) In general.

(b) Trade or business requirement.

(c) Prepaid amounts.

(1) In general.

(2) Transfers of property.

(d) Written research agreement.

(1) In general.

(2) Agreement between a corporation and a qualified organization after June 30, 1983.

(i) In general.

(ii) Transfers of property.

(3) Agreement between a qualified fund and a qualified educational organization after June 30, 1983.

(e) Exclusions.

(1) Research conducted outside the United States.

(2) Research in the social sciences or humanities.

(f) Procedure for making an election to be treated as a qualified fund.

§1.41-8 Aggregation of expenditures.

(a) Controlled group of corporations; trade or businesses under common control.

(1) In general.

(2) Definition of trade or business.

(3) Determination of common control.

(4) Examples.

(b) Minimum base period research expenses.

(c) Tax accounting periods used.

(1) In general.

(2) Special rule where timing of research is manipulated.

(d) Membership during taxable year in more than one group.

(e) Intra-group transactions.

(1) In general.

(2) In-house research expenses.

(3) Contract research expenses.

(4) Lease Payments.

(5) Payment for supplies.

§1.41-9 Special rules.

(a) Allocations.

(1) Corporation making an election under subchapter S.

(i) Pass-through, for taxable years beginning after December 31, 1982, in the case of an S corporation.

(ii) Pass-through, for taxable years beginning before January 1, 1983, in the case of a subchapter S corporation.

(2) Pass-through in the case of an estate or trust.

(3) Pass-through in the case of a partnership.

(i) In general.

(ii) Certain expenditures by joint ventures.

(4) Year in which taken into account.

(5) Credit allowed subject to limitation.

(b) Adjustments for certain acquisitions and dispositions—Meaning of terms.

(c) Special rule for pass-through of credit.

(d) Carryback and carryover of unused credits.

§1.41-1 Introduction to regulations under section 41.

Sections 1.41-2 through 1.41-9 deal only with certain provisions of section 41. The following table identifies the provisions of section 41 that are dealt with, and lists each with the section of the regulations in which it is covered:

Section of the regulations	*Section of the Code*
§1.41-2	41(b)(1) 41(b)(2)(A)(ii) 41(b)(2)(A)(iii) 41(b)(2)(B) 41(b)(3)
§1.41-3	41(c)(2) 41(f)(4)
§1.41-5	41(d)
§1.41-7	41(e)
§1.41-8	41(f)(1)
§1.41-9	41(f)(2) 41(f)(3) 41(g)

Sections 1.41-4 and 1.41-6 deal with the definition of qualified research and basic research for taxable years beginning after December 31, 1985. Section 1.41-3 also deals with the special rule in section 221(d)(2) of the Economic Recovery Tax Act of 1981 relating to taxable years overlapping the effective dates of section 41. Section 41 was formerly designated sections 30 and 44F. The regulations refer to these sections as section 41 for conformity purposes. Of course, whether section 41, 30 or 44F applies to a particular expenditure depends upon when the expenditure was paid or incurred.

§1.41-2 Qualified Research Expenses.

(a) *Trade or business requirement*—(1) *In general.* An in-house research expense of the taxpayer or a contract research expense of the taxpayer is a qualified research expense only if the expense is paid or incurred by the taxpayer in carrying on a trade or business of the taxpayer. The phrase "in carrying on a trade or business" has the same meaning for purposes of section 41(b)(1) as it has for purposes of section 162; thus, expenses paid or incurred in connection with a trade or business within the meaning of section 174(a) (relating to the deduction for research and experimental expenses) are not necessarily paid or incurred in carrying on a trade or business for purposes of section 41. A research expense must relate to a particular trade or business being carried on by the taxpayer at the time the expense is paid or incurred in order to be a qualified research expense. For purposes of section 41, a contract research expense of the taxpayer is not a qualified research expense if the product or result of the research is intended to be transferred to another in return for license or royalty payments and the taxpayer does not use the product of the research in the taxpayer's trade or business.

(2) *New business*. Expenses paid or incurred prior to commencing a new business (as distinguished from expanding an existing business) may be paid or incurred in connection with a trade or business but are not paid or incurred in carrying on a trade or business. Thus, research expenses paid or incurred by a taxpayer in developing a product the sale of which would constitute a new trade or business for the taxpayer are not paid or incurred in carrying on a trade or business.

(3) *Research performed for others*—(i) *Taxpayer not entitled to results*. If the taxpayer performs research on behalf of another person and retains no substantial rights in the research, that research shall not be taken into account by the taxpayer for purposes of section 41. See §1.41-5(d)(2).

(ii) *Taxpayer entitled to results*. If the taxpayer in carrying on a trade or business performs research on behalf of other persons but retains substantial rights in the research, the taxpayer shall take otherwise qualified expenses for that research into account for purposes of section 41 to the extent provided in §1.41-5(d)(3).

(4) *Partnerships*—(i) *In general*. An in-house research expense or a contract research expense paid or incurred by a partnership is a qualified research expense of the partnership if the expense is paid or incurred by the partnership in carrying on a trade or business of the partnership, determined at the partnership level without regard to the trade or business of any partner.

(ii) *Special rule for certain partnerships and joint ventures*. (A) If a partnership or a joint venture (taxable as a partnership) is not carrying on the trade or business to which the research relates, then the general rule in paragraph (a)(4)(i) of this section would not allow any of such expenditures to qualify as qualified research expenses.

(B) Notwithstanding paragraph (a)(4)(ii)(A) of this section, if all the partners or venturers are entitled to make independent use of the results of the research, this paragraph (a)(4)(ii) may allow a portion of such expenditures to be treated as qualified research expenditures by certain partners or venturers.

(C) First, in order to determine the amount of credit that may be claimed by certain partners or venturers, the amount of qualified research expenditures of the partnership or joint venture is determined (assuming for this purpose that the partnership or joint venture is carrying on the trade or business to which the research relates).

(D) Second, this amount is reduced by the proportionate share of such expenses allocable to those partners or venturers who would not be able to claim such expenses as qualified research expenditures if they had paid or incurred such expenses directly. For this purpose such partners' or venturers' proportionate share of such expenses shall be determined on the basis of such partners' or venturers' share of partnership items of income or gain (excluding gain allocated under section 704(c)) which results in the largest proportionate share. Where a partner's or venturer's share of partnership items of income or gain (excluding gain allocated under section 704(c)) may vary during the period such partner or venturer is a partner or venturer in such partnership or joint venture, such share shall be the highest share such partner or venturer may receive.

(E) Third, the remaining amount of qualified research expenses is allocated among those partners or venturers who would have been entitled to claim a credit for such expenses if they had paid or incurred the research expenses in their own trade or business, in the relative proportions that such partners or venturers share deductions for expenses under section 174 for the taxable year that such expenses are paid or incurred.

(F) For purposes of section 41, research expenditures to which this paragraph (a)(4)(ii) applies shall be treated as paid or incurred directly by such partners or venturers. See §1.41-9(a)(3)(ii) for special rules regarding these expenses.

(iii) The following examples illustrate the application of the principles contained in paragraph (a)(4)(ii) of this section.

Example (1). A joint venture (taxable as a partnership) is formed by corporations A, B, and C to develop and market a supercomputer. A and B are in the business of developing computers, and each has a 30 percent distributive share of each item of income, gain, loss, deduction, credit and basis of the joint venture. C, which is an investment banking firm, has a 40 percent distributive share of each item of income, gain, loss, deduction, credit and basis of the joint venture. The joint venture agreement provides that A's, B's and C's distributive shares will not vary during the life of the joint venture, liquidation proceeds are to be distributed in accordance with the partners' capital account balances, and any partner with a deficit in its capital account following the distribution of liquidation proceeds is required to restore the amount of such deficit to the joint venture. Assume in Year 1 that the joint venture incurs $100x of "qualified research expenses." Assume further that the joint venture cannot claim the research credit for such expenses because it is not carrying on the trade or business to which the research relates. In addition A, B, and C are all entitled to make independent use of the results of the research. First, the amount of qualified research expenses of the joint venture is $100x. Second, this amount is reduced by the proportionate share of such expenses allocable to C, the venturer which would not have been able to claim such expenses as qualified research expenditures if it had paid or incurred them directly. C's proportionate share of such expenses is $40x (40% of $100x). The reduced amount is $60x. Third, the remaining $60x of qualified research expenses is allocated between A and B in the relative proportions that A and B share deductions for expenses under section 174. A is entitled to treat $30x ((30% / (30% + 30%)) $60x) as a qualified research expense. B is also entitled to treat $30x ((30% / (30% + 30%)) $60x) as a qualified research expense.

Example (2). Assume the same facts as in example (1) except that the joint venture agreement provides that during the first 2 years of the joint venture, A and B are each allocated 10 percent of each item of income, gain, loss, deduction, credit and basis, and C is allocated 80 percent of each item of income, gain, loss, deduction, credit and basis. Thereafter the allocations are the same as in example (1). Assume for purposes of this example that such allocations have substantial economic effect for purposes of section 704(b). C's highest share of such items during the life of the joint venture is 80 percent. Therefore C's proportionate share of the joint venture's qualified research expenses is $80x (80% of $100x). The reduced amount of qualified research expenses is $20x ($100x — $80x). A is entitled to treat $10x ((10% / (10% + 10%)) $20x) as a qualified research expense in Year 1. B is also entitled to treat $10x ((10% / (10% + 10%)) $20x) as a qualified research expense in Year 1.

(b) *Supplies and personal property used in the conduct of qualified research*—(1) *In general*. Supplies and personal property (except to the extent provided in paragraph (b)(4) of this section) are used in the conduct of qualified research if they are used in the performance of qualified services (as defined in section 41(b)(2)(B), but without regard to the last sentence thereof) by an employee of the taxpayer (or by a person acting in a capacity similar to that of an employee of the taxpayer; see example (6) of §1.41-2(e)(5)). Expenditures for supplies or for the use of personal property that are indirect research expenditures or general and administrative expenses do not qualify as in-house research expenses.

(2) *Certain utility charges*—(i) *In general.* In general, amounts paid or incurred for utilities such as water, electricity, and natural gas used in the building in which qualified research is performed are treated as expenditures for general and administrative expenses.

(ii) *Extraordinary expenditures.* To the extent the taxpayer can establish that the special character of the qualified research required additional extraordinary expenditures for utilities, the additional expenditures shall be treated as amounts paid or incurred for supplies used in the conduct of qualified research. For example, amounts paid for electricity used for general laboratory lighting are treated as general and administrative expenses, but amounts paid for electricity used in operating high energy equipment for qualified research (such as laser or nuclear research) may be treated as expenditures for supplies used in the conduct of qualified research to the extent the taxpayer can establish that the special character of the research required an extraordinary additional expenditure for electricity.

(3) *Right to use personal property.* The determination of whether an amount is paid to or incurred for another person for the right to use personal property in the conduct of qualified research shall be made without regard to the characterization of the transaction as a lease under section 168(f)(8) (as that section read before it was repealed by the Tax Reform Act of 1986). See §5c.168(f)-(8)-1(b).

(4) *Use of personal property in taxable years beginning after December 31, 1985.* For taxable years beginning after December 31, 1985, amounts paid or incurred for the use of personal property are not qualified research expenses, except for any amount paid or incurred to another person for the right to use (time-sharing) computers in the conduct of qualified research. The computer must be owned and operated by someone other than the taxpayer, located off the taxpayer's premises, and the taxpayer must not be the primary user of the computer.

(c) *Qualified services*—(1) *Engaging in qualified research.* The term "engaging in qualified research" as used in section 41(b)(2)(B) means the actual conduct of qualified research (as in the case of a scientist conducting laboratory experiments).

(2) *Direct supervision.* The term "direct supervision" as used in section 41(b)(2)(B) means the immediate supervision (first-line management) of qualified research (as in the case of a research scientist who directly supervises laboratory experiments, but who may not actually perform experiments). "Direct supervision" does not include supervision by a higher-level manager to whom first-line managers report, even if that manager is a qualified research scientist.

(3) *Direct support.* The term "direct support" as used in section 41(b)(2)(B) means services in the direct support of either—

(i) Persons engaging in actual conduct of qualified research, or

(ii) Persons who are directly supervising persons engaging in the actual conduct of qualified research. For example, direct support of research includes the services of a secretary for typing reports describing laboratory results derived from qualified research, of a laboratory worker for cleaning equipment used in qualified research, of a clerk for compiling research data, and of a machinist for machining a part of an experimental model used in qualified research. Direct support of research activities does not include general administrative services, or other services only indirectly of benefit to research activities. For example, services of payroll personnel in preparing salary checks of laboratory scientists, of an accountant for accounting for research expenses, of a janitor for general cleaning of a research laboratory, or of officers engaged in supervising financial or personnel matters do not qualify as direct support of research. This is true whether general administrative personnel are part of the research department or in a separate department. Direct support does not include supervision. Supervisory services constitute "qualified services" only to the extent provided in paragraph (c)(2) of this section.

(d) *Wages paid for qualified services*—(1) *In general.* Wages paid to or incurred for an employee constitute in-house research expenses only to the extent the wages were paid or incurred for qualified services performed by the employee. If an employee has performed both qualified services and nonqualified services, only the amount of wages allocated to the performance of qualified services constitutes an in-house research expense. In the absence of another method of allocation that the taxpayer can demonstrate to be more appropriate, the amount of in-house research expense shall be determined by multiplying the total amount of wages paid to or incurred for the employee during the taxable year by the ratio of the total time actually spent by the employee in the performance of qualified services for the taxpayer to the total time spent by the employee in the performance of all services for the taxpayer during the taxable year.

(2) "*Substantially all.*" Notwithstanding paragraph (d)(1) this section, if substantially all of the services performed by an employee for the taxpayer during the taxable year consist of services meeting the requirements of section 41(b)(2)(B)(i) or (ii), then the term "qualified services" means all of the services performed by the employee for the taxpayer during the taxable year. Services meeting the requirements of section 41(b)(2)(B)(i) or (ii) constitute substantially all of the services performed by the employee during a taxable year only if the wages allocated (on the basis used for purposes of paragraph (d)(1) of this section) to services meeting the requirements of section 41(b)(2)(B)-(i) or (ii) constitute at least 80 percent of the wages paid to or incurred by the taxpayer for the employee during the taxable year.

(e) *Contract research expenses*—(1) *In general.* A contract research expense is 65 percent of any expense paid or incurred in carrying on a trade or business to any person other than an employee of the taxpayer for the performance on behalf of the taxpayer of—

(i) Qualified research as defined in §1.41-5, or

(ii) Services which, if performed by employees of the taxpayer, would constitute qualified services within the meaning of section 41(b)(2)(B).

Where the contract calls for services other than services described in this paragraph (e)(1), only 65 percent of the portion of the amount paid or incurred that is attributable to the services described in this paragraph (e)(1) is a contract research expense.

(2) *Performance of qualified research.* An expense is paid or incurred for the performance of qualified research only to the extent that it is paid or incurred pursuant to an agreement that—

(i) Is entered into prior to the performance of the qualified research.

(ii) Provides that research be performed on behalf of the taxpayer, and

(iii) Requires the taxpayer to bear the expense even if the research is not successful.

If an expense is paid or incurred pursuant to an agreement under which payment is contingent on the success of the research, then the expense is considered paid for the product or result rather than the performance of the research, and the payment is not a contract research expense. The previous sentence applies only to that portion of a payment which is contingent on the success of the research.

(3) "*On behalf of.*" Qualified research is performed on behalf of the taxpayer if the taxpayer has a right to the research results. Qualified research can be performed on behalf of the taxpayer notwithstanding the fact that the taxpayer does not have exclusive rights to the results.

(4) *Prepaid amounts.* Notwithstanding paragraph (e)(1) of this section, if any contract research expense paid or incurred during any taxable year is attributable to qualified research to be conducted after the close of such taxable year, the expense so attributable shall be treated for purposes of section 41(b)(1)-(B) as paid or incurred during the period during which the qualified research is conducted.

(5) *Examples.* The following examples illustrate provisions contained in paragraphs (e)(1) through (4) of this section.

Example (1). A, a cash-method taxpayer using the calendar year as the taxable year, enters into a contract with B Corporation under which B is to perform qualified research on behalf of A. The contract requires A to pay B $300x, regardless of the success of the research. In 1982, B performs all of the research, and A makes full payment of $300x under the contract. Accordingly, during the taxable year 1982, $195x (65 percent of the payment of $300x) constitutes a contract research expense of A.

Example (2). The facts are the same as in example (1), except that B performs 50 percent of the research in 1983. Of the $195x of contract research expense paid in 1982, paragraph (e)(4) of this section provides that $97.5x (50 percent of $195x) is a contract research expense for 1982 and the remaining $97.5x is contract research expense for 1983.

Example (3). The facts are the same as in example (1), except that instead of calling for a flat payment of $300x, the contract requires A to reimburse B for all expenses plus pay B $100x. B incurs expenses attributable to the research as follows:

Labor	$ 90x
Supplies	20x
Depreciation on equipment	50x
Overhead	40x
Total	$ 200x

Under this agreement A pays B $300x during 1982. Accordingly, during taxable year 1982, $195x (65 percent of $300x) of the payment constitutes a contract research expense of A.

Example (4). The facts are the same as in example (3), except that A agrees to reimburse B for all expenses and agrees to pay B an additional amount of $100x, but the additional $100x is payable only if the research is successful. The research is successful and A pays B $300x during 1982. paragraph (e)(2) of this section provides that the contingent portion of the payment is not an expense incurred for the performance of qualified research. Thus, for taxable year 1982, $130x (65 percent of the payment of $200x) constitutes a contract research expense of A.

Example (5). C conducts in-house qualified research in carrying on a trade or business. In addition, C pays D Corporation, a provider of computer services, $100x to develop software to be used in analyzing the results C derives from its research. Because the software services, if performed by an employee of C, would constitute qualified services, $65x of the $100x constitutes a contract research expense of C.

Example (6). C conducts in-house qualified research in carrying on C's trade or business. In addition, C contracts with E Corporation, a provider of temporary secretarial services, for the services of a secretary for a week. The secretary spends the entire week typing reports describing laboratory results derived from C's qualified research. C pays E $400 for the secretarial service, none of which constitutes wages within the meaning of section 41(b)(2)(D). These services, if performed by employees of C, would constitute qualified services within the meaning of section 41(b)(2)(B). Thus, pursuant to paragraph (e)(1) of this section, $260 (65 percent of $400) constitutes a contract research expense of C.

Example (7). C conducts in-house qualified research in carrying on C's trade or business. In addition, C pays F, an outside accountant, $100x to keep C's books and records pertaining to the research project. The activity carried on by the accountant does not constitute qualified research as defined in section 41(d). The services performed by the accountant, if performed by an employee of C, would not constitute qualified services (as defined in section 41(b)(2)(B)). Thus, under paragraph (e)(1) of this section, no portion of the $100x constitutes a contract research expense.

§1.41-3 Base period research expense.

(a) *Number of years in base period.* The term "base period" generally means the 3 taxable years immediately preceding the year for which a credit is being determined ("determination year"). However, if the first taxable year of the taxpayer ending after June 30, 1981, ends in 1981 or 1982, then with respect to that taxable year the term "base period" means the immediately preceding taxable year. If the second taxable year of the taxpayer ending after June 30, 1981, ends in 1982 or 1983, then with respect to that taxable year the term "base period" means the 2 immediately preceding taxable years.

(b) *New taxpayers.* If, with respect to any determination year, the taxpayer has not been in existence for the number of preceding taxable years that are included under paragraph (a) of this section in the base period for that year, then for purposes of paragraph (c)(1) of this section (relating to the determination of average qualified research expenses during the base period), the taxpayer shall be treated as—

(1) Having been in existence for that number of additional 12-month taxable years that is necessary to complete the base period specified in paragraph (a) of this section, and

(2) Having had qualified research expenses of zero in each of those additional years.

(c) *Definition of base period research expenses.* For any determination year, the term "base period research expenses" means the greater of—

(1) The average qualified research expenses for taxable years during the base period, or

(2) Fifty percent of the qualified research expenses for the determination year.

(d) *Special rules for short taxable years*—(1) *Short determination year.* If the determination year for which a research credit is being taken is a short taxable year, the amount taken into account under paragraph (c)(1) of this section shall be modified by multiplying that amount by the number of months in the short taxable year and dividing the result by 12.

(2) *Short base period year.* For purposes of paragraph (c)(1) of this section. if a year in the base period is a short taxable year, the qualified research expenses paid or incurred in the short taxable year are deemed to be equal to the qualified research expenses actually paid or incurred in that year multiplied by 12 and divided by the number of months in that year.

(3) *Years overlapping the effective dates of section 41 (section 44F)*—(i) *Determination years.* If a determination year includes months before July 1981, the determination year is deemed to be a short taxable year including only the months after June 1981. Accordingly. paragraph (d)(1) of this section is applied for purposes of determining the base period expenses for such year. See section 221(d)(2) of the Economic Recovery Tax Act of 1981.

(ii) *Base period years.* No adjustment is required in the case of a base period year merely because it overlaps June 30, 1981.

(4) *Number of months in a short taxable year.* The number of months in a short taxable year is equal to the number of whole calendar months contained in the year plus fractions for any partially included months. The fraction for a partially included month is equal to the number of days in the month that are included in the short taxable year divided

by the total number of days in that month. Thus, if a short taxable year begins on January 1, 1982, and ends on June 9, 1982, it consists of 5 and 9/30 months.

(e) *Examples*. The following examples illustrate the application of this section.

Example (1). X Corp., an accrual-method taxpayer using the calendar year as its taxable year, is organized and begins carrying on a trade or business during 1979 and subsequently incurs qualified research expenses as follows:

1979	$ 10x
1980	150x
1/1/81—6/30/81	90x
7/1/81—12/31/81	110x
1982	250x
1983	450x

(i) *Determination year 1981*. For determination year 1981, the base period consists of the immediately preceding taxable year, calendar year 1980. Because the determination year includes months before July 1981, paragraph (d)(3)(i) requires that the determination year be treated as a short taxable year. Thus, for purposes of paragraph (c)(1), as modified by paragraph (d)(1), the average qualified research expenses for taxable years during the base period are $75x ($150x, the average qualified research expenses for the base period, multiplied by 6, the number of months in the determination year after June 30, 1981, and divided by 12). Because this amount is greater than the amount determined under paragraph (c)(2)(50 percent of the determination year's qualified research expense of $110x, or $55x), the amount of base period research expenses is $75x. The credit for determination year 1981 is equal to 25 percent of the excess of $110x (the qualified research expenditures incurred during the determination year including only expenditures accrued on or after July 1, 1981, through the end of the determination year) over $75x (the base period research expenses).

(ii) *Determination year 1982*. For determination year 1982, the base period consists of the 2 immediately preceding taxable years, 1980 and 1981. The amount determined under paragraph (c)(1) of this section (the average qualified research expenses for taxable years during the base period) is $175x (($150x + $90x + $110x) / 2). This amount is greater than the amount determined under paragraph (c)(2)(50 percent of $250x, or $125x). Accordingly, the amount of base period research expenses is $175x. The credit for determination year 1982 is equal to 25 percent of the excess of $250x (the qualified research expenses incurred during the determination year) over $175x (the base period research expenses).

(iii) *Determination year 1983*. For determination year 1983, the base period consists of the 3 immediately preceding taxable years 1980, 1981 and 1982. The amount determined under paragraph (c)(1) of this section (the average qualified research expenses for taxable years during the base period) is $200x (($150x + $200x + $250x) / 3). The amount determined under paragraph (c)(2) is $225x (50 percent of the $450x of qualified research expenses in 1983). Accordingly, the amount of base period research expenses is $225x. The credit for determination year 1983 is equal to 25 percent of the excess of $450x (the qualified research expenses incurred during the determination year) over $225x (the base period research expenses).

Example (2). Y, an accrual-basis corporation using the calendar year as its taxable year comes into existence and begins carrying on a trade or business on July 1, 1983. Y incurs qualified research expenses as follows:

7/1/83 -12/31/83	$ 80x
1984	200x
1985	200x

(i) *Determination year 1983*. For determination year 1983, the base period consists of the 3 immediately preceding taxable years: 1980, 1981 and 1982. Although Y was not in existence during 1980, 1981 and 1982, Y is treated under paragraph (b) of this section as having been in existence during those years with qualified research expenses of zero. Thus, the amount determined under paragraph (c)(1) of this section (the average qualified research expenses for taxable years during the base period) is $0x (($0x + $0x + $0x) / 3). The amount determined under paragraph (c)(2) of this section is $40x (50 percent of $80x). Accordingly, the amount of base period research expenses is $40x. The credit for determination year 1983 is equal to 25 percent of the excess of $80x (the qualified research expenses incurred during the determination year) over $40x (the base period research expenses).

(ii) *Determination year 1984*. For determination year 1984, the base period consists of the 3 immediately preceding taxable years: 1981, 1982, and 1983. Under paragraph (b) of this section, Y is treated as having been in existence during years 1981 and 1982 with qualified research expenses of zero. Because July 1 through December 31, 1983 is a short taxable year, paragraph (d)(2) of this section requires that the qualified research expenses for that year be adjusted to $160x for purposes of determining the average qualified research expenses during the base period. The $160x results from the actual qualified research expenses for that year ($80x) multiplied by 12 and divided by 6 (the number of months in the short taxable year). Accordingly, the amount determined under paragraph (c)(1) of this section (the average qualified research expenses for taxable years during the base period) is $53-1/3x (($0x + $0x + $160x) / 3). The amount determined under paragraph (c)(2) of this section is $100x (50 percent of $200x). The amount of base period research expenses is $100x. The credit for determination year 1984 is equal to 25 percent of the excess of $200x (the qualified research expenses incurred during the determination year) over $100x (the base period research expenses).

(iii) *Determination year 1985*. For determination year 1985, the base period consists of the 3 immediately preceding taxable years: 1982, 1983, and 1984. Pursuant to paragraph (b) of this section, Y is treated as having been in existence during 1982 with qualified research expenses of zero. Because July 1 through December 31, 1982, is a short taxable year, paragraph (d)(2) of this section requires that the qualified research expense for that year be adjusted to $160x for purposes of determining the average qualified research expenses for taxable years during the base period. This $160x is the actual qualified research expense for that year ($80x) multiplied by 12 and divided by 6 (the number of months in the short taxable year). Accordingly, the amount determined under paragraph (c)(1) of this section (the average qualified research expenses for taxable years during the base period) is $120x (($0x + $160x + $200x) / 3). The amount determined under paragraph (c)(2) of this section is $100x (50 percent of $200x). The amount of base period research expenses is $120x. The credit for determination year 1985 is equal to 25 percent of the excess of $200x (the qualified research expenses incurred during the determination year) over $120x (the base period research expenses).

§1.41-4 Qualified research for taxable years beginning after December 31, 1985.

[Reserved]

§1.41-5 Qualified research for taxable years beginning before January 1, 1986.

(a) *General rule*. Except as otherwise provided in section 30 (d) (as that section read before amendment by the Tax Reform Act of 1986) and in this section, the term "qualified research" means research, expenditures for which would be research and experimental expenditures within the meaning of section 174. Expenditures that are ineligible for the section 174 deduction elections are not expenditures for qualified research. For example, expenditures for the acquisition of land or depreciable property used in research, and mineral exploration costs described in section 174(d), are not expenditures for qualified research.

(b) *Activities outside the United States*—(1) *In-house research*. In-house research conducted outside the United States (as defined in section 7701(a)(9)) cannot constitute qualified research. Thus, wages paid to an employee scientist for services performed in a laboratory in the United States and in a test station in Antarctica must be apportioned between the services performed within the United States and the services performed outside the United States, and only the wages apportioned to the services conducted within the United States are qualified research expenses unless the 80 percent rule of §1.41-2(d)(2) applies.

(2) *Contract research*. If contract research is performed partly within the United States and partly without, only 65 percent of the portion of the contract amount that is attributable to the research performed within the United States can qualify as contract research expense (even if 80 percent or more of the contract amount was for research performed in the United States).

(c) *Social sciences or humanities*. Qualified research does not include research in the social sciences or humanities. For purposes of section 30(d)(2) (as that section read before amendment by the Tax Reform Act of 1986) and of this section, the phrase "research in the social sciences or humanities" encompasses all areas of research other than research in a field of laboratory science (such as physics or biochemistry), engineering or technology. Examples of research in the social sciences or humanities include the development of a new life insurance contract, a new economic model or theory, a new accounting procedure or a new cookbook.

(d) *Research funded by any grant, contract, or otherwise*—(1) *In general.* Research does not constitute qualified research to the extent it is funded by any grant, contract, or otherwise by another person (including any governmental entity). All agreements (not only research contracts) entered into between the taxpayer performing the research and other persons shall be considered in determining the extent to which the research is funded. Amounts payable under any agreement that are contingent on the success of the research and thus considered to be paid for the product or result of the research (see §1.41-2(e)(2)) are not treated as funding. For special rules regarding funding between commonly controlled businesses, see §1.41-8(e).

(2) *Research in which taxpayer retains no rights.* If a taxpayer performing research for another person retains no substantial rights in research under the agreement providing for the research, the research is treated as fully funded for purposes of section 41(d)(4)(H), and no expenses paid or incurred by the taxpayer in performing the research are qualified research expenses. For example, if the taxpayer performs research under an agreement that confers on another person the exclusive right to exploit the results of the research, the taxpayer is not performing qualified research because the research is treated as fully funded under this paragraph (d)(2). Incidental benefits to the taxpayer from performance of the research (for example, increased experience in a field of research) do not constitute substantial rights in the research. If a taxpayer performing research for another person retains no substantial rights in the research and if the payments to the researcher are contingent upon the success of the research, neither the performer nor the person paying for the research is entitled to treat any portion of the expenditures as qualified research expenditures.

(3) *Research in which the taxpayer retains substantial rights*—(i) *In general.* If a taxpayer performing research for another person retains substantial rights in the research under the agreement providing for the research, the research is funded to the extent of the payments (and fair market value of any property) to which the taxpayer becomes entitled by performing the research. A taxpayer does not retain substantial rights in the research if the taxpayer must pay for the right to use the results of the research. Except as otherwise provided in paragraph (d)(3)(ii) of this section, the taxpayer shall reduce the amount paid or incurred by the taxpayer for the research that would, but for section 41(d)(4)(H), constitute qualified research expenses of the taxpayer by the amount of funding determined under the preceding sentence.

(ii) *Pro rata allocation.* If the taxpayer can establish to the satisfaction of the district director—

(A) The total amount of research expenses,

(B) That the total amount of research expenses exceed the funding, and

(C) That the otherwise qualified research expenses (that is, the expenses which would be qualified research expenses if there were no funding) exceed 65 percent of the funding, then the taxpayer may allocate the funding pro rata to nonqualified and otherwise qualified research expenses, rather than allocating it 100 percent to otherwise qualified research expenses (as provided in paragraph (d)(3)(i) of this section). In no event, however, shall less than 65 percent of the funding be applied against the otherwise qualified research expenses.

(iii) *Project-by-project determination.* The provisions of this paragraph (d)(3) shall be applied separately to each research project undertaken by the taxpayer.

(4) *Independent research and development under the Federal Acquisition Regulations System and similar provisions.* The Federal Acquisition Regulations System and similar rules and regulations relating to contracts (fixed price, cost plus, etc.) with government entities provide for allocation of certain "independent research and development costs" and "bid and proposal costs" of a contractor to contracts entered into with that contractor. In general, any "independent research and development costs" and "bid and proposal costs" paid to a taxpayer by reason of such a contract shall not be treated as funding the underlying research activities except to the extent the "independent research and development costs" and "bid and proposal costs" are properly severable from the contract. See §1.451-3(e); see also section 804(d)(2) of the Tax Reform Act of 1986.

(5) *Funding determinable only in subsequent taxable year.* If at the time the taxpayer files its return for a taxable year, it is impossible to determine to what extent particular research performed by the taxpayer during that year may be funded, then the taxpayer shall treat the research as completely funded for purposes of completing that return. When the amount of funding is finally determined, the taxpayer should amend the return and any interim returns to reflect the proper amount of funding.

(6) *Examples.* The following examples illustrate the application of the principles contained in this paragraph.

Example (1). A enters into a contract with B Corporation, a cash-method taxpayer using the calendar year as its taxable year, under which B is to perform research that would, but for section 41(d)(3)(H), be qualified research of B. The agreement calls for A to pay B $120x, regardless of the outcome of the research. In 1982, A makes full payment of $120x under the contract, B performs all the research, and B pays all the expenses connected with the research, as follows:

In-house research expenses	$100x
Outside research (amount B paid to third parties for research, 65 percent of which ($26x) is treated as a contract research expense of B)	40x
Overhead and other expenses	10x
Total	$150x

If B has no rights to the research, B is fully funded. Alternatively, assume that B retains the right to use the results of the research in carrying on B's business. Of B's otherwise qualified research expenses of $126x ($100x + $26x), $120x is treated as funded by A. Thus $6x ($126x — $120x) is treated as a qualified research expense of B. However, if B establishes the facts required under paragraph (d)(3) of this section, B can allocate the funding pro rata to nonqualified and otherwise qualified research expenses. Thus $100.8x ($120x ($126x/$150x)) would be allocated to otherwise qualified research expenses. B's qualified research expenses would be $25.2x ($126x — $100.8x). For purposes of the following examples (2), (3) and (4) assume that B retains substantial rights to use the results of the research in carrying on B's business.

Example (2). The facts are the same as in example (1) (assuming that B retains the right to use the results of the research in carrying on B's business) except that, although A makes full payment of $120x during 1982, B does not perform the research or pay the associated expenses until 1983. The computations are unchanged. However, B's qualified research expenses determined in example (1) are qualified research expenses during 1983.

Example (3). The facts are the same as in example (1) (assuming that B retains the right to use the results of the research in carrying on B's business) except that, although B performs the research and pays the associated expenses during 1982, A does not pay the $120x until 1983. The computations are unchanged and the amount determined in example (1) is a qualified research expense of B during 1982.

Example (4). The facts are the same as in example (1) (assuming that B retains the right to use the results of the research in carrying on B's business) except that, instead of agreeing to pay B $120x, A agrees to pay $100x regardless of the outcome and an additional $20x only if B's research produces a useful product. B's research produces a useful product and A pays B $120x during 1982. The $20x payment that is conditional on the success of the research is not treated as funding. Assuming that B establishes to the satisfaction of the district director the actual research expenses, B can allocate the funding to nonqualified and otherwise qualified research expenses. Thus $84x ($100x ($126x/$150x)) would be allocated to otherwise qualified research expenses. B's qualified research expenses would be $42x ($126x — $84x).

Example (5). C enters into a contract with D, a cash-method taxpayer using the calendar year as its taxable year, under which D is to perform research in which both C and D will have substantial rights. C agrees to reimburse D for 80 percent of D's expenses for the research. D performs part of the research in 1982 and the rest in 1983. At the time that D files its return for 1982, D is unable to determine the extent to which the research is funded under the provisions of this paragraph. Under these circumstances, D may not treat any of the expenses paid by D for this research during 1982 as qualified research expenses on its 1982 return. When the project is complete and D can determine the extent of funding, D should file an amended return for 1982 to take into account any qualified research expense for 1982.

§1.41-6 Basic research for taxable years beginning after December 31, 1985.

[Reserved]

§1.41-7 Basic research for taxable years beginning before January 1, 1986.

(a) *In general.* The amount expended for basic research within the meaning of section 30(e) (before amendment by the Tax Reform Act of 1986) equals the sum of money plus the taxpayer's basis in tangible property (other than land) transferred for use in the performance of basic research.

(b) *Trade or business requirement.* Any amount treated as a contract research expense under section 30(e) (before amendment by the Tax Reform Act of 1986) shall be deemed to have been paid or incurred in carrying on a trade or business, if the corporation that paid or incurred the expense is actually engaged in carrying on some trade or business.

(c) *Prepaid amounts*—(1) *In general.* If any basic research expense paid or incurred during any taxable year is attributable to research to be conducted after the close of such taxable year, the expense so attributable shall be treated for purposes of section 30(b)(1)(B) (before amendment by the Tax Reform Act of 1986) as paid or incurred during the period in which the basic research is conducted.

(2) *Transfers of property.* In the case of transfers of property to be used in the performance of basic research, the research in which that property is to be used shall be considered to be conducted ratably over a period beginning on the day the property is first so used and continuing for the number of years provided with respect to property of that class under section 168(c)(2) (before amendment by the Tax Reform Act of 1986). For example, if an item of property which is 3-year property under section 168(c) is transferred to a university for basic research on January 12, 1983, and is first so used by the university on March 1, 1983, then the research in which that property is used is considered to be conducted ratably from March 1, 1983, through February 28, 1986.

(d) *Written research agreement*—(1) *In general.* A written research agreement must be entered into prior to the performance of the basic research.

(2) *Agreement between a corporation and a qualified organization after June 30, 1983*—(i) *In general.* A written research agreement between a corporation and a qualified organization (including a qualified fund) entered into after June 30, 1983, shall provide that the organization shall inform the corporation within 60 days after the close of each taxable year of the corporation what amount of funds provided by the corporation pursuant to the agreement was expended on basic research during the taxable year of the corporation. In determining amounts expended on basic research, the qualified organization shall take into account the exclusions specified in section 30(e)(3) (before amendment by the Tax Reform Act of 1986) and in paragraph (e) of this section.

(ii) *Transfers of property.* In the case of transfers of property to be used in basic research, the agreement shall provide that substantially all use of the property is to be for basic research, as defined in section 30(e)(3) (before amendment by the Tax Reform Act of 1986).

(3) *Agreement between a qualified fund and a qualified educational organization after June 30, 1983.* A written research agreement between a qualified fund and a qualified educational organization (see section 30(e)(4)(B)(iii) (before amendment by the Tax Reform Act of 1986)) entered into after June 30, 1983, shall provide that the qualified educational organization shall furnish sufficient information to the qualified fund to enable the qualified fund to comply with the written research agreements it has entered into with grantor corporations, including the requirement set forth in paragraph (d)(2) of this section.

(e) *Exclusions*—(1) *Research conducted outside the United States.* If a taxpayer pays or incurs an amount for basic research to be performed partly within the United States and partly without, only 65 percent of the portion of the amount attributable to research performed within the United States can be treated as a contract research expense (even if 80 percent or more of the contract amount was for basic research performed in the United States).

(2) *Research in the social sciences or humanities.* Basic research does not include research in the social sciences or humanities, within the meaning of §1.41-5(c).

(f) *Procedure for making an election to be treated as a qualified fund.* In order to make an election to be treated as a qualified fund within the meaning of section 30(e)(4)(B)(iii) (before amendment by the Tax Reform Act of 1986) or as an organization described in section 41(e)(6)(D), the organization shall file with the Internal Revenue service center with which it files its annual return a statement that—

(1) Sets out the name, address, and taxpayer identification number of the electing organization (the "taxpayer") and of the organization that established and maintains the electing organization (the "controlling organization"),

(2) Identifies the election as an election under section 41(e)(6)(D) of the Code,

(3) Affirms that the controlling organization and the taxpayer are section 501(c)(3) organizations,

(4) Provides that the taxpayer elects to be treated as a private foundation for all Code purposes other than section 4940,

(5) Affirms that the taxpayer satisfies the requirement of section 41(e)(6)(D)(iii), and

(6) Specifies the date on which the election is to become effective.

If an election to be treated as a qualified fund is filed before February 1, 1982, the election may be made effective as of any date after June 30, 1981, and before January 1, 1986. If an election is filed on or after February 1, 1982, the election may be made effective as of any date on or after the date on which the election is filed.

§1.41-8 Aggregation of expenditures.

(a) *Controlled group of corporations; trades or businesses under common control*—(1) *In general.* In determining the amount of research credit allowed with respect to a trade or business that at the end of its taxable year is a member of a controlled group of corporations or a member of a group of trades or businesses under common control, all members of the group are treated as a single taxpayer and the credit (if any) allowed to the member is determined on the basis of its proportionate share (if any) of the increase in qualified research expenses of the aggregated group.

(2) *Definition of trade or business.* For purposes of this section, a trade or business is a sole proprietorship, a partnership, a trust, an estate, or a corporation that is carrying on a trade or business (within the meaning of section 162). For purposes of this section, any corporation that is a member of a commonly controlled group shall be deemed to be carrying on a trade or business if any other member of that group is carrying on any trade or business.

(3) *Determination of common control.* For rules for determining whether trades or businesses are under common control, see paragraphs (b) (g) of §1.52-1 except that the words "singly or" in §1.52-1(d)(1)(i) shall be treated as deleted.

(4) *Examples.* The following examples illustrate provisions of this paragraph.

Example (1). (i) *Facts.* A controlled group of four corporations (all of which are calendar-year taxpayers) had qualified research expenses ("research expenses") during the base period and taxable year as follows:

Corporation	*Base Period (average)*	*Taxable year*	*Change*
A	$60	$40	$20
B	10	15	5
C	30	70	40
D	15	25	10

(ii) *Total credit.* Because the research expenses of the four corporations are treated as if made by one taxpayer, the total amount of incremental expenses eligible for the credit is $35 ($55 increase attributable to B, C, and D less $20 decrease attributable to A). The total amount of credit allowable to members of the group is 20% of the incremental amount or $7.00.

(iii) *Allocation of credit.* No amount of credit is allocated to A since A's research expenses did not increase in the taxable year. The $7.00 credit is allocated to B, C, and D, the members of the group that increased their research expenses. This allocation is made on the basis of the ratio of each corporation's increase in its research expenses to the sum of increases in those expenses. Inasmuch as the total increase made by those members of the group whose research expenses rose (B, C, and D) was $55, B's share of the $7.00 credit is 5/55; C's share is 40/55; and D's share is 10/55.

Example (2). The facts are the same as in example (1) except that A had zero research expenses in the taxable year. Thus, the controlled group had a decrease rather than an increase in aggregate research expenses. Accordingly, no amount of credit is allowable to any member of the group even though B, C, and D actually increased their research expenses in comparison with their own base period expenses.

(b) *Minimum base period research expenses.* For purposes of this section, the rule in section 41(c)(3) (pertaining to minimum base period research expenses) shall be applied only to the aggregate amount of base period research expenses. See the treatment of corporation C in example (1) of paragraph (a)(4) of this section.

(c) *Tax accounting periods used*—(1) *In general.* The credit allowable to a member of a controlled group of corporations or of a group of trades or businesses under common control is that member's share of the aggregate credit computed as of the end of such member's taxable year. In computing the aggregate credit in the case of a group whose members have different taxable years, a member shall generally treat the taxable year of another member that ends with or within the determination year of the computing member as the determination year of that other member. The base period research expenses taken into account with respect to a determination year of another member shall be the base period research expenses determined for that year under §1.41-3, except that §1.41-3(c)(2) shall be applied only at the aggregate level.

(2) *Special rule where timing of research is manipulated.* If the timing of research by members using different tax accounting periods is manipulated to generate a credit in excess of the amount that would be allowable if all members of the group used the same tax accounting period, the district director may require each member of the group to calculate the credit in the current taxable year and all future years as if all members of the group had the same taxable year and base period as the computing member.

(d) *Membership during taxable year in more than one group.* A trade or business may be a member of only one group for a taxable year. If, without application of this paragraph, a business would be a member of more than one group at the end of its taxable year, the business shall be treated as a member of the group in which it was included for its preceding taxable year. If the business was not included for its preceding taxable year in any group in which it could be included as of the end of its taxable year, the business shall designate in its timely filed (including extensions) return the group in which it is being included. If the return for a taxable year is due before July 1, 1983, the business may designate its group membership through an amended return for that year filed on or before June 30, 1983. If the business does not so designate, then the district director with audit jurisdiction of the return will determine the group in which the business is to be included.

(e) *Intra-group transactions*—(1) *In general.* Because all members of a group under common control are treated as a single taxpayer for purposes of determining the research credit, transfers between members of the group are generally disregarded.

(2) *In-house research expenses.* If one member of a group performs qualified research on behalf of another member, the member performing the research shall include in its qualified research expenses any in-house research expenses for that work and shall not treat any amount received or accrued as funding the research. Conversely, the member for whom the research is performed shall not treat any part of any amount paid or incurred as a contract research expense. For purposes of determining whether the in-house research for that work is qualified research, the member performing the research shall be treated as carrying on any trade or business carried on by the member on whose behalf the research is performed.

(3) *Contract research expenses.* If a member of a group pays or incurs contract research expenses to a person outside the group in carrying on the member's trade or business, that member shall include those expenses as qualified research expenses. However, if the expenses are not paid or incurred in carrying on any trade or business of that member, those expenses may be taken into account as contract research expenses by another member of the group provided that the other member—

(i) Reimburses the member paying or incurring the expenses, and

(ii) Carries on a trade or business to which the research relates.

(4) *Lease Payments.* The amount paid or incurred to another member of the group for the lease of personal property owned by a member of the group is not

taken into account for purposes of section 41. Amounts paid or incurred to another member of the group for the lease of personal property owned by a person outside the group shall be taken into account as in-house research expenses for purposes of section 41 only to the extent of the lesser of—

(i) The amount paid or incurred to the other member, or

(ii) The amount of the lease expenses paid to the person outside the group.

(5) *Payment for supplies.* Amounts paid or incurred to another member of the group for supplies shall be taken into account as in-house research expenses for purposes of section 41 only to the extent of the lesser of—

(i) The amount paid or incurred to the other member, or

(ii) The amount of the other member's basis in the supplies.

§1.41-9 Special rules.

(a) *Allocations*—(1) *Corporation making an election under subchapter S*—(i) *Pass-through, for taxable years beginning after December 31, 1982, in the case of an S corporation.* In the case of an S corporation (as defined in section 1361) the amount of research credit computed for the corporation shall be allocated to the shareholders according to the provisions of section 1366 and section 1377.

(ii) *Pass-through, for taxable years beginning before January 1, 1983, in the case of a subchapter S corporation.* In the case of an electing small business corporation (as defined in section 1371 as that section read before the amendments made by the Subchapter S Revision Act of 1982), the amount of the research credit computed for the corporation for any taxable year shall be apportioned pro rata among the persons who are shareholders of the corporation on the last day of the corporation's taxable year.

(2) *Pass-through in the case of an estate or trust.* In the case of an estate or trust, the amount of the research credit computed for the estate or trust for any taxable year shall be apportioned among the estate or trust and the beneficiaries on the basis of the income of the estate or trust allocable to each.

(3) *Pass-through in the case of a partnership*—(i) *In general.* In the case of a partnership, the research credit computed for the partnership for any taxable year shall be apportioned among the persons who are partners during the taxable year in accordance with section 704 and the regulations thereunder. See, for example, §1.704-1(b)(4)(ii). Because the research credit is an expenditure-based credit, the credit is to be allocated among the partners in the same proportion as section 174 expenditures are allocated for the year.

(ii) *Certain expenditures by joint ventures.* Research expenses to which §1.41-2(a)(4)(ii) applies shall be apportioned among the persons who are partners during the taxable year in accordance with the provisions of that section. For purposes of section 41, these expenses shall be treated as paid or incurred directly by the partners rather than by the partnership. Thus, the partnership shall disregard these expenses in computing the credit to be apportioned under paragraph (a)(3)(i) of this section, and in making the computations under section 41 each partner shall aggregate its distributive share of these expenses with other research expenses of the partner. The limitation on the amount of the credit set out in section 41(g) and in paragraph (c) of this section shall not apply because the credit is computed by the partner, not the partnership.

(4) *Year in which taken into account.* An amount apportioned to a person under this paragraph shall be taken into account by the person in the taxable year of such person which or within which the taxable year of the corporation, estate, trust, or partnership (as the case may be) ends.

(5) *Credit allowed subject to limitation.* The credit allowable to any person to whom any amount has been apportioned under paragraph (a)(1), (2) or (3)(i) of this section is subject to section 41(g) and sections 38 and 39 of the Code, if applicable.

(b) *Adjustments for certain acquisitions and dispositions—Meaning of terms.* For the meaning of "acquisition," "separate unit," and "major portion," see paragraph (b) of §1.52-2. An "acquisition" includes an incorporation or a liquidation.

(c) *Special rule for pass-through of credit.* The special rule contained in section 41(g) for the pass-through of the credit in the case of an individual who owns an interest in an unincorporated trade or business, is a partner in a partnership, is a beneficiary of an estate or trust, or is a shareholder in an S corporation shall be applied in accordance with the principles set forth in §1.53-3.

(d) *Carryback and carryover of unused credits.* The taxpayer to whom the credit is passed through under paragraph (c) of this section shall not be prevented from applying the unused portion in a carryback or carryover year merely because the entity that earned the credit changes its form of conducting business.

Lawrence B. Gibbs,
Commissioner of Internal Revenue.

Approved April 6, 1989.

John G. Wilkins,
Acting Assistant Secretary of the Treasury.

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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 January 1989. See Rev. Rul. 89-1, page 2.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of February 1989. See Rev. Rul. 89-15, page 262.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of March 1989. See Rev. Rul. 89-34, page 263.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of April 1989. See Rev. Rul. 89-39, page 264.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of May 1989. See Rev. Rul. 89-65, page 265.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of June 1989. See Rev. Rul. 89-77, page 266.

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26 CFR 1.42-1T Limitation on low-income housing credit allowed with respect to qualified low-income buildings receiving housing credit allocations from a State or local housing credit agency.

Guidance is provided for computing the income limits applicable to low-income housing credits under section 42 of the Code. See Rev. Rul. 89-24, page 24.

Subpart E.—Rules for Computing Credit for Investment in Certain Depreciable Property

Section 47.—Certain Dispositions, Etc., of Section 38 Property

26 CFR 1.47-3: Exceptions to the application of section 1.47-1.
(Also Sections 38, 355, 368.)

Recapture; investment credit; divisive reorganizations. When, pursuant to a single integrated transaction, a corporation transfers section 38 recovery property to a newly formed subsidiary in year one and distributes its stock in the subsidiary to its shareholders in year two, the disposition of the section 38 recovery property triggering investment credit recapture under section 47(a) of the Code occurs in year one.

Rev. Rul. 89-18

ISSUE

If, pursuant to a reorganization described under sections 368(a)(1)(D) and 355(a)(1) of the Internal Revenue Code, section 38 recovery property of a corporation is transferred to a newly formed subsidiary in year one and the subsidiary's stock is distributed to the corporation's shareholders in year two, then, for purposes of section 47(a), does the resulting disposition of the section 38 recovery property occur in year one or in year two?

FACTS

X, a domestic corporation, has several divisions that conduct separate businesses. *X* files its federal income tax return on the basis of a calendar year.

On May 1, 1988, *X* announced a plan to transfer the assets of division *a* and certain of *X*'s liabilities to *Y*, a newly formed corporation, in exchange for the stock of *Y*, and then to transfer to the *X* shareholders the stock received from *Y*.

The transfer to *Y* of division *a*'s assets and of *X*'s liabilities took place on December 31, 1988. The assets that were transferred included section 38 recovery property with respect to which *X* had been allowed an investment credit in an earlier year. *X* distributed *Y*'s stock to *X*'s shareholders on February 1, 1989. Both the transfer of the assets to *Y* and the distribution of *Y*'s stock to the *X* shareholders were part of a single integrated plan, all aspects of which were known when the transaction began.

X's transfer of the assets to *Y* solely for *Y* stock followed by the subsequent distribution of *Y*'s stock to *X*'s shareholders constituted a divisive reorganization within the meaning of section 368(a)(1)(D) of the Code. It met the requirements for nonrecognition of gain or loss to *X*'s shareholders pursuant to section 355(a). As a result of the integrated transaction, the section 38 recovery property that had been transferred from *X* to *Y* ceased to be section 38 property with respect to *X*.

The specific issue is whether that section 38 recovery property was disposed of, for purposes of section 47(a) of the Code, when the assets were transferred to *Y* (in *X*'s 1988 taxable year) or when *X* distributed the *Y* stock to the *X* shareholders (in *X*'s 1989 taxable year).

LAW AND ANALYSIS

Section 47(a)(1) of the Code provides that, if during any taxable year any property is disposed of or otherwise ceases to be section 38 property with respect to the taxpayer before the close of the useful life that was taken into account in computing the credit under section 38, the tax for such taxable year shall be increased. Section 47(a)(5) provides a similar rule with respect to section 38 recovery property.

Section 47(b) of the Code provides that property shall not be treated as ceasing to be section 38 property with respect to the taxpayer if the transaction involves a mere change in form of conducting the trade or business so long as the property transferred is retained in the trade or business as section 38 property and the taxpayer retains a substantial interest in the trade or business.

Section 1.47-3(f)(1)(i) of the Income Tax Regulations provides that the mere-change-in-form exception to the recapture of the investment credit will not apply unless certain conditions specified in section 1.47-3(f)(1)(ii) are met, including the condition that the transferor of the section 38 property retains a "substantial interest" in the trade or business.

Section 1.47-3(f)(5)(ii) of the regulations provides rules concerning investment credit recapture for situations in which an initial transfer of section 38 property is subject to the mere-change-in-form exception but the transferor subsequently fails to retain a substantial interest in the trade or business.

Rev. Rul. 74-101, 1974-1 C.B. 7, concerns a corporation engaged in the same business in three states that transferred its business activities in two of the states and all related assets, including section 38 property, to two newly formed corporations solely in exchange for all their stock and immediately thereafter transferred the stock to its sole shareholder in a section 368(a)(1)(D) divisive reorganization. The ruling holds that investment credit recapture under section 47(a)(1) of the Code is required. The mere-change-in-form exception does not apply, because after the reorganization the corporation was not the owner of a substantial interest in the transferred businesses.

Rev. Rul. 82-20, 1982-1 C.B. 6, concerns a transfer of section 38 property between members of an affiliated group in a consolidated return year. The transfer was part of a plan to transfer the section 38 property outside the affiliated group in a transaction qualifying as a reorganization under section 368(a)(1)-(D). Holding that the transfer constitutes a disposition of section 38 property under section 47(a)(1) of the Code, that ruling concludes that the exception to recapture of investment credit contained in section 1.1502-3(f)(2)(i) of the regulations for transfers of section 38 property between members of the affiliated group does not apply to the transaction. The exception is inapplicable because the transfer of the section 38 property was a step in the planned transfer of the property outside the affiliated group.

Both Rev. Rul. 74-101 and Rev. Rul. 82-20 conclude that recapture is triggered by the disposition of the section 38 property that occurred in the divisive section 368(a)(1)(D) reorganizations. Neither ruling, however, explicitly addresses the issue of whether the event triggering recapture is the transfer of section 38 property or the subsequent distribution of the stock.

The legislative history to section 47 of the Code contains an example similar to the fact pattern in this ruling. In the example, section 38 property was transferred to a subsidiary as part of a transaction that included a subsequent transfer of the subsidiary's stock. Section 47(a) applied to the transfer of the section 38 property to the subsidiary. The mere-change-in-form exception of section 47(b) was not discussed. *See* Example 2 in S. Rep. No. 1881, 87th Cong., 2d Sess. 153 (1962), 1962-3 C.B. 707, 857.

The transfer of section 38 property from a corporation to a newly formed subsidiary triggers investment credit recapture unless the mere-change-inform exception is applicable. In the present situation, the transfer of the section 38 property by *X* to *Y* and the subsequent distribution by *X* of *Y*'s stock to the *X* shareholders were parts of a single integrated transaction, a divisive reorganization. Because *X* retains no substantial interest in division *a* upon completion of the reorganization, the mere-change-in-form exception does not apply to this transaction. Therefore, the general recapture rules of section 47(a) of the Code are triggered by the transfer of the section 38 recovery property to *Y*, and *X* is subject to recapture in the year the property is so transferred. The rules of section 1.47- 3(f)(5)(ii) of the regulations do not apply here, because the mere-change-in-form exception was not applicable to the transfer of the section 38 recovery property from *X* to *Y*.

HOLDING

When, pursuant to a single integrated transaction, a corporation transfers section 38 recovery property to a newly formed subsidiary in year one and distributes its stock in the subsidiary to its shareholders in year two, the disposition under section 47(a) of the Code occurs in year one.

Part VI.—Alternative Minimum Tax

Section 58.—Denial of Certain Losses

26 CFR 1.58-9T: Application of the tax benefit rule to the minimum tax for taxable years beginning prior to 1987 (temporary).

T.D. 8249

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

Minimum Tax—Tax Benefit Rule

AGENCY: Internal Revenue Service, Treasury.

ACTION: Temporary regulations.

SUMMARY: This document contains temporary regulations relating to the application of the tax benefit rule to the minimum tax. Changes to the applicable law were made by the Tax Reform Act of 1976. The regulations provide taxpayers with guidance necessary to determine the amount of tax preference items that do not provide a current tax benefit because of available credits and, therefore, are not subject to minimum tax. The text of the temporary regulations set forth in this document also serves as the text of the proposed regulations cross-referenced in * * * [IA-56-87, page 1018, this Bulletin].

DATES: Except as otherwise provided, the amendments are effective for items of tax preference that are subject to the minimum tax imposed by section 56 of the Code and arise in taxable years beginning after December 31, 1975, and before January 1, 1987.

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

This regulation is 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 requirements contained in this regulation have been reviewed and, pending receipt and evaluation of public comments, approved by the Office of Management and Budget (OMB) under control number 1545-1093. The estimated annual burden per respondent or recordkeeper varies from 10 minutes to 14 minutes, depending on individual circumstances, with an estimated average of 12 minutes.

These estimates are an approximation of the average time expected to be necessary for a collection of information. They are based on such information as is available to the Internal Revenue Service. Individual respondents may require greater or less time, depending on individual circumstances.

For further information concerning these collections of information, where to submit comments on these collections of information, the accuracy of the estimated burden, and suggestions for reducing this burden, please refer to the preamble to the cross-reference notice of proposed rulemaking published * * * [page 1018, this Bulletin].

BACKGROUND

This document contains temporary regulations amending the Income Tax Regulations (26 CFR Part 1) under section 58(h) of the Internal Revenue Code of 1954 (Code). These amendments would conform the regulations to section 301(d)(3) of the Tax Reform Act of 1976 (Pub. L. 94-455, 90 Stat. 1553) [1976-3 C.B. (Vol. 1) 1, 29] and are issued under the authority contained in sections 58(h) and 7805 of the Code (90 Stat. 1553 and 68A Stat. 917; 26 U.S.C. 58(h), 7805).

These temporary regulations are applicable for purposes of determining minimum tax liability imposed by section 56 of the Code for taxable years beginning before January 1, 1987. Except as otherwise provided, the temporary regulations do not apply for purposes of determining alternative minimum tax liability imposed by section 55.

EXPLANATION OF PROVISIONS

In general

For taxable years beginning after December 31, 1976, and before January 1, 1987, section 56 of the Code imposes a 15-percent minimum tax on a corporate taxpayer's tax preference items, as defined in section 57, to the extent that such preference items exceed the greater of (i) $10,000, or (ii) the taxpayer's regular tax liability computed without regard to taxes imposed by sections 531 and 541 and after reduction by credits. This minimum tax is imposed in addition to other taxes imposed by chapter 1 of the Code. Section 58(h) provides that the Secretary shall prescribe regulations under which items of tax preference shall be properly adjusted where the tax treatment giving rise to such items will not result in the reduction of tax under subtitle A of the Code for any taxable years.

Application of the Tax Benefit Rule

Section 1.58-9T(a) of the temporary regulations provides that under section 58(h) of the Code taxpayers are not liable for the minimum tax imposed by section 56 on tax preference items from which no current tax benefit is derived because available credits would have reduced or eliminated the taxpayer's regular tax liability if preference items had not been allowed in computing taxable income. These regulations follow the holding in *First Chicago Corp. v. Commissioner*, 88 T.C. 663 (1987), *aff'd*, 842 F.2d 180 (7th Cir. 1988). In *First Chicago* the court held that under section 58(h) the taxpayer owed no minimum tax on items of tax preference that did not produce a current tax benefit because available credits would have eliminated tax liability even if the preference items had not been allowed. The court recognized that the effect of the tax preference items was to "free up" for possible use in subsequent years additional credits that otherwise would have been used to reduce tax liability. Section 1.58-9T(a) of the temporary regulations further provides that any credits that, because of such preference items, are not needed for use against regular tax ("freed-up credits"), are required to be reduced under the rules of §1.58-9T(c) of the temporary regulations.

Adjustment to credits

Section 1.58-9T(c) of the temporary regulations provides that a taxpayer's freed-up credits must be reduced by the additional minimum tax that would have been imposed if a current tax benefit had been derived from preference items that did not actually produce a current tax benefit. The amount of this reduction shall be calculated in the following manner—

(i) Determine the amount of freed-up credits,

(ii) Determine the amount of tax preference items (if any) for which a current tax benefit was derived for the taxable year ("beneficial preferences"), and the amount of preferences for which no current tax benefit was derived for the taxable year ("non-beneficial preferences"), and

(iii) Determine the portion of the total minimum tax on all tax preference items for the taxable year that is attributable to the non-beneficial preferences. The freed-up credits are then reduced by an amount equal to such portion of the minimum tax.

The regulations include rules necessary to allocate properly the required credit reduction among credits that are of more than one type (*e.g.*, investment tax credits and foreign tax credits) or that were earned in more than one taxable year. These rules take into account the order in which such credits would have been applied to offset the additional tax that would have been imposed if preferences had not been allowed, percentage limitations that would have affected the use of such credits against this additional tax, and the marginal rates at which this additional tax would have been imposed.

Determination of Freed-up Credit

Section 1.58-9T(c)(2)(i) of the temporary regulations provides that to determine the freed-up credits for the taxable year, the first step is to determine the regular tax that would have been imposed if preference items had not been allowed in computing taxable income ("non-preference regular tax"). The second step is to compute the amount of credits that would have been allowed to reduce the non-preference regular tax. The third step is to subtract the amount of credits that were actually allowed to reduce the regular tax for such taxable year from the amount of credits that would have been allowed to reduce non-preference regular tax. The result is the amount of the freed-up credits.

Determination of Beneficial and Non-beneficial Preferences

Section 1.58-9T(c)(3) of the temporary regulations provides the method for determining the amount of tax preferences from which a current tax benefit is derived ("beneficial preferences") and the amount from which no current tax benefit is derived ("non-beneficial preferences") for the taxable year. If the taxpayer's tax liability (after credits) would be the same regardless of whether preference items were allowed to reduce taxable income, then all of the taxpayer's preference items are non-beneficial preference items.

If tax liability (after credits) is less because preference items are allowed to reduce taxable income, then some of these preference items have provided a current tax benefit. In such cases, the non-beneficial preferences are determined by converting the freed-up credits for such taxable year into an amount of taxable income. To make this conversion, freed-up credits are "grossed up" (*i.e.*, divided by the regular tax marginal rate at which such credits would have offset non-preference regular tax) to determine the amount of tax preferences that freed up such credits. The aggregate of these grossed-up amounts is the total amount of non-beneficial preferences for the taxable year.

The freed-up credits are to be grossed up beginning at the lowest marginal tax rate that would have applied to the additional taxable income arising if tax preferences were not allowed. Thus, the marginal tax rates at which the actual regular tax was imposed shall not be taken into account in grossing up freed-up credit, even if all or a portion of such tax is not offset by credits because of limitations on the allowance of such credits (such as the section 904 limit on foreign tax credits or the section 38(c) limit on investment tax credits). For example, if the first dollar of additional non-preference taxable income would have been taxed at a rate of 46 percent, then freed-up credits shall be grossed up at 46 percent, even if regular tax imposed on taxable income at a 40-percent rate was not offset by credits because of the limitations on investment tax credits under section 38(c).

The amount of beneficial preferences for the taxable year is computed by subtracting the non-beneficial preferences for the taxable year from the total amount of tax preferences for such year.

Determination of the Credit Reduction Amount

Section 1.58-9T(c)(4) of the temporary regulations provides the method for determining the amount of minimum tax attributable to the nonbeneficial preferences. This amount is also referred to as the credit reduction amount. The credit reduction amount is determined by computing the amount of minimum tax that would be imposed on all tax preference items for the taxable year if all such preferences had produced a current tax benefit. The minimum tax that is imposed on only beneficial preferences is subtracted from this amount. The result is the minimum tax attributable to the non-beneficial preferences for the taxable year.

Reduction of Freed-up Credits

Section 1.58-9T(c)(5)(i) of the temporary regulations provides that the freed-up credits are reduced by an amount equal to the minimum tax attributable to the non-beneficial preferences ("credit reduction amount"). If the taxpayer only has one type of freed-up credit (*i.e.*, only investment tax credit or only foreign tax credit) and that credit was earned in only one year (the current year or a carryback or carryforward year), then such credit is reduced by the credit reduction amount.

However, if the taxpayer has more than one type of freed-up credit, or the taxpayer's credits are from more than one taxable year, then the credit reduction amount must be allocated either under the exact method of credit reduction, or if an election is made, under the simplified method.

Section 1.58-9T(c)(5)(ii) of the temporary regulations provides that under the exact method of credit reduction, for each type of freed-up credits and for each taxable year within such type from which any such credits are earned, the amount of credit reduction shall be equal to the amount of minimum tax attributable to the non-beneficial preferences that freed up the credits for that type and taxable year. The amount of the credit reduction is computed by multiplying the amount of non-beneficial preferences which freed up credits for each type and taxable year by the minimum tax rate.

In lieu of the exact credit reduction method, taxpayers may elect to use the simplified credit reduction method described in §1.58-9T(c)(5)(iii)(A). Under the simplified credit reduction method, the amount of freed-up credits for each type of credit and for each taxable year from which such credit is carried over is multiplied by a fraction. The numerator of the fraction is the total credit reduction amount. The denominator is the total amount of freed-up credits. The product of this multiplication is the amount of credit reduction for each type and taxable year of freed-up credit.

Section 1.58-9T(c)(5)(iii)(B) provides that a taxpayer may elect to use the simplified credit reduction method for all taxable years to which these regulations apply by attaching a statement indicating such an election on the amended Federal income tax return or returns applying the adjustments of these regulations. If an election is made for any taxable year, it must be made for all taxable years. Once an election has been made, it can be revoked only with the permission of the Commissioner. Similarly, once returns have been filed applying the exact credit reduction method, an election to apply the simplified method can be made only with the consent of the Commissioner.

Section 1.58-9T(c)(5)(iv) of the temporary regulations provides that under both the exact method and the simplified method, the determination of credit carrybacks and carryforwards to other taxable years is made on the basis of freed-up credits remaining after such reduction, plus any other unused credits. Thus, an amount of freed-up credits equal to the credit reduction amount shall not reduce tax liability in any taxable year. Such disallowance is without regard to whether such credits would otherwise be allowed as a carryback or carryforward. No minimum tax liability shall be due with respect to the non-beneficial preferences for any taxable year.

Periods of limitations; adjustments to tax liability

Section 1.58-9T(e)(2) of the temporary regulations provides that the adjustments described in the temporary regulations shall, in general, apply for purposes of assessing deficiencies or claiming refunds of tax for any taxable year for which the tax liability for such year is affected by these adjustments, provided that the period of limitations under section 6501 has not expired for such taxable year. Therefore, these adjustments generally apply for purposes of assessing deficiencies and refunding any overpayment of tax for all years for which the period of limitations has not expired regardless of whether the period of limitations has expired for the taxable year in which the non-beneficial preferences arose. However, the adjustments contained in these temporary regulations do not apply to reduce freed-up credits otherwise allowable in any year where:

(i) The taxpayer paid minimum tax on all tax preference items arising in the taxable year in which the non-beneficial preferences arose;

(ii) The taxpayer has not made a claim for a credit or refund for such minimum tax; and

(iii) The period of limitations for claiming a credit or refund under section 6511 has expired for such taxable year.

Claim for credit or refund

Section 1.58-9T(e)(3) of the temporary regulations provides that a taxpayer generally may claim a credit or refund of minimum tax that was paid on non-beneficial preferences. However, such a claim for a credit or refund shall be disallowed to the extent that the taxpayer has reduced tax liability in a taxable year for which the period of limitations has expired by using freed-up credits in excess of the amount that would have been available if the credit reduction required under these regulations had been made. Such a claim must be made by filing an amended return for the taxable year for which such minimum tax was paid. Further, if a claim for credit or refund is filed, amended returns must also be filed for any taxable year for which tax liability would be affected as a result of the reduction, under these regulations, of credits freed up by such non-beneficial preferences.

Net operating losses

Section 1.58-9T(f) of the temporary regulations has been reserved for the purpose of providing rules relating to the application of the tax benefit rule in cases where tax preference items provide no tax benefit in the current taxable year because available net operating loss carrybacks or carryforwards would have reduced or eliminated tax liability if the preference items had not been allowed in computing taxable income. The Internal Revenue Service intends to issue additional regulations at a later date which will address the adjustments required in such cases.

SPECIAL ANALYSES

No general notice of proposed rulemaking is required by 5 U.S.C. 553(b) for temporary regulations. Accordingly, the Regulatory Flexibility Act does not apply and no Regulatory Flexibility Analysis is required for this rule. The Commissioner of Internal Revenue has determined that this temporary rule is not a major rule as defined in Executive Order 12291 and that a regulatory impact analysis therefore is not required.

* * * * * *

Adoption of amendments to the regulations

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

PART 1—INCOME TAX; TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1953

Paragraph 1. The authority for Part 1 is amended by adding the following citation:

Authority: 26 U.S.C. 7805 * * * Section 1.58-9T is also issued under 26 U.S.C. 58(h).

Par. 2. A new §1.58-9T is added immediately following §1.58-8 to read as set forth below:

§1.58-9T Application of the tax benefit rule to the minimum tax for taxable years beginning prior to 1987 (Temporary).

(a) *In general.* For purposes of computing the minimum tax liability imposed under section 56 of the Internal Revenue Code of 1954 (Code), taxpayers are not liable for minimum tax on tax preference items from which no current tax benefit is derived because available credits would have reduced or eliminated the taxpayer's regular tax liability if the preference items had not been allowed in computing taxable income. However, any credits that, because of such preference items, are not needed for use against regular tax ("freed-up credits"), are required to be reduced under the rules of paragraph (c) of this section. For purposes of this section, a taxpayer's regular tax is the Federal income tax liability under subchapter A of Chapter 1 of the Code, not including the minimum tax imposed by section 56. Unless otherwise noted, all references to Internal Revenue Code sections refer to the Internal Revenue Code of 1954.

(b) *Effective date*. The rules of this section are effective for tax preference items which arise in taxable years beginning after December 31, 1976, and before January 1, 1987.

(c) *Adjustment of carryback and carryover credits*—(1) *In general*. A taxpayer's freed-up credits must be reduced by the additional minimum tax that would have been imposed if a current tax benefit had been derived from preference items that did not actually produce a current tax benefit. The amount of this reduction shall be calculated in the following manner—

(i) Determine the amount of freed-up credits,

(ii) Determine the amount of tax preference items (if any) for which a current tax benefit was derived for the taxable year ("beneficial preferences"), and the amount of preferences for which no current tax benefit was derived for the taxable year ("non-beneficial preferences"), and

(iii) Determine the portion of the total minimum tax on all tax preference items for the taxable year that is attributable to the non-beneficial preferences.

The freed-up credits are then reduced by an amount equal to such portion of the minimum tax.

(2) *Determine freed-up credits*. (i) To determine the freed-up credits for the taxable year, first determine the regular tax that would have been imposed if preference items had not been allowed in computing taxable income ("non-preference regular tax"). Second, compute the amount of credits that would have been allowed to reduce the non-preference regular tax. Third, subtract the amount of credits that were actually allowed to reduce the regular tax for such taxable year from the amount of credits that would have been allowed to reduce non-preference regular tax. The result is the amount of the freed-up credits.

(ii) The following examples illustrate the determination of freed-up credits:

Example (1). In 1982 Corporation B has $17.6 million dollars in foreign tax credits available for the taxable year. Assume that the foreign tax credits being used in this example do not exceed the limitation under section 904. If preference items were not allowed in determining regular tax, the regular tax would have been $10.2 million and foreign tax credits used to reduce regular tax would have been $10.2 million. Because of tax preference items, however, B's regular tax is $6.3 million and the amount of foreign tax credits actually used to reduce the regular tax is $6.3 million. The amount of freed-up foreign tax credits is $3.9 million ($10.2 million minus $6.3 million).

Example (2). Assume the same facts as in Example (1) except that Corporation B has $7.2 million dollars in foreign tax credits. If preference items were not allowed, the non-preference regular tax would have been $10.2 million and the foreign tax credits used to reduce the regular tax would have been $7.2 million. Because of tax preference items, B's regular tax, however, is $6.3 million, and the foreign tax credits actually used to reduce the regular tax is $6.3 million. The amount of freed-up foreign tax credits is $.9 million ($7.2 million minus $6.3 million).

Example (3). In 1983 Corporation C has $500,000 of investment tax credits available. If preference items were not allowed, non-preference regular tax would have been $690,000 and all $500,000 of investment tax credits would have been allowed to reduce non-preference regular tax liability. Because of tax preferences, however, C's actual regular tax is $439,750. As a result of the limitation under section 38(c), only $377,537 of the investment tax credits are allowed to reduce the actual regular tax. Freed-up credits are $122,463 ($500,000 minus $377,537).

(3) *Determination of beneficial and non-beneficial preferences*—(i) *In general*. The amount of tax preferences from which a current tax benefit is derived ("beneficial preferences") and the amount from which no current tax benefit is derived ("non-beneficial preferences") for the taxable year are determined as set forth below.

(ii) *Regular tax liability is the same regardless of preference items*. (A) If the taxpayer's tax liability (after credits) would be the same regardless of whether preference items were allowed to reduce taxable income, then all of the taxpayer's preference items are non-beneficial preference items.

(B) The following example illustrates the rule set forth in paragraph (c)(3)(ii)-(A) of this section. This example assumes that foreign tax credits being used do not exceed the limitation under section 904.

Example (4). Assume the facts in Example (1). All of B's $17.6 million of credits are foreign tax credits. The total amount of B's tax preference items is $8.4 million. B's non-preference regular tax is $10.2 million and, reduced by foreign tax credits, is zero. B's actual regular tax is $6.3 million, and, reduced by foreign tax credits, is zero. Since the amount of credits that would have been allowed to offset the non-preference regular tax would have reduced such tax to an amount ($0) equal to the actual regular tax liability ($0), B received a tax benefit from none of the $8.4 million of tax preferences and therefore all of these preferences are non-beneficial preferences.

(iii) *Regular tax liability differs because of preference items*. If tax liability (after credits) is less because preference items are allowed to reduce taxable income, then some of these preference items have provided a current tax benefit. In such cases, the amount of beneficial and non-beneficial preferences are determined as follows:

(A) *Non-beneficial preferences*. (*1*) The non-beneficial preferences are determined by converting the freed-up credits for such taxable year into an amount of taxable income. To make this conversion, freed-up credits are "grossed up" (*i.e.*, divided by the regular tax marginal rate at which such credits would have offset non-preference regular tax) to determine the amount of tax preferences that freed up such credits. For purposes of this calculation, the 5-percent addition to tax provided by section 11 (b) shall be included in determining the marginal rate. The aggregate of these grossed-up amounts is the total amount of non-beneficial preferences for the taxable year.

(*2*) The freed-up credits shall be grossed up beginning at the lowest marginal tax rate that would have applied to the additional taxable income arising if tax preferences were not allowed. Thus, the marginal tax rates at which the actual regular tax was imposed shall not be taken into account in grossing up freed-up credits, even if all or a portion of such tax is not offset by credits because of limitations on the allowance of such credits (such as the section 904 limit on foreign tax credits or the section 38 (c) limit on investment tax credits). For example, if the first dollar of additional non-preference taxable income would have been taxed at a rate of 46 percent, then freed-up credits shall be grossed up at 46 percent, even if regular tax imposed on taxable income at a 40-percent rate was not offset by credits because of the limitations on investment tax credits under section 38 (c). *See* Examples (12) and (13) in paragraph (d) of this section for illustrations of the gross up of freed-up credits in cases where limitations apply to the amount of credit allowed to offset actual regular tax.

(*3*) The following example illustrates the gross up of freed-up credits to determine non-beneficial preferences. This example assumes that foreign tax credits being used do not exceed the limitation under section 904.

Example (5). Corporation L has the following items for the 1985 taxable year:

Actual taxable income		$90,000
Regular tax		21,750
Available credits:		
Foreign tax credits for 1985	$15,000	
Foreign tax credits carried forward from 1984	25,000	
Investment tax credits carried forward from 1984	20,000	
		$60,000
Credit allowed to offset actual regular tax:		
Foreign tax credits for 1985	$15,000	
Foreign tax credits carried forward from 1984	6,750	
		$21,750
Actual regular tax liability		-0-
Preferences		110,000
Taxable income for 1985 determined as though preferences were not allowed		200,000
Non-preference regular tax		71,750
Credits allowed to offset non-preference regular tax:		
Foreign tax credits for 1985	$15,000	
Foreign tax credits carried forward from 1984	25,000	
Investment tax credits carried forward from 1984	20,000	
		$60,000
Non-preference regular tax liability		11,750

The freed-up credits for 1985 are $38,250 ($60,000 minus $21,750).

The non-preference regular tax of $71,750 is determined by applying the regular tax rates set forth in section 11 (b) to the $200,000 of taxable income as follows:

Taxable Income	*Rate*	*Tax*
$ 25,000	× .15 =	$ 3,750
25,000	× .18 =	4,500
25,000	× .30 =	7,500
25,000	× 40 =	10,000
100,000	× 46 =	46,000
$200,000		$71,750

Thus, for purposes of determining the non-beneficial preferences, freed-up credits are grossed up as follows:

The credits allowed against the regular tax and the freed-up credits are treated as offsetting non-preference regular tax in the same order as such credits would have been allowed to offset such tax, beginning at the lowest marginal tax rate. The freed-up credits are grossed up beginning at the lowest marginal tax rate at which additional taxable income would have been taxed if preferences were not allowed. Thus, in this example freed-up credits are grossed up beginning at 40 percent, and the amount of L's non-beneficial preferences for the 1985 taxable year is $84,456.

Type	*Credit allowed against regular tax*	*Freed-up Credit*	*Divided by tax Rate*		*Non-beneficial preferences*
FTC (85)	$ 3,750	—	.15		—
"	4,500	—	.18		—
"	6,750	—	.30		—
FTC (84)	750	—	.30		—
"	6,000	—	40		—
"	—	$ 4,000	40	=	$10,000
"	—	14,250	.46	=	30,978
ITC (84)	—	20,000	.46	=	43,478
	$21,750	$38,250			$84,456

Foreign tax credit = FTC (year)
Investment tax credit = ITC (year)

(B) *Beneficial preferences.* The amount of beneficial preferences for the taxable year is computed by subtracting the non-beneficial preferences for the taxable year from the total amount of tax preferences for such year. This rule may be illustrated by the following example:

Example (6). Assume the same facts as in Example (5). The amount of L's beneficial preferences for 1985 is $25,544 (total preferences of $110,000, minus non-beneficial preferences of $84,456).

(4) *Determine the minimum tax attributable to non-beneficial preferences.* (i) The portion of the minimum tax that is attributable to the non-beneficial preferences is computed as follows—

(A) Compute the minimum tax that would be imposed on all tax preference items for the taxable year if all of the preferences had produced a tax benefit.

(B) Compute the minimum tax that would be imposed on the beneficial preferences if these were the taxpayer's only preferences. (This is the amount of minimum tax actually imposed for the taxable year.)

(C) Subtract the amount computed in (B) from the amount computed in (A). The result is the minimum tax attributable to the non-beneficial preferences for the taxable year. This amount is sometimes referred to hereinafter as the "credit reduction amount".

(ii) The following examples illustrate determination of the credit reduction amount.

Example (7). Assume the facts in Example (4) above. Since B has $8.4 million in total preference items and no regular tax liability, the minimum tax on that amount would be $1,258,500 (($8.4 million minus $10,000) multiplied by .15). None of the preference items is a beneficial preference. Thus, the minimum tax attributable to non-beneficial preferences (and therefore, the credit reduction amount) is $1,258,500.

Example (8). Assume the facts in Example (5) above. The minimum tax on L's total preference items of $110,000 would be $15,000 (($110,000 minus $10,000) multiplied by .15). Since the amount of non-beneficial preferences is $84,456, the amount of L's beneficial preferences for 1985 is $25,544 ($110,000 minus $84,456). The minimum tax on L's beneficial preferences of $25,544 is $2,332 (($25,544 minus $10,000) multiplied by .15). (This is the amount of minimum tax imposed for 1985.) The minimum tax attributable to non-beneficial preference items (and therefore, the credit reduction amount) is $12,668 ($15,000 minus $2,332).

(5) *Reduction of freed-up credits*—(i) *In general.* The freed-up credits are reduced by an amount equal to the minimum tax attributable to the non-beneficial preferences ("credit reduction amount"). If the taxpayer has only one type of freed-up credit (*i.e.*, only investment tax credit or only foreign tax credit) and that credit was earned in only one year (the current year or a carryback or carryforward year), then the credit is reduced by the credit reduction amount. This rule may illustrated by the following example:

Example (9). Assume the facts in Example (7) above. Further assume that all of the $3.9 million of freed-up credits are foreign tax credits that arise in the same year and that otherwise would be carried forward. Since the entire amount of B's tax preferences are non-beneficial preferences, the minimum tax of $1,258,500 that would be imposed on the total tax preferences is the credit reduction amount. Thus, B's $3.9 million of freed-up foreign tax credits is reduced by $1,258,500. The foreign tax credit carryforward from 1982 is $10,041,500. This amount is the sum of $2,641,500 (the freed-up foreign tax credit of $3,900,000, reduced by the credit reduction amount of $1,258,500), plus $7.4 million (the foreign tax credit that would have been carried over even if tax preference items had not been allowed).

However, if the taxpayer has more than one type of freed-up credit, or the taxpayer's freed-up credits are from more than one taxable year, then the credit reduction amount must be allocated under the exact method described in paragraph (c)(5)(ii) of this section, unless an election is made under paragraph (c)(5)(iii) of this section to use the simplified method.

(ii) *Exact method*. For each type of freed-up credits and for each taxable year within such type from which any such credits are earned, the amount of credit reduction shall be equal to the amount of minimum tax attributable to the non-beneficial preferences that freed up the credits for that type and taxable year. The amount of the credit reduction is computed by multiplying the amount of non-beneficial preferences which freed up credits for each type and taxable year by the minimum tax rate. For purposes of this computation, if the amount of the taxpayer's minimum tax exemption for the taxable year (as determined under section 56(a)) exceeds the amount of the taxpayer's beneficial preferences, such excess exemption shall reduce the amount of non-beneficial preferences to be multiplied by the minimum tax rate. The non-beneficial preferences shall be reduced by any such excess exemption in the same order in which the credits that were freed up by such preferences would have been allowed to offset tax. Thus, for example, any excess exemption shall first reduce non-beneficial preferences that freed up foreign tax credits. Any such excess exemption remaining after reducing non-beneficial preferences that freed up foreign tax credits to zero would then be used to reduce the non-beneficial preferences that freed up investment tax credits.

(iii) *Simplified method*—(A) *Description of method*. In lieu of the exact credit reduction method described in paragraph (c)(5)(ii) of this section, taxpayers may elect to use the simplified credit reduction method. Under the simplified credit reduction method, the amount of freed-up credits for each type of credit and for each taxable year in which such credit is earned is multiplied by a fraction. The numerator of the fraction is the total credit reduction amount as determined in paragraph (c)(4)(i)(C) of this section. The denominator is the total amount of freed-up credits as determined in paragraph (c)(2)(i) of this section. The product of this multiplication is the amount of credit reduction for each type and taxable year of freed-up credit.

(B) *Election to use simplified method*. A taxpayer may elect to use the simplified credit reduction method for all taxable years to which this section applies by attaching a statement indicating such an election on the amended Federal income tax return or returns applying the adjustments of this section. If an election is made for any taxable year, it must be made for all taxable years. Once an election has been made, it can be revoked only with the permission of the Commissioner. Similarly, once returns have been filed applying the exact credit reduction method, an election to apply the simplified method can be made only with the consent of the Commissioner.

(iv) *Effect of credit reduction on credit carrybacks and carryforwards*. Under both the exact method and the simplified method, the determination of credit carrybacks and carryforwards to other taxable years is made on the basis of freed-up credits remaining after such reduction, plus any other unused credits. Thus, an amount of freed-up credits that is equal to the credit reduction amount shall not be allowed to reduce tax liability in any taxable year. Such disallowance is without regard to whether such credits would otherwise be allowed as a carryback or carryforward. No minimum tax liability shall be due with respect to the non-beneficial preferences for any taxable year.

(v) *Examples*. The following examples illustrate reduction of freed-up credits.

Example (10). Assume the facts in Example (8) above. The credit reduction amount for 1985 is $12,668, the amount of minimum tax attributable to L's non-beneficial preferences. This amount is allocated to reduce each category of freed-up credit and to each year from which such credit is carried over. L's $38,250 of freed-up credits consists of $18,250 of foreign tax credits carried forward from 1984, which were freed up by $40,978 of non-beneficial preferences, and $20,000 of investment tax credits carried forward from 1984, which were freed up by $43,478 of non-beneficial preferences.

(a) The apportionment of this credit reduction amount to each category of freed-up credit and each taxable year from which such credits are carried over is determined as follows under the exact credit reduction method:

(i) Foreign tax credits carried forward from 1984:

Non-beneficial preferences that freed up 1984 FTC	× .15 =	Credit reduction of 1984 FTC
$40,978	× .15 =	$6,146

(ii) Investment tax credits carried forward from 1984:

Non-beneficial preferences that freed up 1984 ITC	× .15 =	Credit reduction of 1984 ITC
$43,478	× .15 =	$6,522

Thus, the foreign tax credits from 1984 that are carried forward to 1986 are $12,104 ($18,250 minus $6,146). The investment tax credits from 1984 that are carried forward to 1986 are $13,478 ($20,000 minus $6,522).

(b) The reduction of the freed-up credit under the simplified credit reduction method is as follows:

(i) Foreign tax credit carried forward from 1984:

$$\text{Freed-up foreign tax credits from 1984} \times \frac{\text{Credit reduction amount}}{\text{Total freed-up credit}}$$
$$= \text{Credit reduction allocated to freed-up foreign tax credits carried forward from 1984}$$

$$\$18{,}250 \times \frac{\$12{,}668}{\$38{,}250} = \$6{,}044$$

(ii) Investment tax credits carried forward from 1984:

$$\text{Freed-up investment tax credits from 1984} \times \frac{\text{Credit reduction amount}}{\text{Total freed-up credit}}$$
$$= \text{Credit reduction allocated to freed-up investment tax credit carried forward from 1984}$$

$$\$20{,}000 \times \frac{\$12{,}668}{\$38{,}250} = \$6{,}624$$

Thus, under the simplified credit reduction method, L has $12,206 of foreign tax credits for 1984 ($18,250 minus $6,044) that are carried forward to 1986, and $13,376 of investment tax credits for 1984 ($20,000 minus $6,624) that are carried forward to 1986.

Example (11). Assume the same facts as in Example (10), except that the foreign tax credits available for use in 1985 include $10,750 in credits carried forward from 1980 and $14,250 in credits carried forward from 1984, rather than $25,000 carried forward from 1984. Thus, $4,000 of the freed-up foreign tax credit is carried over from 1980. The other $14,250 of freed-up foreign tax credit is carried over from 1984. The non-beneficial preferences that freed up the 1980 foreign tax credit are $10,000. The non-beneficial preferences that freed up the 1984 foreign tax credit are $30,978. Under the exact credit reduction method, the credit reduction amounts for each of these credits are determined as follows:

(a) Foreign tax credit carried forward from 1980:

$10,000 × .15 = $1,500

(b) Foreign tax credit carried forward from 1984:

$30,978 × .15 = $4,646

Thus, the foreign tax credit from 1984 that is carried forward to 1986 is $9,604 ($14,250 minus $4,646). Since the foreign tax credit from 1980 expires after 1985, none of that credit is carried forward to 1986.

(d) *Examples*. The following examples are comprehensive illustrations of the adjustments described in paragraph (c) of this section:

Example (12). This example illustrates the operation of the credit reduction adjustment when the amount of foreign tax credit allowed is subject to the overall limitation under section 904. For purposes of this example, assume that Corporation X has the following items for the 1984 taxable year:

Taxable income (determined as though preferences were not allowed)	$ 140,000
From foreign sources	70,000
Foreign tax credits from 1984	5,000
Foreign tax credits from 1983	7,000
Actual taxable income	50,000
From foreign sources	25,000

The credit reduction adjustment and minimum tax liability for the taxable year are determined as follows:

1. Taxable income (determined as though preferences were not allowed) $140,000
2. Tax preferences for 1984. 90,000
3. Taxable income (line 1 minus line 2) . . . 50,000
4. Regular tax on line 3 amount (actual regular tax) before credits:

   25,000 × .15 = $3,750
   25,000 × .18 = 4,500 8,250
5. Foreign tax credits allowed against regular tax (limited to 50% of actual regular tax under sec. 904) — 1984 foreign tax credits 4,125
6. Regular tax after credits (line 4 minus line 5) 4,125
7. Regular tax on line 1 amount (non-preference regular tax) before credits:

   $25,000 × .15 = $ 3,750
   25,000 × .18 = 4,500
   25,000 × .3 = 7,500
   25,000 × 4 = 10,000
   40,000 × 46 = 18,400. 44,150
8. Foreign tax credits allowed against non-preference regular tax:

   5,000 (1984 foreign tax credits)
   7,000 (1983 foreign tax credits) 12,000
   (the allowed credits do not exceed the section 904 limitation of $22,075)
9. Non-preference regular tax after credits (line 7 minus line 8) 32,150
10. Freed-up credits (line 8 minus line 5):

    1984 foreign tax credits $5,000
    (4,125)
    $875
    1983 foreign tax credits $7,000
    - 0 -
    7,000
    Total $7,875
11. Non-beneficial preferences are computed as set forth in the table below. Under this computation, non-beneficial preferences are considered to free up credits that would have offset non-preference regular tax beginning at the lowest tax rates at which income that was offset by tax preferences otherwise would have been subject to regular tax. In this case, income that was offset by tax preferences would have been taxed beginning at the 30 percent marginal tax rate.

Type	*Freed-up Credit*	*Divided by tax Rate*	*Non-beneficial preferences*
FTC (84)	$ 875	.30	$ 2,917
FTC (83)	6,625	.30	22,083
"	375	.40	938
	$7,875		$25,938

Total non-beneficial preferences 25,938

12. Beneficial preferences (line 2 minus line 11) 64,062
13. Minimum tax on total tax preferences ((line 2 minus the greater of line 6 or $10,000) × .15). 12,000
14. Minimum tax on beneficial preferences ((line 12 minus the greater of line 6 or $10,000) × .15) 8,109
15. Credit reduction amount (line 13 minus line 14) 3,891
16. Reduction of freed-up credits under the exact method (subtotals of line 11 multiplied by .15):

    (a) 1984 foreign tax credits:
    $2,917 × .15 = $438
    (b) 1983 foreign tax credits:
    ($22,083 + $938) × .15 = $3,453
    (c) Total credit reduction. 3,891

Note: If X had elected to use the simplified credit reduction method, the amount of credit reduction would be determined by multiplying the amount of freed-up credit in each category and taxable year by the following ratio:

$$\frac{\text{credit reduction amount}}{\text{total freed-up credit}} = \frac{\$3,891}{\$7,875} = .494$$

Under this method, the 1984 freed-up foreign tax credits would be reduced by $433 ($875 × .494) and the 1983 freed-up foreign tax credits would be reduced by $3,458 ($7,000 × 494).

17. Freed-up credits after reduction under the exact method (line 10 subtotal minus line 16 subtotals):

    (a) 1984 foreign tax credits (875 minus 438) 437
    (b) 1983 foreign tax credits (7,000 minus 3,453) 3,547

Thus, assuming that Corporation X did not elect to use the simplified method, Corporation X will carryover $437 of 1984 foreign tax credits to 1985 and $3,547 of 1983 foreign tax credits to 1985.

Had Corporation X elected to use the simplified method, freed-up credits after reduction would be as follows:

(a) 1984 foreign tax credits (875 minus 433). . 442
(b) 1983 foreign tax credits (7,000 minus 3,458) 3,542

Example (13). Corporation X has the following items for its 1985 taxable year:

Taxable income (determined as though preferences were not allowed)	$1,500,000
1984 investment tax credits	400,000
1985 investment tax credits	100,000
Actual taxable income	1,000,000

The credit reduction and minimum tax of X for 1985 are determined as follows:

1. Taxable income determined as though preferences were not allowed $1,500,000
2. Tax preferences for 1985 500,000
3. Taxable income (line 1 minus line 2) 1,000,000
4. Regular tax on line 3 amount (actual regular tax) before credits:

   $25,000 × .15 = $ 3,750
   25,000 × .18 = 4,500
   25,000 × .30 = 7,500
   25,000 × .40 = 10,000
   900,000 × .46 = 414,000 439,750
5. Investment tax credits allowed (limited under section 38 (c) to $25,000 of net tax liability, plus 85 percent of net tax liability in excess of $25,000 377,537
6. Regular tax after credits (line 4 minus line 5) 62,212
7. Regular tax on line 1 amount (non-preference regular tax) before credits:

   $ 25,000 × .15 = $ 3,750
   25,000 × .18 = 4,500
   25,000 × .30 = 7,500
   25,000 × .40 = 10,000
   900,000 × .46 = 414,000
   405,000 × .51 = 206,550
   95,000 × .46 = 43,700. 690,000
8. Investment tax credits allowed against non-preference regular tax 500,000
9. Non-preference regular tax after credits (line 7 minus line 8) 190,000
10. Freed-up credits (line 8 minus line 5):

    1984 investment tax credit $400,000
    (377,537)
    22,463
    1985 investment tax credit $100,000
    0
    100,000
    Total $122,463
11. Non-beneficial preferences are computed as set forth in the table below. Under this computation, non-beneficial preferences are considered to free up credits that would have offset non-preference regular tax beginning at the lowest tax rates at which income that was offset by tax preferences otherwise would have been subject to regular tax. In this case, income that was offset by tax preferences would have been taxed beginning at the 51 percent marginal tax rate. Although some of the income offset by preferences would be taxed at the 46 percent marginal rate (because taxable income in excess of $1,405,000 is not subject to the 5 percent addition to tax on taxable income in excess of $1 million), the 51 percent marginal rate is taken into account first.

Type	*Freed-up Credit*	*Divided by tax Rate*	*Non-beneficial preferences*
ITC (84)	$22,463	.51	$44,045
ITC (85)	100,000	.51	196,078
	$122,463		$240,123

Total non-beneficial preferences 240,123

12. Beneficial preferences (line 2 minus line 11) 259,877
13. Minimum tax on total tax preferences ((line 2 minus the greater of line 6 or $10,000) × .15). 65,668
14. Minimum tax on beneficial preferences ((line 12 minus the greater of line 6 or $10,000) × .15) 29,650

15. Credit reduction amount (line 13 minus line 14) 36,018
16. Reduction of freed-up credits under the exact method (subtotals of line 11 multiplied by .15):
   (a) 1984 investment tax credits: $44,045 × .15 = $6,607
   (b) 1985 investment tax credits: $196,078 × .15 = $29,411
   (c) Total credit reduction. 36,018
17. Freed-up credits after reduction (assuming that Corporation X does not elect the simplified method):
   (a) 1984 investment credit ($22,463 minus $6,607) 15,856
   (b) 1985 investment credit ($100,000 minus $29,411). 70,589

(e) *Miscellaneous rules*—(1) *Investment Credit Recapture*. If during any taxable year, property to which section 47 applies is disposed of, then for purposes of determining any increase in tax under section 47 for such year, the amount of any reduction under this section of freed-up section 38 credit which was earned in the year the property was placed in service shall be treated as a credit that was allowed in a prior taxable year.

Example (14). Assume corporation D places property in service in 1983 that generates investment tax credits of $10,000. D earned no other investment tax credits in 1983. None of the investment tax credits are used to reduce tax liability in 1983 or any prior years. In 1984, D uses $1,000 of this credit to reduce regular tax liability. In addition, D has items of tax preference in 1984. However, under section 58 (h), D is not liable for minimum tax on any of these preference items because none of these preference items produced a tax benefit in 1984. As a result, an adjustment is made under the provisions of §1.58-9T and the investment tax credit carryforward from 1983 is reduced by $4,000. Thus, D has an investment tax credit carryforward of $5,000 that is attributable to the property placed in service in 1983. In 1986, the property is disposed of and the investment tax credits earned in 1983 are recomputed as required under section 47. This recomputation results in a reduction of $6,000 of the investment tax credits earned in 1983. D must now adjust its 1983 investment tax credit carryforward under section 47(a)(6) by reducing this carryforward to zero. In addition, D has an additional tax liability of $1,000 for 1986.

(2) *Period of limitations; adjustments to tax liability*. (i) The adjustments described in this section shall, in general, apply for purposes of assessing deficiencies or claiming refunds of tax for any taxable year for which the tax liability is affected by the adjustments of this section, provided that the period of limitations under section 6501 has not expired for such taxable year. Therefore, these adjustments generally apply for purposes of assessing deficiencies and refunding any overpayment of tax for all years for which the period of limitations has not expired regardless of whether the period of limitations has expired for the taxable year in which the non-beneficial preferences arose.

(ii) However, the adjustments of this section do not apply to reduce otherwise allowable credits that were freed up by such non-beneficial preferences where:

(A) The taxpayer paid minimum tax on all tax preference items arising in the taxable year in which the non-beneficial preferences arose;

(B) The taxpayer has not made a claim for a credit or refund for such minimum tax; and

(C) The period of limitations for claiming a credit or refund under section 6511 has expired for such taxable year.

(iii) Further, if—

(A) the taxpayer never paid minimum tax attributable to non-beneficial preferences,

(B) credits that were freed up by such preferences were used to reduce tax liability for a taxable year for which the period of limitations has expired, and

(C) credits so used exceed the amount of credits that would have been available if the credit reduction required under this section with respect to such preferences had been made,

then the taxpayer shall be liable for the minimum tax equal to the amount of credits so used, provided the period of limitations has not expired for the taxable year in which preferences arose.

(3) *Claims for credit or refund*. A taxpayer may claim a credit or refund of minimum tax that was paid on non-beneficial preferences. However, such a claim for a credit or refund shall be disallowed to the extent that the taxpayer has reduced tax liability in a taxable year for which the period of limitations has expired by using freed-up credits in excess of the amount that would have been available if the credit reduction required under this section had been made. Such claim must be made by filing an amended return for the taxable year for which such minimum tax was paid. Further, if a claim for credit or refund is filed, amended returns must also be filed for any taxable year for which tax liability would be affected as a result of the reduction, under this section, of credits freed up by such non-beneficial preferences. See section 6511 and the regulations thereunder regarding the period of limitations for claiming a credit or refund.

(4) *Carryforwards of foreign tax credit to taxable years after 1986*. In the case of foreign tax credit carryforwards to taxable years beginning after December 31, 1986, reductions in such credits required under this section shall apply for purposes of computing the alternative minimum tax foreign tax credit under section 59(a) of the Internal Revenue Code of 1986 as well as for purposes of computing the foreign tax credit for regular tax purposes.

(5) *Credit carrybacks*. If credit carrybacks increase the amount of credits for a taxable year, the adjustments described in this section shall be recomputed taking into account the additional credits. This rule may be illustrated by the following examples:

Example (15). Assume that in 1981, corporation D has actual taxable income of $72,500 and regular tax before credits of $15,000. Also assume that, in computing actual regular taxable income, D made use of $36,739 of tax preference items, so that D's taxable income determined as though preference were not allowed would be $109,239. D's non-preference regular tax before credits is $30,000. D earned $25,000 of foreign tax credits in 1981, none of which exceed the limitation under section 904 determined using either actual regular taxable income or the non-preference taxable income. These credits reduce actual regular tax to zero ($0) and would have reduced non-preference regular tax to $5,000 ($30,000 minus $25,000). Thus, D has freed-up foreign tax credits from 1981 of $10,000 ($25,000 minus $15,000). Pursuant to the adjustments required under this section, D determines that its credit reduction amount is $3,843 and reduces its freed-up credit (and its credit carryover) from 1981 to $6,157 ($10,000 minus $3,843). D also pays minimum tax of $167 on $11,114 of beneficial preferences (($11,114 minus $10,000) multiplied by .15).

In 1982, D earns additional foreign tax credits. After application of the foreign tax credit carryback rules, D would have $5,000 of 1982 foreign tax credits available for use in 1981. D must recalculate the adjustments required under this section by treating $5,000 of foreign tax credit from 1982 as carried back and (assuming that these credits do not exceed the limitation under section 904) used to reduce non-preference regular tax liability in 1981 to zero ($0). That is, $5,000 of the foreign tax credits earned in 1982 are treated as credits freed up because of D's tax preference items in 1981. Pursuant to the rules set forth herein, D must take into account the foreign tax credits from both 1981 and 1982 in determining to what extent a tax benefit was derived from the preference items used to determine actual regular tax liability in 1981 and in computing the credit reduction amount. When the $5,000 of foreign tax credits from 1982 are considered, all preferences become non-beneficial preferences, and the credit reduction amount is $4,010. Assuming that D elects the simplified method, the 1981 freed-up credits and the 1982 freed-up credits will each be reduced by the following percentage:

$$\frac{4{,}010 \text{ (credit reduction amount)}}{15{,}000 \text{ (total freed up credits)}} = .2673$$

The 1981 freed-up foreign tax credits of $10,000 are thus reduced by $2,673 ($10,000 multiplied by .2673), to $7,327 and the 1982 freed-up foreign tax credits of $5,000 are reduced by $1,334 ($5,000 multiplied by .2673) to $3,666. D also files a claim for credit or refund of the $167 of minimum tax paid in 1981.

Example (16). In 1985, corporation E's non-preference regular taxable income is $25,000. E has no available credits. It pays zero in regular tax, however, because of $25,000 in preference items. E paid $2,250 of minimum tax on these preferences (($25,000 minus $10,000) multiplied by .15). In 1986, E has additional investment tax credits. After application of the investment tax credit carryback rules, E would have $1,000 investment tax credit from 1986 available for use in 1985. E must recompute the adjustments required under this section by treating $1,000 of these 1986 investment tax credits as carried back and used to reduce non-preference regular tax liability for 1985. Pursuant to the rules of this section, all of these $1,000 of credits are freed-up credits. Non-beneficial preferences are $6,667 ($1,000 grossed up at a 15 percent regular tax rate). Beneficial preferences are $18,333 ($25,000 minus $6,667). Minimum tax on all preferences would be $2,250 (($25,000 minus $10,000) multiplied by .15); minimum tax on beneficial preferences would be $1,250 (($18,333 minus $10,000) multiplied by .15) Minimum tax attributable to the non-beneficial preferences is thus $1,000 ($2,250 minus $1,250), which is the credit reduction amount. E thus reduces the $1,000 of credits carried back to 1985 to zero. Under the rules of this section, the amount of minimum tax due for 1985 is redetermined. It is equal to the minimum tax on beneficial preferences, which, as described above, is $1,250. Because E paid minimum tax of $2,250 in 1985, E files a claim for credit or refund for $1,000 of the minimum tax paid in 1985.

(f) *Treatment of net operating losses.* [Reserved]

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

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

Authority: 26 U.S.C. 7805

Par. 4. Section 602.101(c) is amended by adding in the appropriate place in the table:

" §1.58-9T(c)(5)(iii)(B) 1545-1093."

" §1.58-9T(e)(3). . . . . . .1545-1093."

There is need for immediate guidance with the provisions contained in this Treasury decision. For this reason, it is found impracticable to issue it with notice and public procedure under subsection (b) of section 553 of Title 5 of the United States Code or subject to the effective date limitations of subsection (d) of that section.

Michael J. Murphy,
Acting Commissioner of Internal Revenue.

Approved March 16, 1989.

Dennis E. Ross,
Acting Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on May 4, 1989, 8:45 a.m., and published in the issue of the Federal Register for May 5, 1989, 54 F.R. 19363)

Part VII.—Environmental Tax

Section 59A.—Environmental Tax

(Also Part I, Section 1363.)

Section 59A environmental tax and S corporations. An S corporation is not subject to the section 59A environmental tax because under section 1361 of the Code an S corporation is not subject to the taxes imposed by Chapter 1 of the Code and section 59A is a Chapter 1 tax.

Rev. Rul. 89-82

ISSUE

Is an S corporation subject to the environmental tax imposed by section 59A of the Internal Revenue Code?

FACTS

X is an S corporation as defined under section 1361 of the Internal Revenue Code.

LAW AND ANALYSIS

Section 59A(a) of the Code provides that in the case of a corporation there is imposed a tax equal to 0.12 percent of the excess of the corporation's modified alternative minimum taxable income (MAMTI) for the taxable year over $2 million.

Under section 59A(b), MAMTI is defined to mean the alternative minimum taxable income (AMTI) (as defined in section 55(b)(2)), but determined without regard to the alternative tax net operating loss deduction (as defined in section 56(d)), and the deduction allowed under section 164(a)(5) (and the last sentence of section 56(f)(2)(B)). Pursuant to section 59A(e), this tax is applicable to taxable years beginning after December 31, 1986, and before January 1, 1992, but is subject to earlier termination under section 4611 where applicable.

Under section 1361(a), an S corporation is a small business corporation, as that term is defined under section 1361(b) of the Code, for which an election under section 1362(a) is in effect. Section 1363(a) provides that, except as otherwise provided in Subchapter S, an S corporation is not subject to the taxes imposed by Chapter 1 of the Code. The environmental tax imposed on corporations by section 59A is a tax imposed by Chapter 1 of the Code and no provision of Subchapter S provides that an S corporation is subject to the environmental tax. Therefore, an S corporation is not subject to the section 59A tax.

HOLDING

An S corporation is not subject to the environmental tax imposed by section 59A of the Code.

Subchapter B.—Computation of Taxable Income

Part I.—Deinition of Gross Income, Adjusted Gross Income, Taxable Income, etc.

Section 67.—2-Percent Floor on Miscellaneous Itemized Deductions

If a taxpayer incurs expenses to secure a ruling from the Service on a non-business tax issue and deducts those expenses under section 212 of the Code, are those expenses considered miscellaneous itemized deductions subject to the 2-percent floor provided by section 67. See Rev. Rul. 89-68, page 82.

Part III.—Items Specifically Excluded from Gross Income

Section 101.—Certain Death Benefits

26 CFR 1.101-1: Exclusion from gross income of proceeds of life insurance contracts payable by reason of death.

Whether the Service will rule as to whether proceeds of "self-insured" life insurance and survivor benefit plans established through a trust qualified under section 501(c)(9) of the Code are excludable from the beneficiary's gross income as amounts paid by reason of the death of the insured under section 101(a). See Rev. Proc. 89-36, page 919.

Section 103.—Interest on State and Local Bonds

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

Average area purchase price safe harbor limitations for Guam and Puerto Rico are added to the list in Rev. Proc. 88-48, 1988-2 C.B. 635. See Rev. Proc. 89-27, page 892.

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

The median gross income for the United States and the average purchase prices for the United States are set forth for use in computing the income limitation under section 143(f)(5) of the Code. See Rev. Proc. 89-32, page 904.

26 CFR 1.103-8: Interest on bonds to finance certain exempt facilities.

Guidance is provided for computing the income limits applicable to exempt facility bonds issued to provide for qualified residential rental projects. See Rev. Rul. 89-24, page 24.

26 CFR 1.103-14: Temporary investments, reserve funds, and refunding issues.

Rev. Proc. 89-3, page 761, this Bulletin, is modified regarding whether the Service will issue rulings that state or local governmental obligations are arbitrage bonds under former section 103(c)(2) of the Code if bond proceeds are invested at a materially higher yield beyond a temporary period. See Rev. Proc. 89-5, page 774.

Section 133.—Interest on Certain Loans Used to Acquire Employer Securities

26 CFR 1.133-1T: Questions and answers relating to interest on certain loans used to acquire employer securities.

Interest on certain loans used to acquire employer securities. A corporation's actions as an underwriter in the sale of notes evidencing a securities acquisition loan will not adversely affect the status, under section 133 of the Code, of interest received or accrued on such notes. A qualified lender will be entitled to the partial interest exclusion of section 133 without regard to whether each previous holder of the note was a qualified lender.

Rev. Rul. 89-76

ISSUES

1) Whether X corporation's actions as an underwriter in the sale of ESOP notes will adversely affect the status, under section 133 of the Internal Revenue Code, of interest on an ESOP note that is received or accrued by a "qualified lender" (as described in section 133(a)).

2) Whether a qualified lender will be entitled to the partial interest exclusion of section 133 with respect to interest received or accrued on a note evidencing a securities acquisition loan for the period that it holds the note without regard to whether each previous holder of the note was a qualified lender.

FACTS

X is a corporation whose activities consist of underwriting debt and equity securities and providing research and financial services to clients. *X* is not a qualified lender as described in section 133(a).

Corporation *Y* maintains an employee stock ownership plan (ESOP) that is a qualified plan under section 401(a) and satisfies the requirements of section 4975(e)(7). The ESOP will borrow money through the issuance of notes guaranteed by Corporation *Y* and will purchase employer securities (as defined in section 409(l)) with the borrowed funds.

X will act as the ESOP's underwriter in the sale of the notes guaranteed by Corporation *Y*. *X* will underwrite the notes on either a "best efforts" or "firm commitment" basis. In a "best efforts" underwriting, *X* arranges for the borrower (the ESOP trust) to sell the notes directly to investors. This is contrasted with a "firm commitment" underwriting in which the ESOP trust initially sells all the notes to *X* which then resells the notes to investors. If *X* cannot resell the ESOP notes, the ESOP trust has no obligation to repurchase the notes. (See Rev. Rul. 78-294, 1978-2 C.B. 141, for a further discussion of these underwriting techniques.) *X* will receive a percentage of the principal amount of the notes as commission.

X sells or arranges to sell the note evidencing the ESOP loan to *Z*, a qualified lender. *Z* subsequently sells the note to *R*, an underwriter who is not a qualified lender. *R*, in turn, sells the note to its client *W*, who is a qualified lender.

LAW AND ANALYSIS

Section 133(a) of the Code provides that fifty percent of the interest received or accrued with respect to a "securities acquisition loan" by (1) a bank (as defined in section 581); (2) an insurance company to which subchapter L applies; (3) a corporation actively engaged in the business of lending money; or (4) a regulated investment company (as defined in section 851) is excludable from gross income.

The actions of *X* as an underwriter (on either a best efforts or firm commitment basis) will not adversely affect the status, under section 133 of the Code, of interest on an ESOP note that is received or accrued by a qualified lender. However, if *X* receives or accrues any interest with respect to an ESOP note, the interest will not be excludable under section 133 because *X* is not a qualified lender.

Interest received or accrued by *Z* with respect to the notes purchased from *X* in either a best efforts or firm commitment underwriting would be eligible for the partial interest exclusion of section 133 because *Z* is a qualified lender.

If *X*, or another investor that purchased the ESOP note, sells the note evidencing the ESOP loan to a party that is not a qualified lender, the partial interest exclusion of section 133 will apply to interest received or accrued by a qualified lender who subsequently purchases the note regardless of whether all prior holders of the note were qualified lenders.

Therefore, if *Z* subsequently sells the note to *R*, and *R* then sells the note to *W*, the interest received or accrued by *W* is eligible for the partial interest exclusion of section 133 because *W* is a qualified lender.

HOLDINGS

(1) X corporation's actions as an underwriter (on either a best efforts or firm commitment basis) in the sale of notes evidencing a securities acquisition loan, will not adversely affect the status, under section 133 of the Code, of interest received or accrued by a qualified lender with respect to the ESOP notes. Question and Answer 3 of section 1.133-1T of the Temporary Income Tax Regulations will be modified in a manner consistent with the holding of this revenue ruling.

(2) A qualified lender will be entitled to the partial interest exclusion of section 133 with respect to interest received or accrued on a note evidencing a securities acquisition loan for the period that it holds the note without regard to whether each previous holder of the note was a qualified lender.

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

Subpart A.—Private Activity Bonds

Section 142.—Exempt Facility Bond

(Also Sections 42, 103, 6652; 1.42-1T, 1.103-8.)

Exempt facility bonds; low-income housing credit. Guidance is provided for computing the income limits applicable to exempt facility bonds issued to provide for qualified residential rental projects under section 142 of the Code and to low-income housing credits under section 42.

Rev. Rul. 89-24

This revenue ruling provides the manner in which properly to compute the income limits applicable both to exempt facility bonds issued to provide for qualified residential rental projects under section 142 of the Internal Revenue Code and to low-income housing credits under section 42.

LAW

Section 1301 of the Tax Reform Act of 1986, 1986-3 (Vol. 1) C.B. 524 (the Act), revised the income limits applicable to exempt facility bonds issued to provide for multifamily residential rental projects. *Compare* section 142(d) and former section 103(b)(4)(A) of the Code.

In general, in order for interest on an exempt facility bond issued to provide for a multifamily residential rental project to be tax-exempt, the project must meet the income limit requirement of section 142(d)(1) of the Code. Under section 142(d)(1), a "qualified residential rental project" is defined to include only residential rental projects where, either (A) 20 percent or more of the residential units in the project are occupied by individuals whose income is 50 percent or less of the area median gross income (the 20-50 requirement), or (B) 40 percent or more of the residential units in the project are occupied by individuals whose income is 60 percent or less of the area median gross income (the 40-60 requirement), whichever is elected by the issuer of the bonds providing for such project.

Section 142(d)(4) of the Code provides that, in the case of a deep rent skewed project, 15 percent or more of the low-income units must be occupied by individuals whose income is 40 percent or less of the area median gross income.

Section 142(d)(2) of the Code provides that the income of individuals and the area median gross income shall be determined by the Secretary in a manner consistent with determinations of lower income families and area median gross income under section 8 of the United States Housing Act of 1937 or, if such program is terminated, under such program as in effect immediately before such termination. Determinations under the preceding sentence shall include adjustments for family size.

Section 252 of the Act enacted section 42 of the Code, which provides a new federal income tax credit that may be claimed by owners of residential rental projects providing low-income housing. Section 42(a) provides that the amount of the credit shall be based on an applicable percentage of the qualified basis of each qualified low-income building. Section 42(c)(2) defines the term "qualified low-income building" to mean, in part, any building that at all times during the compliance period with respect to such building is part of a qualified low-income housing project.

Section 42(g)(1) provides that the term "qualified low-income housing project" means any project for residential rental property if, either (A) 20 percent or more of the units in the project are both rent-restricted and occupied by individuals whose income is 50 percent or less of the area median gross income, or (B) 40 percent or more of the units in the project are both rent-restricted and occupied by individuals whose income is 60 percent or less of the area median gross income, whichever is elected by the taxpayer.

Section 42(g)(4) of the Code provides, in part, that paragraph (2) (other than subparagraph (A)) and paragraph (4) of section 142(d) shall apply for purposes of determining whether any project is a qualified low-income housing project and whether any unit is a low-income unit.

ANALYSIS AND HOLDING

The income limits applicable to qualified residential rental projects and to qualified low-income housing projects are required to be made in a manner consistent with determinations of lower income families under section 8 of the United States Housing Act of 1937. With respect to the 20-50 requirement of sections 142(d)(1)(A) and 42(g)(1)(A) of the Code, 20 percent or more of the applicable units must be occupied by individuals or families having incomes equal to or less than the income limit for a "very low-income" family of the same size. With respect to the 40-60 requirement of sections 142(d)(1)(B) and 42(g)(1)(B) , 40 percent of the applicable units must be occupied by individuals or families having incomes equal to 120 percent or less of the income limit for a very low-income family of the same size.

With respect to certain deep rent skewed projects, as described in section 142(d)(4), the determination of whether 15 percent of the low-income units are occupied by individuals having incomes equal to 40 percent or less of the area median gross income shall be made by determining whether 15 percent of such units are occupied by individuals or families having incomes equal to or less than 80 percent of the income limit for a very low-income family of the same size.

The income limits for very low-income families are computed and listed, according to family size, by the Department of Housing and Urban Development (HUD) for every Metropolitan Statistical Area, Primary Metropolitan Statistical Area, and nonmetropolitan county of the United States and Puerto Rico. HUD also releases income limits for the possessions of Guam and the Virgin Islands.

A list of income limits released by HUD may be relied upon until 30 days after the Internal Revenue Service publishes an announcement or notice in the Internal Revenue Bulletin indicating that HUD has released updated income limits.

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

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

Average area purchase price safe harbor limitations for Guam and Puerto Rico are added to the list in Rev. Proc. 88-48, 1988-2 C.B. 635. See Rev. Proc. 89-27, page 892.

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

The median gross income for the United States and the average purchase prices for the United States are set forth for use in computing the income limitation under section 143(f)(5) of the Code. See Rev. Proc. 89-32, page 904.

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

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Section 148.—Arbitrage

26 CFR 1.148-OT: Scope and effective date of restrictions on arbitrage (temporary).

T.D. 8252

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

Arbitrage Restrictions on Tax-Exempt Bonds

AGENCY: Internal Revenue Service, Treasury.

ACTION: Temporary regulations.

SUMMARY: This document contains temporary regulations relating to arbitrage restrictions on tax-exempt bonds. In addition, the text of the temporary regulations set forth in this document serves as the text of the proposed regulations cross-referenced in the notice of proposed rulemaking * * * [FI-91-86, page 1011, this Bulletin]. Changes to the applicable law were made by the Tax Reform Act of 1986 and the Technical and Miscellaneous Revenue Act of 1988. These regulations affect issuers of tax-exempt bonds and provide them with the guidance needed to comply with the law.

EFFECTIVE DATE: The temporary regulations generally are effective for private activity bonds issued after December 31, 1985, and for bonds other than private activity bonds issued after August 31, 1986.

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

This regulation is 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 this regulation have been reviewed and, pending receipt and evaluation of public comments, approved by the Office of Management and Budget (OMB) under control number 1545-1098. The estimated annual burden per respondent varies from 60 minutes to 120 minutes, depending on individual circumstances, with an estimated average of 90 minutes.

These estimates are an approximation of the average time expected to be necessary for the collections of information. They are based on such information as is available to the Internal Revenue Service. Individual respondents may require greater or less time, depending on their particular circumstances. For further information concerning these collections of information, and where to submit comments on these collections of information, the accuracy of the estimated burden, and suggestions for reducing this burden, please refer to the cross-reference notice of proposed rulemaking published in * * * [FI-91-86, page 1011, this Bulletin].

Issuance of Proposed Regulation and Submission to Small Business Administration

The rules contained in this document are also being issued as proposed regulations by the notice of proposed rulemaking on this subject in * * * [page 1011, this Bulletin]. Pursuant to section 7805(f) of the Internal Revenue Code, a copy of the rules will be submitted to the Administrator of the Small Business Administration for comment on their impact on small business.

Background

This document amends the Income Tax Regulations (26 CFR Part 1) to provide temporary rules relating to arbitrage restrictions on tax-exempt bonds under sections 148 and 149(d) of the Internal Revenue Code of 1986. The temporary regulations reflect the addition to the Internal Revenue Code of sections 148 and 149(d) by section 1301 of the Tax Reform Act of 1986 (100 Stat. 2602) [Pub. L. 99-514, 1986-3 C.B. (Vol. 1) 1, 558], amendments made by sections 1013, 4005(d), and 5053(b) of the Technical and Miscellaneous Revenue Act of 1988 (Pub. L. No. 100-647), and the applicable effective date provisions of sections 1311-1314 of the Tax Reform Act of 1986 (100 Stat. 2659) [1986-3 C.B. (Vol. 1) 1, 576].

Explanation of Provisions

I. Scope and Effective Date of Restrictions on Arbitrage

A. Section 148 in General

Section 103(a) of the Internal Revenue Code of 1986 provides generally that gross income does not include interest on any State or local bond. If a State or local bond is an arbitrage bond (within the meaning of section 148), interest on the bond is not excluded from gross income under section 103(a). See, section 103(b)(2). Section 148 was added to the Internal Revenue Code by section 1301 of the Tax Reform Act of 1986 (1986 Act) and amended by the Technical and Miscellaneous Revenue Act of 1988 (1988 Act).

The federal income tax exemption of interest on State and local bonds enables State and local governments to borrow at lower interest rates than taxable issuers. This lower interest rate enables State and local governments to finance their governmental activities at significantly less cost. The lower interest rate also provides the potential to benefit from tax arbitrage by investing proceeds of the bonds in taxable investments. The principal purpose of section 148 is to eliminate significant arbitrage incentives to issue more bonds, to issue bonds earlier, and to leave bonds outstanding longer than necessary to carry out the governmental purpose of the tax-exempt issue. A secondary purpose of section 148 is to minimize the tax arbitrage benefit associated with investing proceeds of the bonds in taxable investments. Minimizing this tax benefit targets the tax benefits to the activities for which the tax exemption is provided.

The arbitrage restrictions applicable to State and local bonds formerly were contained in section 103(c) of the Internal Revenue Code of 1954 (1954 Code). Regulations under section 103(c) are contained in §§1.103-13, 1.103-14, 1.103-15, and 1.103-15AT.

The 1986 Act revised the arbitrage restrictions applicable to State and local bonds in response to a growing tendency to maximize arbitrage profits in connection with the issuance of such bonds. Bonds routinely were issued in larger amounts and earlier than necessary to satisfy actual financing needs. A large volume of so-called collapsible bonds were issued, the proceeds of which may never be used for a governmental purpose. A lack of accurate and detailed rules under prior law led to arbitrage abuses, particularly in connection with advance refundings. Section 148 and section 149(d) (relating to advance refundings) were enacted to prevent these and other abuses from recurring.

The most significant changes made by the 1986 Act are the following:

1. Under section 148(a), a bond that is part of an issue is an arbitrage bond if the issuer reasonably expects (at the time of issuance of the bond) to use any portion of the proceeds of the issue to acquire higher yielding investments or to replace funds that were used to acquire such investments unless a specific exception applies. In addition, a bond is treated as an arbitrage bond if the issuer at any time intentionally uses any portion of the proceeds of the issue in such manner.

2. Under section 148(b), the arbitrage restrictions apply to any annuity contract or investment-type property. In addition, under section 148(b) as amended by the 1988 Act, the arbitrage restrictions apply to tax-exempt bonds subject to the alternative minimum tax if acquired with proceeds of bonds issued after March 31, 1988 that are not subject to the alternative minimum tax.

3. Under section 148(c), the initial temporary period for proceeds to be used to make loans is subject to special limits. In addition, under section 149(f) as added by the 1988 Act, pooled financing bonds issued after October 21, 1988 are subject to additional restrictions, including a requirement that 95 percent or more of the lendable proceeds are reasonably expected to be loaned within 3 years.

4. Under section 148(d)(1), the amount of proceeds of the issue that may be invested in higher yielding investments as part of a reasonably required reserve or replacement fund generally is limited to 10 percent of the proceeds of the issue.

5. Under section 148(d)(2), the amount of proceeds from the sale of the

issue that may be part of a reserve or replacement fund generally is limited to 10 percent of the proceeds of the issue.

6. Under section 148(d)(3), the restrictions on investing in higher yielding nonpurpose investments apply to all private activity bonds other than qualified 501(c)(3) bonds.

7. Under section 148(e), the minor portion that may be invested in higher yielding investments is limited to the lesser of 5 percent of the proceeds of the issue and $100,000.

8. Under section 148(f), the requirement that issuers rebate arbitrage profits on nonpurpose investments to the United States is extended to all bonds (other than qualified mortgage bonds and qualified veterans' mortgage bonds subject to the arbitrage rebate requirement of section 143(g)(3)). In addition, under section 148(f) as amended by the 1988 Act, qualified mortgage bonds issued after December 31, 1988 are subject to the arbitrage rebate requirement of section 148(f) rather than section 143(g)(3).

9. Under section 148(h), the yield on the issue is determined on the basis of the issue price to the public.

10. Under section 149(d), advance refundings are subject to several additional restrictions relating to arbitrage.

B. Temporary Regulations Under Section 148

Section 1.148-0T describes the scope and effective date of section 148 and the temporary regulations thereunder and includes a list of the subjects covered by the regulations.

Sections 1.148-1T through 1.148-8T provide rules relating to the arbitrage rebate requirement of section 148(f). A substantial portion of these rules are reserved and will be the subject of a future notice.

Section 1.148-9T provides that some of the new rules apply for purposes of section 148 generally. Except to the extent changed by the 1986 or 1988 Act or by §1.148-9T, issuers should rely on the rules contained in §§1.103-13, 1.103-14, and 1.103-15 for purposes of determining compliance with the requirements of section 148 (other than section 148(f)).

Section 1.150-1T provides definitions and special rules relating to the tax exempt bond requirements in general.

C. Effective Dates

Section 148, as added by the 1986 Act, generally applies to bonds issued after August 15, 1986 (after August 31, 1986 if the bond is a governmental bond described in section 1312(c)(2) of the 1986 Act). In addition, the arbitrage rebate requirement of section 148(f) applies to any bond issued after December 31, 1985 if the bond is not a governmental bond described in section 1312(c)(2) of the 1986 Act (after 3 p.m. E.D.T., July 17, 1986 if the bond is a governmental pool bond described in sections 1312(c)(2) and 1314(d)(3)).

Sections 1.148-1T through 1.148-8T generally apply to any bond to which the arbitrage rebate requirement of section 148(f) applies. An exception is provided for issues retired on or before May 15, 1989, if the issuer in good faith determines and pays the final rebate (if any) no later than the later of May 15, 1989, and the date 60 days after the issue is retired. In the case of any issue to which the new rules apply, the final rebate is considered timely paid if paid no later than January 16, 1990.

The Treasury Department and the Internal Revenue Service carefully considered whether the new rules should apply only to bonds issued after the date of publication, and whether issuers should be allowed to apply the rules in §1.103-15AT of the temporary regulations for purposes of determining compliance with the requirements of section 148(f) in the case of bonds issued before such date. The determination was made, however, that general transitional relief was not necessary or appropriate for bonds still outstanding after the date of publication.

Section 148(f) requires issuers to rebate earnings in excess of the yield on the issue and any income earned on the excess as a condition of tax-exemption. The first rebate with respect to most of the bonds is not due until 1991 or 1992, and many of the bonds will remain outstanding a long time thereafter. Section 148(f), by itself, provides no guidance as to how the rebate is to be computed. In the absence of guidance, issuers could not determine whether they are complying with the requirements of section 148(f), and the Internal Revenue Service could not effectively administer the requirements.

Moreover, the rules in §1.103-15AT were developed to implement the arbitrage rebate requirement of section 103(c)(6)(D) of the 1954 Code, which applied only to certain industrial development bonds (IDBs). Those rules were not intended to apply to other types of bonds and do not provide the necessary detail or special rules needed to accommodate other bonds. Furthermore, it is important to note that the rebate computation under §1.103-15AT can be very complicated, that the results under those rules are often quite harsh, and that the results under the new rules are ordinarily more favorable for issuers.

Although general transitional relief was determined not to be necessary or appropriate, several special transition rules have been provided to protect issuers that reasonably may have relied on regulations promulgated under section 103(c) of the 1954 Code from any material adverse effect that might otherwise arise from such reliance. These transition rules are described below and generally apply to issues sold on or before May 15, 1989, and issued on or before June 14, 1989. Public comments are invited regarding any additional transitional rules that may be necessary or appropriate.

Issuers of certain IDBs to which the arbitrage rebate requirement of section 103(c)(6)(D) of the 1954 Code applies may elect to apply the new rules for purposes of determining compliance with the requirements of section 103(c)(6)(D). Absent this election, the rules in §1.103-15AT will apply.

Section 1.148-9T generally applies to any bond sold after May 15, 1989, or issued after June 14, 1989.

II. Required Rebate to the United States

A. In General

Section 148(f) requires issuers of State and local bonds to rebate arbitrage profits from investing in nonpurpose investments as a condition of tax exemption. This requirement is intended to minimize the tax arbitrage benefit associated with investing proceeds of the bonds in taxable investments, and to provide the accuracy needed to prevent abuses that occurred under prior law from recurring.

B. Exceptions to Rebate Requirement

Congress recognized the potential complexity and administrative burdens associated with requiring arbitrage profits to be rebated and, accordingly, provided two exceptions to the requirement. One exception applies to governmental bonds issued by small issuers with general taxing powers. Under this exception, the rebate does not apply to many small towns, cities, counties, and school districts. The other exception provides a means by which any issuer can avoid the rebate requirement simply by issuing bonds no earlier than 6 months before the proceeds are to be spent.

The 6-month exception generally does not apply unless all the gross proceeds of the issue are spent for the governmental purpose of the issue no later than 6 months after the date of issue. The statute includes special rules relating to bona fide debt service funds, an additional 6-month period for certain bonds, and a safe harbor for tax and revenue anticipation bonds. Rules relating to the 6-month exception will be the subject of a future notice, but certain aspects of those rules can be described at this time.

First, special rules are necessary to enable issuers that do not issue bonds earlier than 6 months before the proceeds are needed to finance expenditures to qualify for the 6-month exception. For example, some bonds may not be marketable without a debt service reserve fund. The regulations will clarify that the 6-month exception is available to issuers of these bonds. Only the earnings attributable to the reserve fund will be subject to rebate if the issue otherwise qualifies. The regulations also will clarify that investment proceeds of an issue may be part of a bona fide debt service fund for purposes of the 6-month exception (and for purposes of the special rule that excludes amounts earned on certain such funds).

Second, special safe harbors are being considered that would encourage more issuers to rely on the 6-month exception. A special safe harbor might apply, for example, if substantially all, but not all, of the gross proceeds of the issue were spent within 6 months, and the delay in spending all the gross proceeds was due to unanticipated events over which the issuer had no control.

Public comments are invited regarding these and other special rules that may be necessary or appropriate to encourage greater reliance on the 6-month exception.

C. Temporary Regulations in General

A primary objective of the temporary regulations is to provide rules that minimize administrative burdens associated with the rebate requirement for those issues that remain subject to the requirement. The regulations provide specific guidance relating to the computation of the rebatable arbitrage, the yield on the issue, and other related matters.

The temporary regulations are lengthy because specific guidance is provided for many types of issues. Only a portion of the rules apply to a particular issue, and most of the more complicated rules apply only to noncustomary or more sophisticated transactions. The rules that apply to the large majority of issues are not difficult to understand or apply. Moreover, the specificity of the rules should significantly reduce administrative burdens by eliminating uncertainty and by facilitating the development of computer programs that can be used to determine the rebatable arbitrage without difficulty.

The basic method for computing the rebatable arbitrage involves future valuing the nonpurpose investment cash flows at an interest rate equal to the yield on the issue. As explained below, this method is accurate and very simple. For example, an issuer that invests all the bond proceeds in a widely held mutual fund can compute the rebatable arbitrage simply by future valuing the initial amount invested and the amount of each mutual fund share redemption that is spent for the governmental purpose of the issue.

States may organize similar funds to enhance investment opportunities of their local governments and reduce compliance costs through economies of scale. The regulations do not yet provide specific rules as to the treatment of these funds. However, it is anticipated that in appropriate cases the State and local governments investing in the funds will be treated in the same manner as if they had invested in shares of a widely held fund. For example, amounts earned by the fund and used to pay reasonable costs incurred by the fund to purchase and account for the investments will not be treated as earnings of the fund investors. Only the dividends actually paid by the fund to the investors will be taken into account for purposes of computing the rebatable arbitrage.

Most of the rules for allocating proceeds of an issue to investments and expenditures are reserved. These rules will accommodate customary governmental accounting practices to the extent possible. For example, a general purpose governmental unit may normally commingle bond proceeds and other funds for investment purposes and allocate earnings to each source of funds on an arm's length basis (*i.e.*, in a manner similar to that of a widely held mutual fund). The regulations will provide that this method of accounting for the bond proceeds may be used for purposes of determining the rebatable arbitrage. In many cases, the allocation of the investment earnings may be reasonably accurate but not fully arm's length (*e.g.*, the investment fund may not be revalued or investment earnings may not be credited to each source of funds on a regular and accurate basis). It is anticipated that the regulations generally will not require issuers to change their normal accounting practices for purposes of determining the rebatable arbitrage. Simplified accounting rules, however, will not apply to any fund formed or availed of to distort the rebatable arbitrage (or to proceeds of bonds issued to advance refund another bond).

The rules for computing the yield on the issue are much more detailed than under prior law. The yield on the issue for arbitrage yield restriction purposes generally is determined on the basis of the issuer's reasonable expectations as of the date of issue regarding the actual yield on the issue. Prior to the 1986 Act, arbitrage yield restrictions typically applied only to advance refundings. Since these bonds pay interest at fixed interest rates, the use of the reasonably expected yield provided a workable (albeit an imperfect) standard. The scope of the arbitrage rebate requirement is much broader. The rebate affects every type of issue and applies to all the gross proceeds. Much more detailed and accurate rules are necessary.

Separate rules are provided for computing the yield on variable yield and fixed yield issues. A variable yield issue includes bonds the interest rates on which are determined by reference to future market rates. For purposes of computing the rebatable arbitrage, the yield on a variable yield issue changes each 5-year period during the term of the issue (or more often, if the issuer elects). Computing the yield separately for each five years is simpler, fairer, and more accurate than computing the yield on a cumulative basis at the end of each five years. Under this method, the rebatable arbitrage reflects the amount earned on each investment in excess of the interest cost on the issue during the 5-year period the investment is held. Since the interest rates on the issue and the investments are properly matched, the rebatable arbitrage from investing during a 5-year period will not change after the 5-year period because of subsequent changes in interest rates.

A transition rule allows issuers of variable yield issues sold on or before May 15, 1989, and issued on or before June

14, 1989, to elect to compute the yield over the term of the issue.

A fixed yield issue is an issue of bonds the interest rates on which are fixed and determinable as of the date of issue. The actual yield on a fixed yield issue may depend on whether bonds are retired early if the issue includes bonds with different interest rates. Interest on such an issue often will accrue at a rate that is lower in the earlier years and at a rate that is higher in the later years. These temporary regulations allow issuers to initially assume, for purposes of making installment payments, that the higher rates will be paid. The computation of the actual yield on the issue and the rebatable arbitrage, however, eventually take into account any early retirements. In most cases, the difference between the actual yield, determined with regard to early retirements, and the expected yield, determined without regard to such retirements, will be very small.

Computation of the actual yield generally is not difficult. In the case of smaller issues, however, the administrative burdens are comparatively larger and the importance of using the actual yield much less. A special rule, therefore, provides that the yield for certain small issues is the expected yield as of the date of issue (determined without regard to early retirements) unless the issuer elects to use the actual yield. Public comments are invited regarding other special rules that may be necessary or appropriate to minimize administrative burdens.

A transition rule generally allows issuers of fixed yield issues sold on or before May 15, 1989, and issued on or before June 14, 1989, to compute the rebatable arbitrage by using the expected yield on the issue as of the date of issue (determined without regard to early retirements) unless the issuer elects to use the actual yield.

III. Rebate Requirement in General

A. General Rule

Section 1.148-1T provides generally that a bond is treated as an arbitrage bond if the bond is issued as part of an issue that does not meet the rebate requirement.

An issue generally meets the rebate requirement if the issuer pays to the United States: (1) At least 90 percent of the rebatable arbitrage as of each installment computation date (rebate installments); and (2) all the rebatable arbitrage as of the final computation date and any income attributable to such rebatable arbitrage (final rebate).

Since a refunding issue continues or replaces the refunded issue, a refunding issue meets the rebate requirement only if each tax-exempt refunded issue also meets any applicable rebate requirement. A tax-exempt issue includes any issue that (when issued) purported to be a tax-exempt issue. A refunding issue includes the nonrefunding portion of the refunding issue, and a refunded issue includes the nonrefunded portion of the refunded issue.

B. Computation and Payment Dates

The rebatable arbitrage is computed as of each installment computation date and as of the final computation date. The first installment computation date is the last day of the fifth bond year. The issuer may select as the last day of each bond year any calendar day that is the last day of a compounding interval used in computing the yield on the issue. Each succeeding installment computation date ends 5 years after the preceding installment computation date. The final computation date is the date the last bond is discharged. The issuer need not actually compute the rebatable arbitrage as of a computation date if there is none.

Rebate installments are due 60 days after each installment computation date. The final rebate is due on the latest of: (1) the date 60 days after the final computation date; (2) the date 8 months after the date of issue; (3) the earlier of the date the issuer no longer reasonably expects the 6-month temporary investment exception to apply, and the date 14 months after the date of issue; and (4) January 16, 1990. Special rules for a series of issues are reserved.

C. Income Included in Final Rebate

The final rebate includes income attributable to the rebatable arbitrage during the final payment period. The final payment period begins on the final computation date and ends 15 days before the final rebate is paid.

An issuer may identify the funds that are to be used to pay the final rebate and rebate income on the basis of the amount actually earned. Otherwise, the income is determined on the basis of the amount that would have been earned if the rebatable arbitrage had been invested at the maximum interest rate in effect on the final computation date for a time deposit security of the State and Local Government Series (SLG) with a term equal to the final payment period. This rate is one-eighth percent less than the United States Treasury borrowing rate for a security with a comparable maturity. If the final rebate is paid no later than January 16, 1990, the applicable rate will not exceed the average of the maximum interest rates in effect on the first business day of each month during the final payment period for a SLG with a term of 60 days.

D. De Minimis Rules

There are three *de minimis* rules. First, the amount of each rebate installment and the final rebate may be rounded down to the nearest multiple of $100. Any amount less than $100 is rounded to zero.

Second, no income is included in the final rebate if the income is less than $300, and the final rebate is paid no later than 60 days after the final computation date. In addition, if the final rebate is paid no later than January 16, 1990, no income is included if the income is less than $1,000.

Third, as described below, the rebatable arbitrage is reduced by a computation date credit. The maximum credit on each computation date is $1,000.

E. Certain Failures Not to Result in Loss of Tax Exemption

Issuers may correct innocent failures (without penalty) if the failure is corrected no later than 60 days after the failure is discovered (180 days if the correction amount is less than $50,000). The Commissioner may extend the time to correct an innocent failure if the correction amount is less than $50,000, or if the issuer requests an extension before the expiration of such time.

A failure is corrected by paying the correction amount. This is the amount not paid when required, together with interest for the period of delay at the maximum interest rate for a SLG with a term equal to such period. In the case of a failure to pay a rebate installment, the interest is computed at a rate no less than the yield on the issue.

If the correction amount is $50,000 or more, a failure is not treated as innocent unless the issuer submits with the correction amount a brief explanation of the failure and basis for concluding that it is innocent. The failure is treated as innocent if the brief description is reasonably accurate (or not required) unless the issuer is notified otherwise within 90 days. It is anticipated that the vast majority of errors can be corrected under this rule.

Issuers may obtain relief from other failures by submitting a request to the Commissioner. Relief is available if the Commissioner determines that the failure is not due to willful neglect, and the issuer pays the correction amount and a penalty. The Commissioner may waive all or any portion of the penalty.

F. Recovery of Overpayments

Rebate payments are not refundable. However, it is anticipated that the regulations will provide that issuers generally may recover overpayments if the issuer establishes to the satisfaction of the Commissioner that: (1) The issuer paid an amount in excess of the rebatable arbitrage determined as of the day before the date of payment (and in certain cases as of the computation date immediately preceding such date); (2) the excess was paid as the result of a mistake (*e.g.*, a mathematical error); and (3) recovery of the overpayment on the date the recovery was first requested would result in no rebatable arbitrage as of such date.

IV. Computation of Rebatable Arbitrage

A. In General

Section 148(f) provides generally that the rebatable arbitrage is the sum of: (1) The excess of (i) the amount earned on nonpurpose investments (other than investments that are attributable to the excess described in this clause (1)), over (ii) the amount that would have been earned on such investments if the yield on such investments was equal to the yield on the issue; and (2) any income attributable to the excess described in clause (1).

The temporary regulations provide a simple and accurate method for computing this sum that does not rely on more complicated and less accurate federal income tax accounting principles. This method involves future valuing the nonpurpose investment cash flows at an interest rate equal to the yield on the issue.

B. Future Value Method

Section 1.148-2T provides generally that the rebatable arbitrage as of a computation date is the excess of: (1) The future value of the nonpurpose receipts (the amounts received from investing in nonpurpose investments); over (2) the future value of the nonpurpose payments (the amounts paid to purchase nonpurpose investments). All future values are computed as of the computation date and by using an interest rate equal to the yield on the issue.

Computation of the rebatable arbitrage under the future value method is very simple, because the computation focuses exclusively on cash flows. Investments attributable to an excess do not have to be separately accounted for to compute the income earned from reinvesting the excess. The amount actually earned is automatically taken into account if the excess is reinvested. If the excess is spent, the issuer's tax-exempt borrowing rate is used as the excess earnings rate. An issuer with a negative excess benefits from the full time value of the negative excess if a positive excess arises in a later year.

The focus on cash flows also eliminates the need to make separate computations with respect to nonpurpose investments that are not held on a computation date. In many cases, the issuer can compute the rebatable arbitrage simply by keeping track of the initial amount that is invested and each amount that is spent.

To illustrate, assume a $100 issue with a 10 percent annual yield. On the date of issue, the $100 is invested in a zero coupon investment that matures at the end of Year 4. The amount the issuer would receive at the end of Year 4 if the $100 was invested at the bond yield is the future value of $100 at the end of Year 4, determined by using an interest rate equal to 10 percent ($146.41).

Example (1). Assume the issuer actually receives $156.41 when the investment matures at the end of Year 4 (a $10 excess) and reinvests the entire amount (the $10 excess and the $146.41 nonexcess) in a 1-year zero coupon investment with a 10 percent yield, which matures at the end of Year 5. The issuer receives $172.05 at the end of Year 5 ($156.41 plus $156.41 × 10%). Since the $146.41 nonexcess is invested at the bond yield, no new positive or negative excess arises from this reinvestment. The amount earned at the end of Year 5 from reinvesting the $10 excess is $1 ($10 × 10%). The rebatable arbitrage at the end of Year 5 is $11 (the sum of the $10 excess and $1 earned from reinvesting the $10 excess).

Under the future value method, the rebatable arbitrage would be computed as follows:

Year	*Receipt (Payment)*	*FV (End of Year 5)*
0	$(100.00)	$(161.05)
4	156.41	172.05
4	(156.41)	(172.05)
5	172.05	172.05
	Rebatable arbitrage	$11.00

Note that the two cash flows in Year 4 (the $156.41 receipt and reinvestment) can be disregarded since they cancel each other out.

The ability to disregard reinvestments makes the computation much simpler. For example, assume the issuer had invested the $100 in a series of many different investments during the first 5 years (rather than only two). Regardless of the number of receipts and payments generated by the additional reinvestments, the issuer could still compute the rebatable arbitrage by future valuing only two cash flows (the initial payment in Year 0 and the final receipt in Year 5). All the other receipts and payments cancel each other out. See, §1.148-2T(c)(2) (Examples).

Example (2). (i) Assume the issuer received $179.87 at the end of Year 5 (instead of $172.05, which is $7.82 less). The rebatable arbitrage at the end of Year 5 is $7.82 more:

Year	*Receipt (Payment)*	*FV (End of Year 5)*
0	$(100.00)	$(161.05)
5	179.87	179.87
	Rebatable arbitrage	$18.82

The $18.82 reflects the Year 4 $10 excess, $1.50 earned from reinvesting the $10 excess during Year 5, and a new $7.32 excess from reinvesting the $146.41 nonexcess at a 5 percent higher yield during Year 5 ($146.41 × 5%).

(ii) Assume the issuer received $164.23 at the end of Year 5 (instead of $172.05, which is $7.82 more). The rebatable arbitrage at the end of Year 5 is $7.82 less:

Year	*Receipt (Payment)*	*FV (End of Year 5)*
0	$(100.00)	$(161.05)
5	164.23	164.23
	Rebatable arbitrage	$ 3.18

The $3.18 reflects the Year 4 $10 excess, $.50 earned from reinvesting the $10 excess during Year 5, and a new $7.32 negative excess from reinvesting the Year 4 $146.41 nonexcess at a 5 percent lower yield during Year 5 ($146.41 × 5%).

Example (3). Assume the issuer spent the $146.41 nonexcess at the end of Year 4 and reinvested only the $10 excess. The yield on the 1-year reinvestment is 5 percent; the issuer therefore receives $10.50 at the end of Year 5. The rebatable arbitrage at the end of Year 5 is computed as follows:

Year	*Receipt (Payment)*	*FV (End of Year 5)*
0	$(100.00)	$(161.05)
4	146.41	161.05
5	10.50	10.50
	Rebatable arbitrage	$10.50

The $10.50 reflects the Year 4 $10 excess and $.50 earned from reinvesting the $10 excess during Year 5. The net receipt at the end of Year 4 is the amount that was spent (*i.e.*, the portion of the $156.41 receipt that was not reinvested).

Example (4). Assume the issuer spent the entire $156.41 at the end of Year 4. The rebatable arbitrage at the end of Year 5 is computed as follows:

Year	*Receipt (Payment)*	*FV (End of Year 5)*
0	$(100.00)	$(161.05)
4	156.41	172.05
	Rebatable arbitrage	$11.00

The $11.00 reflects the Year 4 $10 excess and $1 earned on the $10 excess during Year 5. Since the $10 excess was not reinvested, the issuer's tax-exempt borrowing rate is used to determine what was earned by spending the excess. The receipt at the end of Year 4 is the amount that was spent.

C. Nonpurpose Payments and Receipts

If a nonpurpose investment is purchased with gross proceeds, the amount paid to purchase the investment is the nonpurpose payment. A nonpurpose receipt includes any amount received from investing in nonpurpose investments (including amounts received from the sale of investments). Gain or loss, therefore, is taken into account in computing the rebatable arbitrage.

In addition to these actual amounts, the following amounts are treated as nonpurpose payments and receipts:

1. *Constructive payments and receipts.* If a nonpurpose investment is not actually purchased with gross proceeds, the investment is treated as if purchased for fair market value when it is allocated to gross proceeds (*e.g.*, investments purchased before the date of issue and contributed to a debt service reserve fund are treated as if purchased for fair market value on the date of issue). Similarly, if a nonpurpose investment ceases to be a nonpurpose investment but is not actually sold, the investment is treated as if sold for fair market value (*e.g.*, all nonpurpose investments are treated as if sold for fair market value on the final computation date).

Under these rules, market gain or loss for the period during which an investment is allocated to an issue is the same whether or not the investment is purchased (or sold) at the time it is (or ceases to be) allocated to the issue. In addition, the yield on each investment is based on market interest rates in effect at the time the investment is allocated to the issue whether or not the investment is actually purchased at that time.

Fair market value generally is the price at which a willing buyer would purchase the investment from a willing seller. Specific rules are provided for determining the fair market value of investments traded in an established securities market. Special rules are provided for valuing SLGs that are not in a restricted escrow and certain investment contracts.

2. *Installment date receipt.* For purposes of computing the rebatable arbitrage as of an installment computation date, the fair market value of any nonpurpose investments held on that date is treated as a nonpurpose receipt. Fair market value is generally easy to determine, and the use of fair market value allows net unrealized losses to be counted.

In the case of fixed rate investments, the issuer has the option on any installment computation date to value the investments at present value. Valuing the investments at present value eliminates net unrealized gains from the installment date computation. The present value generally is the present value of the future receipts to be paid on the investment, discounted at the yield on the investment. If the investment is purchased at par, the par amount plus accrued interest can be used (instead of the par amount plus the present value of such interest).

3. *Rebate payment.* Payments of rebatable arbitrage to the United States no later than the date due are treated as nonpurpose payments. These payments, therefore, reduce the rebatable arbitrage. Any amount not paid on or before the date due is treated as a nonpurpose payment as of the due date. The failure to timely pay is corrected by paying the correction amount as described above.

4. *Computation date credit.* A computation date credit generally is taken into account as a nonpurpose payment on each computation date. The credit on each computation date is $1,000 if the outstanding amount of bonds is more than $5 million, $625 if the outstanding amount of bonds is more than $1 million but not more than $5 million, and $250 if the outstanding amount of bonds is $1 million or less. No credit is allowed on a computation date if the computation period is less than one year, or if less than 75 percent of the net sale proceeds have been spent for a governmental purpose by that date.

In the case of a refunding issue, the net sale proceeds requirement is applied separately to each refunding portion and to the nonrefunding portion of the issue. In the case of each refunding portion, the requirement is applied by reference to the use of the sale proceeds of the refunded issue (or in the case of a series of refundings, by reference to the use of the sale proceeds of the original issue). Thus, refunding issues (including advance refundings) are eligible for the credit if all the refunded issues were eligible for the credit (and any new money portion of the refunding issue also qualifies). In addition, a refunding issue can qualify for the credit on a computation date (even if the refunded issue was not eligible) if the 75 percent expenditure requirement is later met.

5. *Imputed receipt.* Imputed receipts are treated as nonpurpose receipts. Section 1.148-5T will contain rules relating to the transactions that give rise to such receipts and the method of determining the amount thereof.

Receipts generally will be imputed to obligations that do not bear interest at an arm's length interest rate. Section 1.148-5T provides two exceptions that apply to investments of gross proceeds in demand accounts that are used to hold funds for a short period of time until the funds can be invested at an arm's length interest rate or spent. The exceptions do not apply to reserve or replacement funds (other than bona fide debt service funds), to proceeds subject to arbitrage yield restrictions, or to accounts formed or availed of to take advantage of the exception and deflect arbitrage profits to third parties. The purpose of the exceptions is to further simplify computation of the rebatable arbitrage under the future value method.

Under the first exception, no receipt is imputed to investments of small balances in a nonpurpose receipt account. This rule facilitates the netting of nonpurpose receipts and payments. The investment activity in the nonpurpose receipt account can be disregarded for purposes of computing the rebatable arbitrage, since all the receipts in the account are reinvested. The investments in the account, however, are taken into account in determining the amount of the rebatable arbitrage (*e.g.*, as zero yielding investments if the account does not pay interest).

Under the second exception, receipts are not imputed to investments of significantly larger balances in a nonpurpose receipt account, a purpose receipt account, or a checking account to produce a yield higher than the yield on the issue. This rule also simplifies the computation. For example, the rule allows an issuer to treat amounts deposited in a qualified checking account as if they were spent on the date of the deposit.

D. Special Rules for Restricted Escrows

Special rules apply to investments in restricted escrows. An investment is in a restricted escrow if the investment is in an advance refunding escrow or an excess proceeds escrow. These rules are necessary primarily to accommodate advance refundings. The rules reflect the economic reality that all investments in a restricted escrow (whether or not held concurrently) are part of a single "locked in" investment.

Nonpurpose investments are in an advance refunding escrow if allocated (without regard to transferred proceeds rules) to proceeds of a refunding issue that are to be used to discharge principal or interest on a refunded issue or that are part of a reserve or replacement fund (until the adjusted maturity date of the refunded issue) unless the proceeds qualify for a temporary period longer than 30 days.

Nonpurpose investments (not in an advance refunding escrow or part of a reasonably required reserve or replacement fund) are in an excess proceeds escrow if allocated (without regard to transferred proceeds rules) to proceeds that are to be used to discharge principal or interest (other than accrued or capitalized interest) on the issue to which the proceeds are allocated. Amounts to be used to pay debt service are not part of a reasonably required reserve or replacement fund unless the purpose of the fund is to cover a temporary shortfall in revenues (or the fund is a bona fide debt service fund). For example, an escrow fund established to defease bonds (legally or economically) is not reasonably required.

The special rules that apply to investments in restricted escrows are as follows:

1. *Installment date receipt.* The installment date receipt is always determined by reference to present value.

2. *Transferred investments.* If the investments transfer to a refunding issue, the present value is always treated as the nonpurpose receipt with respect to the refunded issue and as the nonpurpose payment with respect to the refunding issue. (This rule generally does not apply if the refunded issue is a tax-exempt issue to which the rebate requirement applies unless the refunding issue also is tax-exempt.)

3. *Composite yield.* The present value is determined by treating all investments in the same restricted escrow as one investment (whether or not the investments are held concurrently). Therefore, the discount rate used in computing the present value of the investments is the composite yield on all the investments (not the yield on the investments that happen to be in the escrow on a particular date).

4. *Imputed escrow receipts.* Section 1.148-5 provides that receipts are imputed to investments in an escrow in certain cases. For purposes of these rules, investments in an escrow include tax-exempt investments and investments allocated to gross proceeds (other than proceeds).

The first rule provides that interest savings directly attributable to the defeasance of bonds with investments in an escrow are treated as imputed receipts with respect to those investments. These savings might occur if, as a result of the defeasance, the interest rate on the defeased bonds is reduced, or fees for a guarantee of the defeased bonds no longer have to be paid. A transition rule applies to bonds sold on or before May 15, 1989, and issued on or before June 14, 1989. The transition rule does not apply to any refunding issue issued after August 31, 1986 and to which section 149(d)(4) (relating to abusive advance refunding transactions) applies unless certain interest savings are taken into account in computing the yield on the refunding issue.

The second rule provides that excess receipts from tax-exempt investments in an escrow established after June 14, 1989, are treated as imputed receipts with respect to nonpurpose investments in the same escrow. Excess receipts may arise if the tax-exempt investments are invested at a yield higher than one eighth percent above the yield on the nonpurpose investments in the same escrow. The excess receipts are the receipts on the tax-exempt investments that produce this excess yield.

E. Certain Lower Yielding Investments Not Taken Into Account

Two classes of nonpurpose investments are not taken into account in computing the rebatable arbitrage if the yield on the class as a whole is lower than the yield on the issue. The first class comprises all investments (including transferred investments) in advance refunding escrows and all transferred investments in excess proceeds escrows. The second class comprises all investments allocated to gross proceeds (other than proceeds) that are part of a reserve or replacement fund that is neither reasonably required nor a bona fide debt service fund.

Congress provided the Treasury Department with broad general regulatory authority under section 148 and section 149(d) (relating to advance refundings) and specific authority under section 148(f)(6)(B) to determine what gross proceeds include. The netting limitations herein constitute a necessary exercise of such authority. The limitations are necessary because a tax-exempt issuer enjoys a tax arbitrage benefit whenever the bond proceeds are invested (unless the bond proceeds are invested exclusively in tax-exempt investments). This benefit is equal to the interest rate differential between the tax-exempt issue and a comparable taxable issue.

The two classes of funds to which the netting limitations apply are long-term investment funds that involve major exploitation of arbitrage. These funds rarely, if ever, exist outside the tax-exempt bond market. The netting limitations prevent these funds from being used to exploit arbitrage twice. The double exploitation would occur if the funds were invested at taxable interest rates and also were used to eliminate rebatable arbitrage profits from investing other, unrelated funds at taxable interest rates. The advance refunding escrow limitation prevents advance refunding issues from enjoying a rebate advantage as compared to the refunded and all other issues. The sinking fund limitation prevents sinking funds from being established and unreasonably accumulated for the primary (if not sole) purpose of eliminating rebatable arbitrage profits. These limitations do not prevent negative arbitrage profits from the investment of other, unrelated funds from being used to offset positive arbitrage profits from the investment of these funds.

V. Computation of Yield on Issue

A. In General

Section 1.148-3T distinguishes between fixed yield issues and variable yield issues. A fixed yield issue includes only fixed yield bonds. A variable yield issue includes one or more variable yield bonds.

A variable yield bond includes any bond the interest rate on which is determined by reference to market interest rates after the date of issue. A bond is not a variable yield bond merely because the interest rate will change (*e.g.*, to another interest rate fixed and determinable as of the date of issue) or may change in the event of an unanticipated event (*e.g.*, if there is a change in income tax rates).

The yield on a fixed yield issue is the same throughout the term of the issue. For purposes of computing the rebatable arbitrage as of each installment computation date, the expected actual yield on the issue as of the computation date is used to future value the nonpurpose receipts and payments from the date of issue to the computation date. On the final computation date, the actual yield on the issue over the term of the issue is used to future value the nonpurpose receipts and payments from the date of issue to the final computation date.

In contrast, the yield on a variable yield issue changes each yield period.

For purposes of computing the rebatable arbitrage, the nonpurpose receipts and payments are future valued during each yield period at an interest rate equal to the yield on the issue computed separately for that yield period. Each yield period ends on a computation date (*e.g.*, the first yield period ends on the last day of the fifth bond year). The issuer may elect to treat the last day of any other bond year as the end of another yield period. The yield, therefore, may be computed for each 5-year period or more often (in any combination of 1-year periods).

Under the variable yield rules, the rebatable arbitrage reflects the amount earned on each investment in excess of the interest cost on the issue during the yield period the investment is held. Computation of the rebatable arbitrage on a yield period basis minimizes distortions from changes in market interest rates. For example, if the yield on an issue of long-term current index bonds was recomputed over the term of the issue, the rebatable arbitrage from investing during the construction period would change later if interest rates changed. The issuer could not recover rebate payments if interest rates rose (at least 90 percent must be paid each 5 years), but the issuer would have to rebate more if interest rates fell. The issuer should not have to rebate more, since the arbitrage profits do not in fact change.

The variable yield rules apply to tender bonds that bear interest at short-term rates during the construction period (when the proceeds are invested) and thereafter convert to a long-term fixed interest rate. As applied to these issues, the rules are also necessary to minimize distortions from comparing the current short-term investment rates and the future long-term borrowing rates. Although yield curve distortions can occur in connection with long-term fixed rate issues, there is a fundamental difference between a long-term fixed rate bond and a tender bond. The issuer of a long-term fixed rate bond agrees in advance to pay a fixed rate of interest over the term of the bond. As discussed below, the yield on such a bond should not be viewed as changing because market interest rates later change. By contrast, the yield on a tender bond changes whenever the interest rate on the bond is reset. Moreover, the conversion of a tender bond to a long-term fixed rate bond resembles the refunding of a short-term bond with a long-term bond. A refunding issue is a separate issue and involves a separate yield and rebatable arbitrage computation.

A transition rule provides that the issuer of any variable yield issue sold on or before May 15, 1989, and issued on or before June 14, 1989, may elect to treat the issue as a fixed yield issue. If the issuer so elects, the yield on the issue is computed over the term of the issue.

B. Issue Price

The yield on a bond or issue is determined on the basis of the issue price to the public. The issue price of substantially identical bonds that are publicly offered generally is the initial offering price at which price a substantial amount of the bonds was sold to the public. This price generally is determined on the basis of reasonable expectations as of the date the issuer enters into a binding contract to sell the bonds if the underwriter or other intermediary makes a bona fide public offering of the bonds at the reasonably expected price. The issue price of bonds to be sold after the date of issue must be adjusted to reflect an equivalent date of issue price (*e.g.*, interest accrued after the date of issue is not taken into account).

C. Actually Paid

Payments of principal and interest on a bond that are unconditionally payable generally are treated as if paid on the date actually and unconditionally due (whether or not actually paid on that date) unless the yield is higher by taking into account payments when actually paid (*i.e.*, where taking into account late payments and interest on the late payments produces a higher yield).

This special rule applies only if the bondholders are reasonably assured that sufficient funds will be available to fully retire the bonds if none or an insubstantial portion of the proceeds are used for a governmental purpose. For this purpose, the available funds are reduced by the arbitrage profits (determined without regard to the special rule), and funds are considered available only if there is a binding obligation of a person with sufficient funds to provide them. This exception is necessary to prevent arbitrage profits from being used to pay the issuance costs of collapsible bond issues.

D. Qualified Guarantees

Section 1.103-13(c)(8) provides that premiums paid to insure an issue are taken into account in computing the yield on the issue. Under §1.103-13(c)(5), payments for other bond guarantees (*e.g.*, letters of credit) and for guarantees of purpose investments are taken into account in computing the yield on purpose investments, but not in computing the yield on the issue. The distinction under prior law between bond insurance and other bond guarantees is eliminated.

In some cases, the terms of a purpose investment may be virtually identical to the terms of the bonds, and the obligor on the purpose investment may even be treated for other tax purposes as the obligor on the bonds. In these cases, a guarantee of the purpose investment is treated as a guarantee of the bonds, rather than as a project-related credit enhancement feature of the bonds. This treatment applies if: (1) The purpose investment is acquired with sale proceeds of the issue; (2) the payments on the purpose investment are exclusively and unconditionally pledged to pay the bonds; (3) the payments on the purpose investment coincide with the payments on the bonds; and (4) the yield on the purpose investment does not exceed the yield on the issue by more than one-eighth percent. The last requirement may be satisfied by modifying the purpose investment to comply with the requirement if the purpose investment is acquired on or before June 14, 1989.

In addition, special rules are provided that permit purpose investment guarantees to be treated as bond guarantees in certain cases even though the payments on the purpose investment and the bonds do not exactly coincide, and even though the payments on the purpose investment are not exclusively pledged to pay the bonds. These rules: (1) Treat payments on a purpose investment and a bond as coinciding where the purpose investment provides for monthly payments of principal and interest and the bonds provide for semiannual or annual payments of principal and interest; and (2) treat payments on a purpose investment as exclusively pledged to pay the bonds where the bonds are equally and ratably secured with other bonds under a master resolution if all bonds issued under the master resolution are used only to finance purpose investments that are insured by the same guarantor (*e.g.*, by the Federal Government).

A guarantee is an unconditional obligation of a guarantor enforceable by or on behalf of the bondholder to pay principal or interest on the bond or the tender price of a tender bond. The guarantee may be in the form of an insurance policy, surety bond, irrevocable letter or line of credit, or standby purchase agreement. A line of credit obtained for liquidity reasons is not a guarantee unless the bondholders can unconditionally rely on it. A guarantee also may be in the form of a recourse loan to the guarantor (where the guarantor re-loans the proceeds to the ultimate borrower) if the terms of the loan and the bonds are virtually identical.

The guarantor must be the Federal Government or an entity that is subject to Federal income tax and is either a bank or rated "AA" or "AAA" by a nationally recognized rating agency. The guarantor must be legally entitled to full reimbursement immediately or upon commercially reasonable repayment terms (during a workout period that is not unreasonably long). An obligation to pay is not a guarantee unless it is reasonably expected that the guarantor will not be called upon to make any payment under the guarantee (or will be reimbursed immediately in cash for any payment). For example, a commitment to make a permanent loan is not a guarantee (whether or not the commitment is unconditional).

Payments for the guarantee may not exceed a reasonable charge for the transfer of credit risk and may not include direct or indirect payment for a cost, risk, or other element that is not customarily borne by guarantors of tax-exempt bonds (in transactions in which the guarantor has no other involvement). The reasonable charge requirement is not satisfied unless it is reasonably expected that the guarantee will result in a net present value savings. A nonguarantee element is present, for example, if the guarantee is in the form of a loan to the guarantor unless payments for all nonguarantee services being provided by the guarantor fully and adequately compensate the guarantor for those services (and no portion of such payments is taken into account as a payment for the guarantee). The fees charged for the nonguarantee services must be separately stated if the guarantee is entered into after June 14, 1989.

E. Allocation Rules for Guarantees

Rules are provided for allocating payments for guarantees to the bonds guaranteed and, if the bonds are variable yield bonds, to the proper yield period. In general, level payments are allocated in accordance with the level payment formula and treated as paid when actually paid. Nonlevel (front-loaded or back-loaded) payments are reallocated.

A level payment generally is one of a series of payments determined by use of the same formula (*e.g.*, a series of payments all of which are based on a constant percentage of the amount of guaranteed bonds then outstanding plus an appropriate amount of accrued interest). The series of payments must be payable at regular intervals (*e.g.*, on the first day of each bond year, properly adjusted to take into account any short year).

Nonlevel payments generally are allocated to each guaranteed bond in the same proportion as the interest savings resulting from the guarantee. For example, if the guaranteed bonds are not all substantially identical, the nonlevel payments are allocated to each group of substantially identical guaranteed bonds in the same proportion as the total interest savings with respect to the group bears to the total interest savings with respect to all the guaranteed bonds (determined on a present value basis). Payments allocated to substantially identical bonds are allocated ratably.

Nonlevel payments allocated to a variable yield bond generally are treated as paid on the first day the guarantee is in effect and on the first day of each succeeding bond year during which the guarantee is in effect. The same amount is treated as paid each bond year (other than a short year). The present value of all the amounts treated as paid equals the present value of all the nonlevel payments, using a discount rate equal to the yield on all the guaranteed bonds during the first yield period during which the guarantee is in effect (determined without regard to the nonlevel payments). All guarantees entered into with the same guarantor before the first installment computation date generally are treated as one guarantee for purposes of applying these rules.

If a guaranteed variable yield bond is actually retired before maturity, the amount treated as paid during the bond year is prorated. No other amounts with respect to the bond are thereafter taken into account with respect to the issue.

F. Hedging Transactions

Certain hedging transactions, such as those involving interest rate swaps and interest rate caps or collars, should be taken into account in computing the yield on the issue. The rules relating to hedging transactions are reserved. Public comments are invited regarding the types of hedging transactions that should be taken into account, the methods that should be used to determine whether a particular hedging transaction is entered into with respect to a particular issue, and the method that should be used to take into account payments with respect to each type of transaction. Issuers should be aware that the regulations will apply to interest rate swaps that involve the swap of a fixed rate of interest for a variable rate of interest, and that these swaps may be taken into account in determining whether the issue is a variable yield issue.

VI. Computation of Yield on Fixed Yield Issue

A. In General

The yield on a fixed yield issue as of any computation date is determined by taking into account the issue payments paid on or before the computation date and to be paid after the computation date. The issue payments paid are the amounts paid to discharge principal and interest (not including amounts paid in connection with the early retirement of a bond), the early retirement value of bonds retired before maturity, and the amounts paid for a qualified guarantee. The issue payments to be paid after the computation date generally are determined by assuming that the bonds will remain outstanding until maturity (unless the bonds are subject to mandatory early redemption or otherwise are required to be retired early).

B. Early Retirements

The early retirement value of a bond (rather than the amount actually paid to retire the bond) is treated as the issue payment when a bond is retired before the final maturity date. The early retirement value generally is the price that when used in computing the actual bond yield (the yield to the actual retirement date) produces the original bond yield (the yield to the final maturity date).

The price that preserves the original bond yield is the present value as of the early retirement date of the originally scheduled payments of principal and interest (and payments for a guarantee) to be paid on or after that date, discounted at an interest rate equal to the yield-to-maturity on the bond. The present value of a bond issued at par plus accrued interest is approximately the par amount of the bond plus accrued interest (if the bond pays current interest). This approximate present value can be used instead of actually computing the exact present value. The exact present value may have to be computed for guaranteed bonds and bonds that are issued at a discount (or premium). The present value of these bonds increases (or decreases) as the discount (or premium) accrues, so that the actual yield on the bond is always the same.

The actual price paid to retire the bond is not used, because changes in market interest rates should not be viewed as changing the yield on a fixed yield bond. Economically, the yield over the original term of a noncallable fixed yield bond never changes. If the issuer retires the bond early, the market premium (or discount) paid to retire the bond will reflect the lower (or higher) current market interest rate, which is the same rate at which the early retirement is financed. Financing of the early retirement with a new borrowing will change the timing of the originally scheduled payments, but will not change the present value of the payments or the yield over the original term of the bond. Financing of the early retirement with equity also produces the same results on a present value basis (*i.e.*, the same result as if the equity had been invested at the current market rate and the bond had not been retired, and the same result as if the bond had been retired with new borrowing at the current market rate).

Similarly, the yield over the original term of a callable bond should not be viewed as increasing if the bond is retired early. In this case, the yield with respect to the financing over the original term of the bond may actually decrease. For example, the yield over the original term of a 9 percent 30-year bond would decrease if the bond was called after 10 years at a 3 percent call premium to take advantage of a lower 6 percent interest rate. The higher original bond yield is used for purposes of computing the rebatable arbitrage whether or not the bond is called early (*i.e.*, the yield is not reduced to take into account the value of the call option or the fact that it is exercised).

Issuers should be aware, however, that the issuance of callable bonds for the primary or sole purpose of hedging against a rise in interest rates may violate, *inter alia*, the 10-percent reserve or replacement fund financing limitation added by the 1986 Act. See, H. Rep. No. 100-795, 100th Cong. 447, 451 (1988). Rules relating to this limitation will be the subject of a future notice.

A bond may be subject to optional purchase or redemption at a small discount below present value. For example, a 30-year bond issued at a one percent premium may be subject to optional redemption at par after 20 years. In this case, it is initially assumed that the yield on the bond is the higher yield-to-maturity rather than the lower yield to the par call date. If the bond is part of a fixed yield issue and is retired at or about the time the bond is subject to redemption at a price less than present value, the lower redemption price is the early retirement value (rather than the higher present value).

In extraordinary cases, a bond may be subject to optional purchase or redemption before maturity at a substantial discount below present value. In this case, it is initially assumed that the yield on the bond is the yield-to-call (*i.e.*, the yield computed by treating the optional purchase or call date as the final maturity date). A bond that is part of a fixed yield issue is a yield-to-call bond if the yield-to-maturity on the bond is more than one-fourth percent higher than the lowest yield. If the bond is not retired on or before the call date, the bond is treated as if issued on that date for an issue price equal to the lower call price. The bond, therefore, is treated as a lower yielding bond before the call date and as a higher yielding bond after the call date (assuming the bond is still outstanding after the call date). A yield-to-call bond does not cause the issue of which the bond is a part to be treated as a variable yield issue.

In some cases, bonds may be subject to mandatory sinking fund redemption before the final maturity date. If these bonds are issued at a discount, the present value of the bonds on the mandatory early redemption dates would be less than par if the yield-to-maturity were used as the discount rate in computing the present value. If the bonds are not issued at a large discount, the issuer expects to redeem the bonds at par (rather than at a lower market price), and the yield on each bond is actually the composite yield-to-maturity on all the bonds, determined by treating the mandatory early redemption dates and prices as the final maturity dates and prices. This higher composite yield is used as the discount rate in computing the present value of each bond when it is retired (and each bond is treated as maturing on a mandatory redemption date for purposes of computing the present value). The actual yield on the bonds, therefore, is always the composite yield-to-maturity on all the bonds (regardless of when or at what price the bonds are retired). The lower yield-to-maturity is used for purposes of determining the issue payments to be paid if the bonds are issued at a deep discount.

A single loan that provides for partial principal payments before the final principal payment is due is treated as a series of separate bonds that are subject to mandatory early redemption. The yield on the loan is always the composite yield-to-maturity on all the bonds.

C. Special Rule for Small Issues

Unless the issuer otherwise elects, the yield on certain small fixed yield issues is the expected actual yield as of the date of issue. This yield is computed in the same manner as the actual yield, except that the date of issue is treated as the only computation date. Thus, actual facts after the date of issue (including early retirements) are not taken into account.

For this purpose, an issue is a small issue if the aggregate issue price of the bonds is $5 million or less. This amount is increased to $10 million for governmental issues if the aggregate issue price of all tax-exempt bonds (other than private activity bonds) issued by the issuer and certain related issuers during the same and the immediately preceding calendar years is $30 million or less.

The special rule applies only if: (1) It is reasonably expected that no investments (other than purpose investments) will be subject to arbitrage yield restrictions; (2) the issuer at no time enters into a hedging transaction that is taken into account in computing the yield on the issue and that, if taken into account, would increase the rebatable arbitrage; and (3) at least 75 percent of the net sale proceeds are used for a governmental purpose within 3 years of the date of issue. This 3-year requirement is applied in the same way as the net sale proceeds requirement that applies for purposes of the computation date credit.

D. Transition Rule for Fixed Yield Issues

A transition rule provides that, unless the issuer otherwise elects, the yield on a fixed yield issue sold on or before May 15, 1989, and issued on or before June 14, 1989, is the expected actual yield on the issue, computed by treating the date of issue as the only computation date.

This transition rule applies only if: (1) The issuer at no time enters into a hedging transaction that is taken into account in computing the yield on the issue and that, if taken into account, would increase the rebatable arbitrage; and (2) at least 25 percent of the net sale proceeds are used for a governmental purpose within 3 years of the date of issue.

E. Transitioned Variable Yield Bonds

Special rules are provided for determining the issue payments in connection with variable yield bonds that are part of a fixed yield issue. The issue payments paid generally are determined in the same manner as if the issue were a variable yield issue, except that the term of the issue is the yield period. The interest to be paid after a computation date is determined by assuming that market interest rates in effect on the computation date do not later change. If a tender bond converts to a fixed rate, the bond is thereafter treated as a fixed yield bond for purposes of determining the issue payments paid and to be paid.

VII. Computation of Yield on Variable Yield Issue

A. General Rule

The yield on a variable yield issue during a yield period is determined by taking into account the issue payments attributable to the yield period and the issue prices of bonds issued during the yield period. The issue payments attributable to the yield period include the early retirement value of the bonds outstanding at the end of the yield period, and these same bonds are treated as if issued at the beginning of the next yield period for the same value. In effect, the bonds are treated as if retired and reissued at the end of each yield period for purposes of computing the yield.

A variable yield issue may include tender bonds, other variable yield bonds, and fixed yield bonds. Separate rules are provided for each type of bond.

B. Tender Bonds

Variable yield bonds are tender bonds if the holders are entitled to tender the bonds for purchase at par on one or more tender dates, and all interest on the bonds accrues (and is currently paid) at the lowest rate that would permit the bonds to be remarketed at par on each tender date.

The issue payments attributable to a yield period include: (1) Any interest that accrued and was paid during the yield period; (2) the tender price of any bond tendered during the yield period; (3) the par amount of any bond retired during the yield period; and (4) the par amount plus unpaid accrued interest (as of the date the interest is scheduled to be paid) of any bond outstanding at the end of the yield period.

Remarketed bonds are treated as if issued after the close of business on the date remarketed. The issue price should equal (and offset) the tender price if the bond is remarketed on the tender date. A bond outstanding at the end of the yield period is treated as if issued at the beginning of the next yield period for the par amount.

A tender bond that converts to a fixed rate is thereafter treated as a fixed yield bond. The issue payment taken into account with respect to the tender bond is the par amount plus unpaid accrued interest (as of the date the interest is scheduled to be paid). The fixed yield bond is treated as if issued for the par amount.

C. Other Variable Yield Bonds

In the case of all other variable yield bonds, the issue payments attributable to a yield period include: (1) Interest that accrued and was paid during the yield period; (2) the early retirement value of any bond retired before maturity during the yield period; (3) the retirement price of any bond retired at maturity during the yield period; and (4) the early retirement value plus unpaid accrued interest (as of the date the interest is scheduled to be paid) of any bond outstanding at the end of the yield period.

For purposes of applying the yield-to-call and early retirement value rules to these bonds: (1) Interest on a bond that is determined by reference to market interest rates after the date of issue (*e.g.*, by reference to the prime rate of a designated financial institution) is assumed to be paid on the basis of market interest rates as of the date of issue (*e.g.*, the prime rate as of the date of issue is assumed to remain the same throughout the term of the issue); (2) payments for a guarantee are taken into account only for purposes of determining whether the bond is a yield-to-call bond; and (3) the early retirement value on any day is determined without regard to unpaid accrued interest at the assumed rate (*e.g.*, if the early retirement value otherwise would be par plus the present value of the unpaid accrued interest, the early retirement value is par).

A bond (other than a tender bond) that is part of a variable yield issue is a yield-to-call bond if the yield-to-maturity on the bond is higher than the yield-to-call unless the bond is a fixed yield bond or a current index bond. A fixed yield bond or current index bond is a yield-to-call bond only if the yield-to-maturity on the bond is more than one sixteenth percent higher than the yield-to-call. A variable yield bond is a current index bond if all interest on the bond accrues (and is currently paid) at rates that are based on a single interest index or that are fixed and determinable as of the date of issue.

A bond outstanding at the end of a yield period is treated as if issued at the beginning of the next yield period for the early retirement value.

D. Fixed Yield Bonds

The issue payments in connection with fixed yield bonds that are attributable to a yield period generally are determined in the same manner as for fixed yield bonds that are part of a fixed yield issue. The amount treated as an issue payment on the last day of a yield period is the early retirement value (less principal and interest paid that day). The bond is treated as if issued at the beginning of the next yield period for the same value.

E. Conversion to Fixed Yield Issue

Unless the issuer otherwise elects, a variable yield issue is treated as a fixed yield issue as of the first day of a yield period if the issue would be a fixed yield issue if issued that day. For example, if the first yield period for an issue of tender bonds ends on the last day of the third bond year and all the bonds convert to a fixed rate during the third bond year, the issue is treated as a fixed yield issue as of the first day of the fourth bond year. If the first yield period ended on the last day of the fifth bond year, the issue would be treated as a fixed yield issue as of the first day of the sixth bond year. Each bond is treated as if issued for the same amount that would have been taken into account as the issue price if the issue had remained a variable yield issue. The yield on the issue is thereafter computed in the same manner as for a fixed yield issue.

VIII. Allocation and Accounting Rules

A. In General

Section 1.148-4T provides generally that an investment is allocated to an issue for the period: (1) That begins on the date gross proceeds are allocated to the issue and to the investment; and (2) that ends on the date such gross proceeds cease to be allocated to the issue or to the investment. Less than all the gross proceeds may be allocated to the issue in certain cases if the unspent gross proceeds substantially exceed the outstanding amount of the issue.

Most of the rules for allocating gross proceeds to investments and expenditures are reserved. These rules will provide when proceeds of an issue that are not directly used to pay an expenditure may be allocated to the expenditure. In this connection, issuers should be aware that the use of proceeds of an issue to fund an investment fund does not result in a reduction in the amount of the unspent gross proceeds of the issue. Even if the proceeds were allocated to expenditures rather than to the investments in the fund, the investments would still be allocated to gross proceeds (other than the proceeds) if the investment fund is a direct or indirect replacement fund for the issue. Compare, Revenue Ruling 82-101. See, also, section 148(d)(2).

B. Gross Proceeds

Gross proceeds include proceeds and funds (other than proceeds) that are part of a reserve or replacement fund. Proceeds include original, discount, and transferred proceeds. Original proceeds include sale proceeds (amounts received from the sale of the issue) and investment proceeds (amounts received from investing original proceeds). Public comments are invited regarding the appropriate scope of an exception for investment earnings that are commingled with substantial other revenues of the issuer.

The definitions of discount proceeds and reserve or replacement funds are reserved. Discount proceeds may arise in certain cases if the amount of outstanding bonds substantially increases during the term of the issue because the bonds do not pay interest currently. If discount proceeds arise, the proceeds would be allocated to investments or expenditures as appropriate. Reserve or replacement funds include certain pledged and sinking funds that were treated as proceeds under prior law. Issuers should be aware that funds of the issuer or a beneficiary of the financing (or related person) indirectly pledged to pay debt service on the issue are part of a reserve or replacement fund (*e.g.*, funds pledged by an issuer to reimburse a guarantor in the event the guarantor is called upon to make a payment under the guarantee are gross proceeds).

C. Indirect Use

Proceeds of an issue may be used directly to acquire one investment and indirectly to acquire another investment. Any reference in the temporary regulations to proceeds is to be construed to include a reference to proceeds used directly or indirectly. If proceeds are used directly and indirectly, the proceeds are treated as used directly or indirectly (whichever produces the larger amount of rebatable arbitrage).

The indirect use of proceeds of a refunding issue is illustrated in §1.148-8T(d)(9)(ii) (Examples). These examples illustrate that an indirect use occurs if fully fungible dollars are substituted for other fully fungible dollars solely for tax reasons, and the substitution involves a change in the purpose for which the funds are to be used. The indirect use concept in section 148(a) and §1.103-13(b)(1), and the requirement in 1.103-13(f)(4)(ii) that investments purchased with proceeds of a refunding issue must be allocated to such proceeds, implicate and give meaning to one another. A fundamental principle of Federal income taxation is that the substance of a transaction controls if the form of the transaction has no bona fide business purpose other than tax avoidance. This rule applies even when there is no reference to "indirectly" in the Code or regulations.

D. Nonpurpose Investment

Nonpurpose investment includes any taxable investment other than a purpose investment. Purpose investment means any investment (including a tax-exempt bond) that is allocated to gross proceeds of an issue, and that is acquired in order to carry out the governmental purpose of the issue. The use of gross proceeds to make a loan to a borrower in order to carry out the governmental purpose of the issue is not, in itself, an expenditure of the gross proceeds. The use of the gross proceeds by the borrower to finance expenditures is the relevant expenditure. Taxable investments by the borrower prior to actual expenditure of the gross proceeds are nonpurpose investments.

Arbitrage earned on purpose investments is not subject to rebate under section 148(f). In addition, amounts received with respect to purpose investments are not treated as sale or investment proceeds to the extent properly allocated to recoverable administrative costs or to the permitted one eighth percent higher yield.

E. Check Expenditures

An expenditure of proceeds in a checking or similar account may be treated as made on the date a negotiable check is written on the account if the check is delivered or mailed no later than one business day thereafter, and the payor has no reason to believe that the check will not clear within a reasonable period of time. If the check is delivered or mailed more than one business day after it is written, the expenditure may be treated as occurring on the date of delivery or mailing.

F. Refunding Escrows

Allocation rules are provided for excess gross proceeds of a refunded issue. These rules apply for purposes of section 148 generally.

First, excess replacement funds and excess proceeds of a refunded issue are allocated to investments in the escrow that are to be used to discharge the refunded issue. Second, the excess replacement funds and excess proceeds are allocated to investments in the escrow so that these amounts are used to discharge the refunded issue before sale proceeds of the refunding issue are so used. In other words, the refunding proceeds in the escrow are allocated to the investments that are to be used to discharge the latest payments of principal and interest.

Excess replacement funds of a refunded issue generally include gross proceeds (other than proceeds) of the refunded issue that at or around the time of issuance of the refunding issue were part of a sinking fund for the refunded issue and that are not thereafter part of a reasonably required reserve or replacement fund or bona fide debt service fund for the refunded issue or part of a sinking fund for the refunding issue. Excess replacement funds also include all amounts that were accumulated in a bona fide debt service fund for the refunded portion of the refunded issue. No inference is intended that the freeing up of pledged (non-sinking) funds in connection with a refunding cannot involve a replacement.

Excess proceeds of a refunded issue generally include proceeds of the refunded issue that are to be used to discharge principal or interest on the refunded issue, or that were to be used to pay capitalized interest on the refunded portion of the refunded issue.

A transition rule applies (for purposes of section 148(f)) to refunding issues sold on or before May 15, 1989, and issued on or before June 14, 1989. If the transition rule applies, the first allocation rule does not apply, and the second allocation rule applies only to refunding issues issued after August 31, 1986 and to which section 149(d)(4) (relating to abusive advance refunding transactions) applies. If the second allocation rule applies, the rule applies only to excess replacement funds that were gross proceeds of the refunded issue before the refunding and were not part of a reasonably required reserve or replacement fund or used to defease bonds (legally or economically) before the refunding and excess proceeds that were to be used to pay capitalized interest. In addition, the rule applies only for purposes of determining the extent to which proceeds of the refunded issue become transferred proceeds of the refunding issue (not for purposes of determining the rebatable arbitrage with respect to investments of proceeds of the refunding issue other than transferred proceeds).

G. Transferred Proceeds

Section 1.103-14(e)(2)(ii) provides that proceeds of a refunded issue become transferred proceeds of the refunding issue when the refunding proceeds discharge principal of the refunded issue. Unspent and spent proceeds transfer ratably. The transferred proceeds rule has been modified. The new rule applies for purposes of section 148 generally.

Under the new rule, the proceeds of the refunded issue become transferred proceeds of the refunding issue when the refunding proceeds discharge principal or interest on the refunded issue. The same amount of proceeds generally become transferred proceeds as the amount of the proceeds used to discharge such principal or interest. However, in the case of an advance refunding issue to which section 149(d)(4) applies, no transfer occurs on a date to the extent that the transfer would cause the value of the investments allocated to the refunding portion of the refunding issue to exceed by more than 10 percent the value of the outstanding bonds allocated (on a pro rata basis) to the refunding portion of the issue. Unspent proceeds become transferred proceeds before spent proceeds. For this purpose, proceeds invested exclusively in a purpose investment are spent.

The new transferred proceeds rule is simpler. The proceeds are allocated to expenditures on a first-in, first-out basis. The new rule also more accurately reflects the economics of the replacement. To the extent of the unspent proceeds of the refunded issue, the refunding really involves a replacement (rather than a true refunding). The new rule eliminates any benefit from the replacement by eliminating the replacement.

A transition rule applies (for purposes of section 148(f)) to refunding issues sold on or before May 15, 1989, and issued on or before June 14, 1989. If the transition rule applies, the transferred proceeds of the refunding issue are determined as provided in §1.103-14(e)(2)(ii).

The transition rule does not apply to refunding issues issued after August 31, 1986 that (if the transition rule did apply) would be described in section 149(d)(4) (relating to abusive advance refunding transactions). This exception is intended to apply to an advance refunding that was deliberately structured to earn arbitrage profits through employment of the window refunding device described in the legislative history of section 149(d)(4). See, S. Rep. No. 99-313, 99th Cong., 2d Sess. 850, 851 (1986) (Example (4)).

IX. Elections

Elections under the regulations must be in writing and signed by an authorized representative of the issuer no later than the later of: (1) The date of issue; or (2) if the issue is issued on or before November 15, 1989, the first date after June 14, 1989, that any rebate is paid or required to be paid to the United States. An election is not effective unless the election identifies the issue to which it applies and is maintained as part of the official transcript of the proceedings relating to the issuance. Elections, once made, generally are not revocable.

X. Rules Applicable for Section 148 Generally

Section 1.148-9T provides that the following rules apply for purposes of section 148 generally:

1. The rules for computing the yield on a fixed yield issue apply for purposes of section 148(a) and (d)(3). For this purpose, the date of issue is treated as the only computation date.

2. For purposes of section 148, the yield on nonpurpose investments not purchased with gross proceeds (*e.g.*, investments purchased before the date of issue and contributed to a debt service reserve fund for the issue) is determined on the basis of the same purchase price that is used for purposes of computing the rebatable arbitrage (*e.g.*, a purchase price equal to the fair market value of the investment on the date the investment is allocated to the gross proceeds).

3. The special refunding allocation rules and transferred proceeds rule apply for purposes of section 148. In addition, receipts imputed to an investment in an escrow are treated as interest on the investment for purposes of section 148.

4. A rule that provides that certain perpetual trust funds are not treated as reserve or replacement funds applies for purposes of section 148.

5. The definition of investment property applies for purposes of section 148.

Section 1.148-9T generally applies to issues sold after May 15, 1989, or issued after June 14, 1989.

XI. Abusive Advance Refunding Transactions

Section 149(d)(4) provides that interest on a bond is not tax-exempt if any bond that is part of the issue is issued to advance refund another bond and a device is employed in connection with the issuance to obtain any material financial advantage (based on arbitrage) apart from savings attributable to lower interest rates. Advance refundings are sophisticated financial transactions that present serious potential for arbitrage abuse. Section 1.149(d)-1T(d)(2) provides that any issue to which section 149(d)(4) and the rebate requirement apply that fails to meet the rebate requirement is issued in connection with such a device.

XII. Definitions and Special Rules Relating to Tax-Exempt Bond Requirements in General

Section 1.150-1T includes definitions that apply for purposes of the regulations under sections 141 through 150 except to the extent otherwise provided. These definitions include: (1) definitions of private activity bond, fixed yield bond, variable yield bond, tender bond, and current index bond; and (2) definitions of sale date, date of issue, and final maturity date.

Regulatory Impact Analysis

These rules are not major rules as defined in Executive Order 12291. Therefore, a Regulatory Impact Analysis is not required.

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Adoption of amendments to the regulations

For the reasons set forth in the preamble, Parts 1 and 602 of Title 26, Code of Federal Regulations, are amended as set forth below:

PART 1—[AMENDED]

Paragraph 1. The authority for Part 1 is amended by adding the following citation:

Authority: 26 U.S.C 7805. * * * Sections 1.148-0T through 1.148-9T also issued under 26 U.S.C. 148(f) and (i). Section 1.149(d)-1T also issued under 26 U.S.C. 149(d)(7).

Par. 2. Sections. 1.148-0T through 1.148-9T and sections 1.149(d)-1T, 1.150-0T and 1.150-1T are added in the appropriate places. The new sections read as follows:

§1.148-0T Scope and effective date of restrictions on arbitrage (temporary).

(a) *Scope*—(1) *In general.* The provisions of §§1.148-1T through 1.148-9T prescribe temporary regulations under section 148. The Federal income tax exemption of interest on State and local bonds under section 103(a) enables State and local governments to borrow at lower interest rates than taxable issuers. This lower interest rate enables State and local governments to finance their governmental activities at significantly less cost. The lower interest rate also provides the potential to benefit from tax arbitrage by investing proceeds of the bonds in taxable investments. The principal purpose of section 148 is to eliminate significant arbitrage incentives to issue more bonds, to issue bonds earlier, and to leave bonds outstanding longer than necessary to carry out the governmental purpose of the tax-exempt issue. A secondary purpose of section 148 is to minimize the tax arbitrage benefit associated with investing proceeds of the bonds in taxable investments. Minimizing this tax benefit targets the tax benefits to the activities for which the tax exemption is provided. If a State or local bond is an arbitrage bond (within the meaning of section 148), interest on the bond is not excluded from gross income under section 103(a). See section 103(b)(2).

(2) *Arbitrage bond defined.* Section 148(a) provides generally that the term "arbitrage bond" means any bond issued as part of an issue any portion of the proceeds of which is reasonably expected (at the time of issuance of the bond) to be used to acquire higher yielding investments or to replace funds that were used to acquire such investments. In addition, a bond is treated as an arbitrage bond if the issuer at any time intentionally uses any portion of the proceeds of the issue in such manner. Section 148(b) provides generally that the term "higher yielding investments" means investments (other than certain tax-exempt bonds) that produce a yield over the term of the issue that is materially higher than the yield on the issue. Section 148 (c), (d), and (e) provide exceptions for proceeds invested for a reasonable temporary period, as part of a reasonably required reserve or replacement fund, and as part of a minor portion.

(3) *Required rebate to the United States.* Section 148(f) provides generally that a bond that is part of an issue shall be treated as an arbitrage bond unless the issuer rebates to the United States arbitrage profits earned from investing in nonpurpose investments. Section 148(f)-(6) provides generally that the term "nonpurpose investment" means any investment (other than certain tax-exempt bonds) that is acquired with gross proceeds of the issue, and that is not acquired in order to carry out the governmental purpose of the issue. Section 148(f)(4) provides exceptions for certain 6-month temporary investments and for small issuers with general taxing powers. Section 148(f) does not apply to qualified veterans' mortgage bonds, or to qualified mortgage bonds issued on or before December 31, 1988.

(4) *Reserve or replacement fund financing limitation.* Section 148(d)(2) provides generally that a bond that is part of an issue shall be treated as an arbitrage bond if the amount of the sale proceeds of the issue that is part of a reserve or replacement fund exceeds 10 percent of the proceeds of the issue. This limitation restricts overissuance of tax-exempt bonds in order to obtain significant financial advantages through exploitation of the interest rate differential between the tax-exempt issue and a comparable taxable issue. See also section 149(d) (relating to additional restrictions on advance refundings) and section 149(f) (relating to additional restrictions on pooled financings).

(5) *Nonpurpose investment yield restriction.* Section 148(d)(3) provides generally that a private activity bond (other than a qualified 501(c)(3) bond) that is part of an issue shall be treated as an arbitrage bond if the amount invested during any bond year in nonpurpose investments with a yield materially higher than the yield on the issue exceeds 150 percent of the debt service on the issue for the bond year.

(b) *Effective dates*—(1) *In general*—(i) *1986 Reform Act.* Section 148 was added to the Internal Revenue Code by section 1301 of the Tax Reform Act of 1986 (hereinafter in this section referred to as the "1986 Act"). The restrictions on arbitrage formerly were contained in section 103(c) of the 1954 Code. Regulations under section 103(c) are contained in §§1.103-13, 1.103-14, 1.103-15, and 1.103-15AT.

(ii) *General effective date.* The amendments made by section 1301 of the 1986 Act (including the provisions of section 103 and section 148) generally apply to any bond issued after—

(A) August 15, 1986 if the bond is not a governmental bond described in section 1312(c)(2) of the 1986 Act; and

(B) August 31, 1986 if the bond is a governmental bond described in section 1312(c)(2).

See section 1311(a) and section 1312(c) of the 1986 Act.

(iii) *General transition rules.* In the case of a bond to which the amendments made by section 1301 of the 1986 Act do not apply solely by reason of section 1312(a) (relating to construction or binding agreements) or section 1313(a) or (b) (relating to certain current or advance refundings), the requirements of section 148 are treated as included in section 103 of the 1954 Code. See section 1312(b)-(1)(H) and section 1313(a)(3)(C) and (b)(3)(C) of the 1986 Act. If a bond to which section 148 applies by reason of such provisions is treated as an arbitrage bond under section 148, interest on the bond is not excluded from gross income under section 103(a) of the 1954 Code.

(2) *Required rebate*—(i) *Bonds issued before general effective date or pursuant to special transition rules.* Under section 1314(d) of the 1986 Act, section 103 of the 1954 Code is treated as including the requirements of section 148(f) in order for section 103(a) of the 1954 Code to apply in the case of any bond issued after—

(A) December 31, 1985 if the bond is not a governmental bond described in section 1312(c)(2) of the 1986 Act;

(B) 3 p.m. E.D.T., July 17, 1986 if the bond is a governmental pool bond described in section 1312(c)(2) and section 1314(d)(3); and

(C) August 31, 1986 if the bond is a governmental bond described in section 1312(c)(2) and is not a governmental pool bond described in section 1314(d)(3).

No provision of subtitle B of Title XIII of the 1986 Act overrides the provisions of section 1314(d) unless the provision expressly refers to section 148(f). See section 1314(i) of the 1986 Act.

(ii) *Bonds to which §§1.148-1T through 1.148-8T apply*—(A) *In general.* Except as otherwise provided, the provisions of §§1.148-1T through 1.148-8T apply to any bond to which section 148(f) applies.

(B) *Certain retired issues.* The provisions of §§1.148-1T through 1.148-8T shall not apply to any bond that is part of an issue if—

(*1*) The last bond that is part of the issue is discharged on or before May 15, 1989; and

(*2*) The issuer in good faith determines the amount described in section 148(f)(2) (if any) and pays such amount to the United States no later than the later of May 15, 1989, and the date 60 days after the last bond that is part of the issue is discharged.

(C) *Election in.* In the case of a bond to which section 148(f) does not apply and to which section 103(c)(6)(D) of the 1954 Code applies, the issuer may elect to apply the provisions of §§1.148-1T through 1.148-8T (in lieu of the provisions of §1.103-15AT(d)) for purposes of determining whether the bond meets the requirements of section 103(c)(6)(D) of the 1954 Code. See §1.148-8T(h) for elections.

(3) *Bonds to which §§1.148-9T applies.* Section 1.148-9T provides that certain provisions of §§1.148-1T through 1.148-8T apply for purposes of section 148 generally. Section 1.148-9T generally applies to any bond sold after May 15, 1989, or issued after June 14, 1989.

(c) *Cross reference.* See §1.148-8T for definitions and special rules relating to required rebate. See §1.150-1T for definitions and special rules relating to tax-exempt bond requirements in general.

(d) *List of subjects.* This paragraph (d) lists the paragraphs, subparagraphs, and subdivisions contained in §§1.148-1T through 1.148-9T.

(ii) Yield-to-call bond.
(5) Bond yield.
(i) In general.
(ii) Yield-to-maturity.
(iii) Lowest yield.
(6) Retirement prices.
(i) In general.
(ii) Stated retirement price.
(7) Early retirement value.
(i) In general.
(ii) Tender bond.
(iii) Special rules for certain discount bonds subject to mandatory early redemption.
(8) Present value.
(i) In general.
(ii) Discount rate, etc.
(iii) Approximate method.
(iv) Special present value for large fixed yield issues.
(9) Special rules for variable yield bonds.
(10) Actually paid.
(i) In general.
(ii) Unconditionally payable.
(11) Compounding interval.
(i) Bond.
(ii) Issue.
(12) Qualified guarantees.
(i) In general.
(ii) Guarantee.
(iii) Reasonable charge.
(iv) Nonguarantee element.
(v) Purpose investment bond guarantee.
(vi) When payments coincide.
(vii) Special rule for parity issues.
(viii) Eligible purpose investment.
(ix) Transition rule.
(13) Special rules for guarantee payments.
(i) Allocation to bonds.
(ii) Special rules for variable yield bonds.
(iii) Definitions and special rules.
(14) Certain hedging transactions. [Reserved]
(c) Computation of yield on fixed yield issue.
(1) General rule.
(i) Issue payments.
(ii) Issue prices.
(2) Determination of issue payments paid.
(i) Principal and interest.
(ii) Qualified guarantee.
(iii) Early retirement value.
(iv) Retirement price.
(3) Determination of issue payments to be paid.
(i) Scheduled early retirements.
(ii) Optional retirements.
(4) Special rule for small issues.
(i) In general.
(ii) Eligible small issue.
(5) Transition rule for fixed yield issues.
(6) Special rules for transitioned variable yield bonds.
(i) Issue payments paid.
(ii) Issue payments to be paid.
(iii) Tender bond remarketing.
(7) Examples.
(d) Computation of yield on variable yield issue.
(1) General rule.
(i) Issue payments.
(ii) Issue prices.
(2) Variable yield bonds.
(i) Issue payments.
(ii) Issue prices.
(3) Fixed yield bonds.
(i) Issue payments.
(ii) Issue prices.
(4) Examples.

§1.148-4T Allocation and accounting rules (temporary).

(a) General rule.
(b) Allocation of gross proceeds to issue. [Reserved]
(c) Allocation of gross proceeds to expenditures.
(1) In general. [Reserved]
(2) Expenditures from checking account.
(d) Allocation of gross proceeds to investments. [Reserved]
(e) Special allocation rules for refundings.
(1) Allocation of excess gross proceeds of refunded issue.
(i) Allocation of excess gross proceeds to escrow.
(ii) Allocation of excess gross proceeds in escrow.
(iii) Excess replacement funds.
(iv) Excess proceeds.
(v) Transition rule.
(2) Transferred proceeds.
(i) In general.
(ii) Special rules.
(iii) Transition rule.

§1.148-5T Transactions giving rise to imputed receipts (temporary).

(a) In general. [Reserved]
(b) Certain temporary investment accounts.
(1) No receipt imputed.
(2) Bond yield limit.
(3) Qualified accounts.
(i) Nonpurpose receipt account.
(ii) Purpose receipt account.
(iii) Checking account.
(iv) Disqualified account.
(4) Aggregation of accounts.
(5) Gross proceeds.
(c) Certain imputed escrow receipts.
(1) Defeasance receipt.
(i) In general.
(ii) Interest saving.
(iii) Transition rule.
(iv) Savings treated as paid in computing yield on defeased bond.
(2) Excess tax-exempt receipt.
(i) In general.
(ii) Excess receipts.
(3) Escrow.
(4) Examples.

§1.148-6T 6-month temporary investment exception and other special rules (temporary). [Reserved]

§1.148-7T Exception for small issuers with general taxing powers (temporary). [Reserved]

§1.148-8T Definitions and special rules relating to required rebate (temporary).

(a) Applicability.
(b) Computations and determinations.
(1) Computation dates.
(i) In general.
(ii) Installment date.
(iii) Final date.
(iv) Other date.
(2) Bond year.
(3) Discharge.
(4) Actual facts.
(5) Present value.
(6) Conventions.
(i) Whole intervals.
(ii) Short intervals.
(iii) Yield.
(iv) Other conventions.
(c) Issue price.
(1) In general.

(2) Special rules.
(i) Reasonable expectations.
(ii) Bonds offered at a discount.
(iii) Bona fide offering required.
(iv) Tender bond remarketing.
(3) Fair market value limit.
(4) Aggregate issue price.
(d) Gross proceeds.
(1) In general.
(2) Proceeds.
(3) Original proceeds.
(4) Sale proceeds.
(5) Investment proceeds.
(6) Net sale proceeds.
(i) In general.
(ii) Capitalized interest.
(iii) Special rules for refunded and refunding issues.
(7) Discount proceeds. [Reserved]
(8) Transferred proceeds.
(9) Indirect use.
(i) In general.
(ii) Examples.
(10) Reserve or replacement fund.
(i) In general. [Reserved]
(ii) Certain perpetual trust funds.
(e) Investments.
(1) In general.
(2) Investment property.
(3) Tax-exempt bond.
(i) In general.
(ii) AMT bond.
(iii) Tax-exempt mutual fund.
(4) Qualified exempt investment.
(i) In general.
(ii) Exempt demand deposit.
(iii) Exempt temporary investment. [Reserved]
(5) Security. [Reserved]
(6) Obligation. [Reserved]
(7) Annuity contract. [Reserved]
(8) Investment-type property. [Reserved]
(9) Nonpurpose investment.
(10) Purpose investment.
(11) Transferred investment.
(12) SLG.
(13) Fixed rate investment.
(14) Investment contract.
(f) Issues.
(1) In general. [Reserved]
(2) Refundings.
(i) Refunding issue.
(ii) Refunded issue.
(g) Restricted escrows.
(1) In general.
(2) Advance refunding escrow.
(3) Excess proceeds escrow.
(4) Same escrow.
(5) Examples.
(h) Elections.
(1) In general.
(2) Procedural requirements.
(3) Special rules.
(i) Issue.
(ii) Extension of time.
(4) Cross reference.

§1.148-9T Certain rules applicable for purposes of section 148 generally (temporary).
(a) Computation of yield on fixed yield issue.
(b) Computation of yield on investments.
(c) Refunding allocation rules.
(d) Certain imputed escrow receipts.
(e) Certain perpetual trust funds.
(f) Investment property.
(g) Effective dates.
(1) In general.
(2) Computation of yield on investments.
(3) Investment property.

§1.148-1T Required rebate to the United States (temporary).

(a) *General rule.* Under section 148(f) and this section, any bond that is part of an issue shall be treated as an arbitrage bond (within the meaning of section 148) if the requirements of this section are not met with respect to the issue. This section does not apply to any qualified veterans' mortgage bond, or to any qualified mortgage bond issued on or before December 31, 1988. See §1.148- 0T for scope and effective date. See §1.148-6T for 6-month temporary investment exception. See §1.148-7T for exception for small issuers with general taxing powers. See §1.148-8T for definitions and special rules relating to required rebate. See §1.150-1T for definitions and special rules relating to tax-exempt bond requirements in general.

(b) *Required rebate*—(1) *General rule*—(i) *In general.* Except as otherwise provided in paragraph (b)(1)(ii) of this section, an issue meets the requirements of this section if—

(A) *Rebate installments.* At least 90 percent of the rebatable arbitrage as of each installment computation date; and

(B) *Final rebate.* All the rebatable arbitrage as of the final computation date and any income attributable to such rebatable arbitrage;

is paid to the United States in accordance with the requirements of paragraph (b)(3) of this section. See §1.148-8T(b)(1) for definitions of installment and final computation date. See §1.148-2T for computation of rebatable arbitrage. See paragraph (b)(2) of this section for income included in final rebate.

(ii) *Refunding issues.* A refunding issue shall not be treated as meeting the requirements of this section unless—

(A) Each tax-exempt refunded issue to which this section, §1.103-15AT(d), or §6a.103A-2(i)(4) applies; and

(B) If the refunding issue is part of a series of refundings, each tax-exempt refunded issue in the series and to which this section, §1.103-15AT(d), or §6a.103A-2(i)(4) applies;

meets the requirements of this section, §1.103-15AT(d), or §6a.103A-2(i)(4) (whichever applies).

(2) *Income included in final rebate.* For purposes of this section—

(i) *In general.* Except as otherwise provided in paragraph (b)(2)(iv) of this section, the income attributable to the rebatable arbitrage is—

(A) To the extent amounts are identified under a reasonable accounting system as the rebatable arbitrage and invested at an arm's length interest rate during the final payment period, the amount earned from investing such amounts during the final payment period; and

(B) To the extent amounts are not so identified or invested, the amount that would have been earned if such amounts had been so identified and were invested during the final payment period at the final payment rate.

(ii) *Final payment period.* The final payment period begins on the final computation date and ends on the date 15 days before the final rebate is paid. Such period shall not include any day after the final rebate is required to be paid.

(iii) *Final payment rate.* The final payment rate is the maximum interest rate (with interest compounded and added to principal semiannually) in effect on the final computation date for a SLG with a term equal to the longer of the final payment period and 30 days. If the final rebate is paid no later than January 16, 1990, such rate shall not exceed the average of the maximum interest rates in effect on the first business day of each month during the final payment period for a SLG with a term of 60 days.

(iv) *De minimis rule.* No income shall be attributable to the rebatable arbitrage if—

(A) The amount described in paragraph (b)(2)(i) of this section is less than $300; and

(B) The final rebate is paid no later than 60 days after the final computation date.

If the final rebate is paid no later than January 16, 1990, paragraph (b)(2)(iv)(A) shall be applied by substituting "less than $1000" for "less than $300", and paragraph (b)(2)(iv)(B) shall not apply.

(3) *Payment of required rebate.* For purposes of this section—

(i) *Rebate installments.* Each rebate installment is required to be paid no later than the date 60 days after the installment computation date.

(ii) *Final rebate.*The final rebate is required to be paid no later than the latest of—

(A) The date 60 days after the final computation date;

(B) The date 8 months after the date of issue; and

(C) The earlier of the date the issuer no longer reasonably expects section 148(f)(4)(B) (relating to temporary investment exception) to apply to the issue, and the date 14 months after the date of issue.

In no event shall such date be earlier than January 16, 1990.

(iii) *De minimis rule.* Each rebate installment and the final rebate may be rounded down to the nearest multiple of $100. For example, $793,785.86 is rounded to $793,700. Any amount less than $100 is rounded to zero.

(iv) *Series of issues.* [Reserved]

(v) *Method of payment.* A rebate or correction amount is paid when filed with the Internal Revenue Service Center, Philadelphia, Pennsylvania 19255. The payment shall be accompanied by Form 8038-T if the payment is filed after such form has been made generally available. Prior to such time, the payment should be accompanied by a statement identifying the issuer and the issue with respect to which the rebate or correction amount is paid and a copy of the Form 8038, 8038-G, or 8038-GC filed with respect to the issue (if such form is required to be filed). The statement should include the Committee on Uniform Security Identification Procedures (CUSIP) number for the bond with the latest maturity for which there is a CUSIP number.

(c) *Certain failures not to result in loss of tax exemption.* For purposes of this section—

(1) *Innocent failures may be corrected without penalty*—(i) *In general.* An issue shall be treated as meeting the requirements of this section notwithstanding an innocent failure to meet a requirement if the issuer pays the correction amount to the United States in the manner provided in paragraph (b)(3)(v) of this section no later than the date that is—

(A) 60 days after the later of the date the failure first occurred or is discovered if the correction amount is $50,000 or more; or

(B) 180 days after the later of the date the failure first occurred or is discovered if the correction amount is less than $50,000.

The Commissioner may extend the time specified in this paragraph (c)(1)(i) if the correction amount is less than $50,000, or if the issuer files a request for extension before the expiration of such time.

(ii) *Innocent failure*—(A) *In general.* Factors to be taken into account in determining whether a failure is innocent include the size of the correction amount, the size of the issue, the sophistication of the issuer (or ultimate obligor), the steps taken to comply, the nature of the failure, and the length of the delay.

(B) *Explanation required.* If the correction amount is $50,000 or more, a failure shall be treated as innocent only if the correction amount is accompanied by a brief explanation of the failure and basis for concluding that the failure is innocent.

(C) *Safe harbor.* A failure shall be treated as innocent if—

(*1*) The correction amount is paid no later than the date specified in paragraph (c)(1)(i) of this section;

(*2*) If the correction amount is $50,000 or more, the brief explanation required under paragraph (c)(1)(ii)(B) of this section is reasonably accurate; and

(*3*) The Commissioner does not notify the issuer within 90 days after the receipt of the correction amount that this paragraph (c)(1)(ii)(C) shall not apply.

This paragraph (c)(1)(ii)(C) shall not apply to a failure if the issue is under examination by the Commissioner at any time during the period beginning on the date the failure first occurred and ending on the date 90 days after the receipt of the correction amount.

(iii) *Aggregation rule.* If an issue fails to meet more than one of the requirements of this section as of a date, all the failures as of such date shall be treated as one failure and all the correction amounts shall be treated as one correction amount for purposes of applying this paragraph (c)(1).

(2) *Correction amount*—(i) *In general.* Except as otherwise provided in paragraph (c)(2)(ii) of this section, the correction amount with respect to a failure is the sum of—

(A) The amount of the rebate not paid when required; and

(B) The amount that would have been earned if such amount had been invested during the correction period at the correction rate.

(ii) *Installment failure*—(A) *Corrected on or before final computation date.* The correction amount with respect to a failure to pay a rebate installment that is corrected on or before the final computation date shall not be less than the future value (as of the date the correction amount is paid) of the amount of the rebate installment not paid when required. Future value is determined as provided in §1.148-2T(c)(1) by treating the first interval as beginning on the date the rebate installment was required to be paid and the last interval as ending on the date the correction amount is paid.

(B) *Corrected after final computation date.* The correction amount with respect to a failure to pay a rebate installment that is corrected after the final computation date shall not be less than the sum of—

(*1*) The amount described in paragraph (c)(2)(ii)(A) of this section (determined as if the correction amount was paid on the final computation date); and

(*2*) The amount that would have been earned on such amount after the final computation date and during the correction period if such amount had been invested at the correction rate (determined as if the correction period began on the final computation date).

(iii) *Correction period.* The correction period begins on the date the rebate is required to be paid and ends on the date 7 days before the correction amount is paid.

(iv) *Correction rate.* The correction rate is the maximum interest rate (with interest compounded and added to principal semiannually) in effect on the first business day of the correction period for a SLG with a term equal to the longer of the correction period and 30 days. In the case of a failure to pay the final rebate, such rate shall not be less than the maximum interest rate in effect on the final computation date for a SLG with a term equal to the final payment period and correction period.

(3) *Payment of penalty in lieu of loss of tax exemption.* An issue that (but for this paragraph (c)(3)) would fail to meet a requirement of this section shall be treated as meeting such requirement if (and only if)—

(i) The Commissioner determines that the failure is not due to willful neglect; and

(ii) The issuer pays to the United States no later than the date specified by the Commissioner in such determination—

(A) The correction amount; and

(B) A penalty equal to the sum of—

(*1*) 50 percent of the amount of the rebate not paid when required (100 percent if any bond that is part of the issue is a private activity bond other than a qualified 501(c)(3) bond); and

(*2*) Interest on the amount of the rebate not paid when required for the period beginning on the date the rebate was required to be paid (at the underpayment rate established under section 6621 and the regulations thereunder).

The Commissioner may waive all or any portion of the penalty under paragraph (c)(3)(ii)(B) of this section.

(d) *Recovery of overpayment.* [Reserved]

(e) *Exemption from gross income of sum rebated.* [Reserved]

§1.148-2T Computation of rebatable arbitrage (temporary).

(a) *General rule.* The rebatable arbitrage with respect to an issue as of any computation date is the excess of—

(1) *Nonpurpose receipts.* The future value of all the nonpurpose receipts with respect to the issue; over

(2) *Nonpurpose payments.* The future value of all the nonpurpose payments with respect to the issue.

Future value is computed as of the computation date. See paragraph (b) of this section for determination of nonpurpose receipts and payments. See paragraph (c) of this section for computation of future value. See §1.148-6T for 6-month temporary investment exception and other special rules. See §1.148-8T for definitions and special rules relating to required rebate. See §1.150-1T for definitions and special rules relating to tax-exempt bond requirements in general.

(b) *Determination of nonpurpose receipts and payments*—(1) *In general.* For purposes of paragraph (a) of this section, any receipt or payment with respect to a nonpurpose investment allocated to an issue is a nonpurpose receipt or payment with respect to such issue. See §1.148-4T for allocation and accounting rules.

(2) *Receipts.* For purposes of this section—

(i) *Actual receipt.* The term "receipt" means, with respect to an investment allocated to an issue, any amount actually or constructively received with respect to the investment. Receipts are not reduced by selling commissions, administrative expenses, or similar expenses. See §1.451-2 for examples of constructive receipt.

(ii) *Disposition receipt.* An investment that ceases to be allocated to an issue other than by reason of a sale or retirement shall be treated as if sold on the date of such cessation for fair market value. For example, an investment allocated to an issue on the final computation date is treated as if sold for fair market value on such date. See paragraph (d) of this section for determination of fair market value. This paragraph (b)(2)(ii) shall not apply for purposes of computing the present value of an investment under paragraph (e) of this section.

(iii) *Installment date receipt.* For purposes of applying paragraph (a)(1) of this section on an installment computation date, the fair market value of all nonpurpose investments allocated to the issue at the close of business on such date shall be taken into account as a nonpurpose receipt with respect to the issue as of such date. The preceding sentence may be applied on any installment computation date to all fixed rate investments by substituting "present value" for "fair market value". See paragraph (e) of this section for computation of present value.

(iv) *Rebate receipt.* Any amount recovered with respect to an issue under §1.148-1T(d) shall be treated as a nonpurpose receipt with respect to the issue.

(v) *Imputed receipt.* Any imputed receipt with respect to an investment shall be treated as a receipt with respect to such investment. See §1.148-5T for transactions giving rise to imputed receipts.

(3) *Payments.* For purposes of this section—

(i) *Direct payment.* The term "payment" means, with respect to an investment allocated to an issue, the amount of gross proceeds of the issue to which the investment is allocated directly used to purchase the investment. Payments do not include brokerage commissions, administrative expenses, or similar expenses.

(ii) *Constructive payment.* An investment that was not directly purchased with gross proceeds of the issue to which the investment is allocated shall be treated as if directly purchased with such gross proceeds for fair market value on the date so allocated. For example, an investment in a reserve fund that was not purchased with gross proceeds allocated to the issue is treated as if purchased with such gross proceeds for fair market value on the date the investment is allocated to the issue.

(iii) *Rebate payment.* Any payment of rebatable arbitrage with respect to an issue as provided in §1.148-1T(b)(3)(v) no later than the date required under §1.148-1T(b)(3)(i) shall be treated as a nonpurpose payment with respect to the issue.

(iv) *Coordination with correction amount.* The amount of any rebate installment with respect to an issue required to be paid under §1.148-1T(b)-(1)(i)(A) but not paid by the date required under §1.148-1T(b)(3)(i) shall be treated as a nonpurpose payment with respect to the issue as of the date the amount is required to be paid.

(4) *Computation date credit*—(i) *In general.* For purposes of paragraph (a)(2) of this section, the computation date credit on each eligible computation date shall be treated as a nonpurpose payment with respect to the issue as of such date.

(ii) *Credit amount.* The computation date credit with respect to an issue on an eligible computation date is—

(A) $1,000 if the aggregate issue price of the bonds that are part of the issue and outstanding immediately before such date is more than $5 million;

(B) $625 if the aggregate issue price of such bonds is more than $1 million but not more than $5 million; and

(C) $250 if the aggregate issue price of such bonds is not more than $1 million.

(iii) *Eligible computation date.* For purposes of this paragraph (b)(4), a computation date is an eligible computation date unless—

(A) Such date is less than one year after the immediately preceding computation date (or the date of issue if such date is the first computation date); or

(B) Less than 75 percent of the net sale proceeds have been allocated to expenditures (other than expenditures for the payment of the principal or interest on or the retirement price of any bond) no later than such date. See §1.148-8T(d)(6).

(5) *Certain lower yielding investments not taken into account*—(i) *Advance refunding escrows*—(A) *In general.* For purposes of paragraph (b)(1) and (b)(2)(iii) of this section, investments in advance refunding escrows shall not be treated as nonpurpose investments as of a computation date if the rebatable arbitrage as of such date (with regard to such investments) is lower than the rebatable arbitrage as of such date (without regard to such investments). For purposes of this section, any investment allocated to an issue that ceases to be in an advance refunding escrow (but does not cease to be allocated to the issue) shall be treated as if sold and purchased for present value at the time of such cessation. The receipt arising from such sale shall be treated as a receipt with respect to the investment in the advance refunding escrow, and the payment arising from such purchase shall be treated as a payment with respect to the investment that is not in the advance refunding escrow. See §1.148-8T(g)(5) (Examples).

(B) *Excess proceeds escrows.* For purposes of paragraph (b)(5)(i)(A) of this section, an investment in an excess proceeds escrow shall be treated as in an advance refunding escrow if the investment is a transferred investment. For purposes of this section, an investment shall be treated as if sold and purchased for fair market value at the time the investment is first in an excess proceeds escrow. The receipt arising from such sale shall be treated as a receipt with respect to the investment that is not in the excess proceeds escrow, and the payment arising from such purchase shall be treated as a payment with respect to the investment in the excess proceeds escrow. The preceding two sentences shall not apply if the second sentence of paragraph (b)(5)(i)(A) of this section applies to the investment at such time. See §1.148-8T(g)(5) (Examples).

(ii) *Certain reserve or replacement funds*—(A) *In general.* For purposes of paragraph (b)(1) and (b)(2)(iii) of this section, investments allocated to gross proceeds (other than proceeds) that are part of a reserve or replacement fund (other than a reasonably required reserve or replacement fund or bona fide debt service fund) shall not be treated as nonpurpose investments as of a computation date if the rebatable arbitrage as of such date (with regard to such investments) is lower than the rebatable arbitrage as of such date (without regard to such investments).

(B) *Special rule where necessary to blend down.* If investments allocated to a refunding issue and described in paragraph (b)(5)(ii)(A) of this section are at all times (to the extent practicable) invested in SLGs that pay no interest for the purpose of reducing the yield on transferred investments to which paragraph (b)(5)(i) of this section applies, paragraph (b)(5)(ii)(A) shall not apply to such investments, and such investments shall be treated as investments in an advance refunding escrow for purposes of this section. In the case of an issue sold on or before May 15, 1989, and issued on or before June 14, 1989, the preceding sentence shall be applied by substituting "invested in SLGs" for "invested in SLGs that pay no interest".

(c) *Computation of future value*—(i) *In general.* For purposes of paragraph (a) of this section, the future value of a nonpurpose receipt or payment at the end of any interval is determined by using the following formula:

$$FV = PV\,(1 + i)^n$$

where:

FV = The future value of the nonpurpose receipt or payment at the end of the interval. Each interval ends on the last day of a compounding interval. The compounding interval is the same compounding interval used in computing the yield on the issue.

PV = The future value of the nonpurpose receipt or payment at the beginning of the interval or the amount thereof if the computation is for the first interval. The first interval begins on the date the nonpurpose receipt or payment is actually or constructively received or paid (or otherwise is taken into account). The amount of every nonpurpose receipt and payment with respect to an issue that is taken into account at the beginning of the first interval may be rounded to the nearest whole dollar. The preceding sentence shall not apply to receipts and payments with respect to investments in a restricted escrow.

i = The yield on the issue during the interval (expressed as a decimal) divided by the number of compounding intervals in a year. See §1.148-3T for computation of yield on issue.

n = A fraction, the numerator of which is the length of the interval, and the denominator of which is the length of a whole compounding interval. See §1.148-8T(b)(6) for computation conventions.

(2) *Examples.* The following examples illustrate the application of this paragraph (c):

Example (1). (i) On January 15, 1987, City A issues a fixed yield issue (as defined in §1.148-3T(b)(1)). The compounding interval is each 6-month (or shorter) period ending July 1 and January 1, and the bond year is each 1-year (or shorter) period ending January 1. See §1.148-8T(b)(2). On January 15, 1987, City A invests all the sale proceeds of the issue ($49 million, consisting of the $50 million issue price, less underwriters' discount of $1 million) in shares of a widely held mutual fund to which section 852 applies. The mutual fund does not pay exempt interest dividends. The only investment proceeds of the issue are the daily cash dividends paid on the mutual fund shares, which are reinvested each day in additional mutual fund shares, and amounts received from redemption of the mutual fund shares. Assume there are no other gross proceeds.

(ii) City A redeems the mutual fund shares and expends the gross proceeds for the governmental purpose of the issue as follows:

Date	*Amount*
2/01/87	$2,000,000.00
4/01/87	5,000,000.00
6/01/87	15,000,000.00
9/01/87	20,000,000.00
1/01/88	9,000,000.00

(iii) The first installment computation date is January 1, 1992. See §1.148-8T(b)(1)(ii). The yield on the issue as of the first installment computation date is 7.000 percent per annum compounded semiannually (computed on a 30 day month/360 day year basis). The rebatable arbitrage as of the first installment computation date is $161,590.75, computed as follows:

Date	*Receipts (Payments)*	*FV (7.000%)*
1/15/87	$(49,000,000.00)	$(68,934,646.17)
2/01/87	2,000,000.00	2,805,068.27
4/01/87	5,000,000.00	6,932,714.69
6/01/87	15,000,000.00	20,561,011.00
9/01/87	20,000,000.00	26,947,161.62
1/01/88	9,000,000.00	11,851,281.33
1/01/92	(1,000.00)	(1,000.00)
Rebatable arbitrage (1/01/92)	$	161,590.75

The initial $49 million investment and each daily reinvestment of a cash dividend is a nonpurpose payment. See paragraph (b)(3)(i) of this section. Each daily cash dividend and each amount received from redemption of the mutual fund shares is a nonpurpose receipt. See paragraph (b)(2)(i) of this section. Each nonpurpose receipt arising from a daily cash dividend can be netted against the nonpurpose payment arising from the reinvestment of that dividend. Accordingly, the above computation reflects only the initial $49 million nonpurpose payment, the 5 nonpurpose receipts arising from the mutual fund share redemptions, and the $1,000 computation date credit under paragraph (b)(4) of this section.

(iv) City A pays 90 percent of the rebatable arbitrage ($145,431.68) to the United States on February 28, 1992. City A redeems all the bonds on January 1, 1994. The final computation date is January 1, 1994. See §1.148-8T(b)(1)(iii). The yield on the fixed yield issue as of the final computation date is 6.500 percent per annum compounded semiannually. This yield is used to future value the receipts and payments from the date of issue to the final computation date. See paragraph (c)(1) of this section. The rebatable arbitrage as of the final computation date is $217,090.69, computed as follows:

Date	*Receipts (Payments)*	*FV (6.500%)*
1/15/87	$(49,000,000.00)	$(76,485,055.58)
2/01/87	2,000,000.00	3,112,976.41
4/01/87	5,000,000.00	7,699,913.01
6/01/87	15,000,000.00	22,854,780.43
9/01/87	20,000,000.00	29,989,605.98
1/01/88	9,000,000.00	13,210,621.00
1/01/92	(1,000.00)	(1,136.48)
2/28/92	(145,431.68)	(163,614.11)
1/01/94	(1,000.00)	(1,000.00)
Rebatable arbitrage (1/01/94)	$	217,090.69

Example (2). (i) The facts are the same as in Example (1), except that the issue is a variable yield issue (as defined in §1.148-3T(b)(2)). The yield on the variable yield issue during the first yield period (the period beginning on the date of issue and ending on the first installment computation date) is 7.000 percent per annum compounded semiannually. The rebatable arbitrage as of the first installment computation is the same as in Example (1)(iii) ($161,590.75).

(ii) City A pays 90 percent of the rebatable arbitrage ($145,431.68) to the United States on February 28, 1992. The yield on the variable yield issue during the second yield period (the period beginning after the close of business on the first installment computation date and ending on the final computation date, 1/01/94) is 6.500 percent per annum compounded semiannually. This yield is used to future value the receipts and payments after the first installment computation date (1/01/92). See paragraph (c)(1) of this section. The rebatable arbitrage as of the final computation date is $19,029.89, computed as follows:

Date	*Receipts (Payments)*	*FV (7.000/6.500%)*
1/15/87	$(49,000,000.00)	$(78,342,565.99)
2/01/87	2,000,000.00	3,187,892.56
4/01/87	5,000,000.00	7,878,863.36
6/01/87	15,000,000.00	23,367,094.06
9/01/87	20,000,000.00	30,624,800.52
1/01/88	9,000,000.00	13,468,695.95
1/01/92	(1,000.00)	(1,136.48)
2/28/92	(145,431.68)	(163,614.11)
1/01/94	(1,000.00)	(1,000.00)
Rebatable arbitrage (1/01/94)	$	19,029.89

Alternatively, the rebatable arbitrage as of the final computation date could be computed as follows:

Date	*Receipts (Payments)*	*FV (6.500%)*
1/01/92	$ 161,590.75	$ 183,644.00
2/28/92	(145,431.68)	(163,614.11)
1/01/94	(1,000.00)	(1,000.00)
Rebatable arbitrage (1/01/94)		$ 19,029.89

Example (3). (i) The facts are the same as in Example (2), except that all the bonds are redeemed on January 1, 2001, and the issue is treated as a fixed yield issue after the close of business on the first installment computation date (1/01/92). See §1.148-3T(b)(3)(ii). The yield on the fixed yield issue as of the second installment computation date (1/01/97) is 7.500 percent per annum compounded annually. This yield is used to future value the receipts and payments after the first installment computation date. See paragraph (c)(1) of this section. The rebatable arbitrage as of the second installment computation date is $24,575.56, computed as follows:

Date	*Receipts (Payments)*	*FV (7.000/7.500%)*
1/15/87	$(49,000,000.00)	$(98,964,599.63)
2/01/87	2,000,000.00	4,027,038.27
4/01/87	5,000,000.00	9,952,808.51
6/01/87	15,000,000.00	29,517,990.37
9/01/87	20,000,000.00	38,686,135.49
1/01/88	9,000,000.00	17,014,047.03
1/01/92	(1,000.00)	(1,435.63)
2/28/92	(145,431.68)	(206,408.86)
1/01/97	(1,000.00)	(1,000.00)
Rebatable arbitrage (1/01/97)	$	24,575.56

Alternatively, the rebatable arbitrage as of the second installment computation date could be computed as follows:

Date	*Receipts (Payments)*	*FV (7.500%)*
1/01/92	$ 161,590.75	$ 231,984.42
2/28/92	(145,431.68)	(206,408.86)
1/01/97	(1,000.00)	(1,000.00)
Rebatable arbitrage (1/01/97)		$ 24,575.56

(ii) City A pays 90 percent of the rebatable arbitrage ($22,118.00) to the United States on February 28, 1997. The yield on the fixed yield issue as of the final computation date (1/01/01) is 7.000 percent per annum compounded annually. This yield is used to future value the receipts and payments after the first installment computation date (1/01/92) and until the final computation date. See paragraph (c)(1) of this section. The rebatable arbitrage as of the final computation date is $1,562.68, computed as follows:

Date	*Receipts (Payments)*	*FV (7.000/7.000%)*
1/15/87	$(49,000,000.00)	$126,733,535.30)
2/01/87	2,000,000.00	5,157,003.60
4/01/87	5,000,000.00	12,745,513.18
6/01/87	15,000,000.00	37,800,580.10
9/01/87	20,000,000.00	49,541,257.54
1/01/88	9,000,000.00	21,788,097.35
1/01/92	(1,000.00)	(1,838.46)
2/28/92	(145,431.68)	(264,521.26)
1/01/97	(1,000.00)	(1,310.80)
2/28/97	(22,118.00)	(28,683.26)
1/01/01	(1,000.00)	(1,000.00)
Rebatable arbitrage (1/01/01)	$	1,562.68

Alternatively, the rebatable arbitrage as of the final computation date could be computed as follows:

Date	*Receipts (Payments)*	*FV (7.000%)*
1/01/92	$ 161,590.75	$ 297,078.00
2/28/92	(145,431.68)	(264,521.26)
1/01/97	(1,000.00)	(1,310.80)
2/28/97	(22,118.00)	(28,683.26)
1/01/01	(1,000.00)	(1,000.00)
Rebatable arbitrage (1/01/01)		$ 1,562.68

(d) *Determination of fair market value*—(1) *In general.* Except as otherwise provided in this paragraph (d), the fair market value of an investment is the price at which a willing buyer would purchase the investment from a willing seller. If the investment is not readily salable, the fair market value shall be determined by taking into account the price at which a willing buyer would purchase the same (or a substantially similar) investment from the issuer of the investment. The price shall not be increased by brokerage commissions, administrative expenses, or similar expenses.

(2) *Established securities market.* The price at which a willing buyer would purchase an investment that is traded in an established securities market (within the meaning of §§15A.453-1(e)(4)(iv)) shall be determined as provided in §§20.2031-2 of this chapter (Estate Tax Regulations); provided that, if the investment is an obligation of the United States (or any agency or instrumentality thereof, within the meaning of section 149(b)) and is backed by the full faith and credit of the United States (or any such agency or instrumentality), such price shall be the mean of the bid and asked prices on the date of determination (or, if there are no bid and asked prices on such date, on the first day preceding such date for which there are bid and asked prices). The bid and asked prices shall be determined either by reference to "Composite Closing Quotations for United States Government Securities" published by the Federal Reserve Bank of New York, or by reference to a comparable compilation of bid and asked prices regularly published in a newspaper of general circulation throughout the United States.

(3) *Restricted escrows*—(i) *In general.* For purposes of applying—

(A) Paragraph (b)(2)(iii) of this section to any investment in a restricted escrow on an installment computation date; and

(B) Paragraph (b)(2)(ii) and (b)(3)(ii) of this section to any investment in a restricted escrow when the investment ceases to be allocated to a refunded issue and is allocated to a refunding issue by reason of §1.148-4T(e)(2) (including §1.103-14(e)(2)(ii) if §1.148-4(e)(2)(iii)-(A) applies);

the present value of the investment shall be treated as the fair market value.

(ii) *Exception.* Paragraph (d)(3)(i)(B) of this section shall not apply to an investment that ceases to be allocated to a refunded issue and is allocated to a refunding issue if—

(A) The refunded issue is a tax-exempt issue to which §1.148-1T applies and §1.148-7T does not apply;

(B) The refunding issue is not a tax-exempt issue; and

(C) The refunded issue is sold after May 15, 1989, or issued after June 14, 1989,

or if paragraph (d)(3)(i)(B) of this section previously did not apply to the investment by reason of this paragraph (d)(3)(ii).

(4) *Certain SLGs.* If an SLG is not in a restricted escrow, the present value of the SLG shall be treated as the fair market value. See paragraph (e)(2)(iii)(B) of this section for special rule for determining this present value.

(5) *Investment contract.* In the case of nonpurpose investments purchased pursuant to an investment contract, the outstanding principal balance plus accrued interest shall be treated as the fair market value for purposes of applying paragraph (b)(2)(iii) of this section on an installment computation date.

(e) *Computation of present value.* For purposes of this section—

(1) *In general.* The present value of an investment on any date is the present value as of such date of all the receipts to be received with respect to the investment after such date. In the case of an investment in a restricted escrow, payments to be paid after such date shall be taken into account as negative receipts. See §1.148-8T(b)(5) for formula for determining present value. See paragraph (e)(5) of this section for approximate method for determining present value of certain investments.

(2) *Discount rate*—(i) *In general.* The present value of an investment is computed by using the yield on the investment as the discount rate. The yield on an investment that is allocated to an issue is the discount rate that when used in computing the present value of all the receipts received and to be received with respect to the investment payments with respect to the investment. For purposes of the preceding sentence, present value is computed as of the date the investment became allocated to the issue.

(ii) *Special rules for restricted escrows.* The yield on an investment in a restricted escrow is computed by treating—

(A) All investments in the same restricted escrow (whether or not held concurrently) as one investment; and

(B) The date any investment in the restricted escrow was first in the escrow as the date the one investment became allocated to the issue.

(iii) *Special rules for certain SLGs.* If an SLG is not in a restricted escrow—

(A) *Present value.* Except for purposes of paragraph (d)(4) of this section, the yield on the issue to which the SLG is allocated shall be treated as the yield on the SLG for purposes of computing the present value of the SLG; and

(B) *Fair market value.* For purposes of paragraph (d)(4) of this section, the maximum interest rate in effect on the date of determination for an SLG with a term equal to the remaining term of the SLG shall be treated as the yield on the SLG for purposes of computing the present value of the SLG.

(3) *Disposition assumption.* For purposes of computing the present value of and yield on any investment that is not in a restricted escrow, it shall be assumed that the investment remains allocated to the issue until and will be sold on the highest yield date for the stated price on such date. The highest yield date is the date on which the holder is entitled (under the terms of the investment or pursuant to a separate agreement or option) to require the investment to be purchased, redeemed, or retired at a stated price that, when used in computing the yield on the investment, produces the highest yield.

(4) *Compounding interval.* For purposes of computing the present value of and yield on an investment, the compounding interval is the accrual period (within the meaning of section 1272 and the regulations thereunder) except that—

(i) The accrual period shall be determined by treating the date the investment became allocated to the issue as the issue date;

(ii) If the investment is in a restricted escrow, the accrual period shall be the same as the compounding interval used in computing the yield on the issue that established the escrow or an issue for which the escrow was established or to which the investment is allocated; and

(iii) If the yield on the issue to which an SLG is allocated is treated as the yield on the SLG, the accrual period shall be the same as the compounding interval used in computing the yield on the issue.

(5) *Approximate method*—(i) *In general.* If an investment is an eligible investment, the issuer may treat the outstanding par amount of the investment plus accrued interest unpaid at the close of business on a date as the present value of the investment on such date.

(ii) *Eligible investment.* An investment is an eligible investment if—

(A) The investment is a fixed rate investment that is not an SLG and is not in a restricted escrow;

(B) The payment taken into account with respect to the investment is equal to the outstanding par amount of the investment plus accrued interest (if any) for the period that begins on a date that is less than one year before the date the investment is allocated to the issue and that ends on the date the investment is allocated to the issue;

(C) All interest on the investment (other than such accrued interest) accrues on the outstanding par amount of the investment and is actually and unconditionally due at periodic intervals of one year or less;

(D) The first payment of interest on the investment (including such accrued interest) is due at the end of the first short compounding interval or at the end of the first whole compounding interval; and

(E) The final maturity date of the investment is the highest yield date. See paragraph (e)(3) of this section for highest yield date. See §1.150-1T(d)(1) for final maturity date.

(6) *Example.* The following example illustrates the application of this paragraph (e):

Example. (i) On July 1, 1993, the first installment computation date, City Y holds two fixed rate investments that are not in a restricted escrow. City Y may treat both of these investments as if sold for present value (or both as if sold for fair market value) for purposes of determining the installment date receipt on the first installment computation date under paragraph (b)(2)(iii) of this section.

(ii) One of the investments is a $100,000 face amount 8.625% United States Treasury note due August 15, 1997, that pays interest on February 15 and August 15 of each year. The present value of the Treasury note is determined by using the yield on the Treasury note as the discount rate. See paragraph (e)(2)(i) of this section. The Treasury note was purchased with gross proceeds for $112,000 (including accrued interest) on February 1, 1990. The yield on the Treasury note is 7.225% per annum compounded semiannually, computed as follows:

Date	*Receipts*	*PV (7.2251652778%)*
2/15/90	$ 4,312.50	$ 4,300.61
8/15/90	4,312.50	4,150.67
2/15/91	4,312.50	4,005.95
8/15/91	4,312.50	3,866.28
2/15/92	4,312.50	3,731.47
8/15/92	4,312.50	3,601.37
2/15/93	4,312.50	3,475.80
8/15/93	4,312.50	3,354.62
2/15/94	4,312.50	3,237.65
8/15/94	4,312.50	3,124.77
2/15/95	4,312.50	3,015.82
8/15/95	4,312.50	2,910.67
2/15/96	4,312.50	2,809.19
8/15/96	4,312.50	2,711.24
2/15/97	4,312.50	2,616.71
8/15/97	104,312.50	61,087.19
	Payment (2/01/90) $	112,000.00

See paragraph (e)(2)(i) of this section.

(iii) The present value of the Treasury note on the first installment computation date is $108,159.41, computed as follows:

Date	*Receipts*	*PV (7.225%)*
8/15/93	$ 4,312.50	$ 4,275.25
2/15/94	4,312.50	4,126.19
8/15/94	4,312.50	3,982.33
2/15/95	4,312.50	3,843.49
8/15/95	4,312.50	3,709.48
2/15/96	4,312.50	3,580.15
8/15/96	4,312.50	3,455.32
2/15/97	4,312.50	3,334.85
8/15/97	104,312.50	77,852.35
	Treasury note PV (7/01/93) $	108,159.41

See paragraph (e)(1) and (e)(2)(i) of this section.

§1.148-3T Computation of yield on issue (temporary).

(a) *In general.* Under this section, the yield on a fixed yield issue is the same throughout the term of the issue, whereas the yield on a variable yield issue changes each yield period. See paragraph (b) of this section for definitions and special rules. See paragraph (c) of this section for computation of yield on fixed yield issue. See paragraph (d) of this section for computation of yield on variable yield issue. See §1.148-8T for definitions and special rules relating to required rebate. See §1.150-1T for definitions and special rules relating to tax-exempt bond requirements in general.

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

(1) *Fixed yield issue*—(i) *In general.* The term "fixed yield issue" means any issue if each bond that is part of the issue is a fixed yield bond. See §1.150-1T(b)(5) and (b)(6) for definitions of fixed yield bond and variable yield bond.

(ii) *Transition rule.* Any issue sold on or before May 15, 1989, and issued on or before June 14, 1989, shall be treated as a fixed yield issue if the issuer elects to treat the issue as a fixed yield issue. See §1.148-8T(h) for elections.

(2) *Variable yield issue*—(i) *In general.* The term "variable yield issue" means any issue that is not a fixed yield issue.

(ii) *Yield period*—(A) *In general.* The first yield period for a variable yield issue begins on the date of issue and ends at the close of business on the first computation date. Each succeeding yield period begins immediately after the close of business on a computation date and ends at the close of business on the next succeeding computation date.

(B) *Bond year election.* The issuer of a variable yield issue may elect to treat the last day of any bond year that is not a computation date as a computation date for purposes of applying paragraph (b)(2)(ii)(A) of this section. An election under the preceding sentence with respect to the last day of a bond year may be revoked at any time before the close of business on a computation date (without regard to the preceding sentence) that precedes such last day. The revocation shall be effective only if it is in writing and signed by an authorized representative of the issuer and satisfies the procedural requirements of §1.148-8T(h)(2).

(C) *First and last day.* Any reference to the last day of a yield period shall be construed as a reference to the period before the close of business on such day, and any reference to the first day of a yield period shall be construed as a reference to the period after the close of business on such day.

(3) *Conversion to fixed yield*—(i) *Conversion to fixed yield bond.* A variable yield bond shall be treated as a fixed yield bond after the close of business on the first day the bond would be a fixed yield bond if issued immediately after the close of business on such day. The fixed yield bond shall be treated as if issued on such day for an issue price equal to the amount taken into account with respect to the bond on such day under paragraph (d)(2)(ii) of this section (without regard to any accrued interest taken into account under paragraph (d)(2)(ii)(A)). The preceding sentence shall not apply for purposes of paragraph (c)(1)(ii) of this section. Principal or interest that accrued on the variable yield bond on or before such day shall not be treated as principal or interest on the fixed yield bond. See paragraph (d)(4) of this section (Examples (9)-(11)). This paragraph (b)(3)(i) shall apply to a variable yield bond that is not a tender bond only if the issuer elects to apply this paragraph (b)(3)(i) to the bond.

(ii) *Conversion to fixed yield issue.* Unless the issuer otherwise elects, a variable yield issue shall be treated as a fixed yield issue as of the first day of a yield period if the issue would be a fixed yield issue if issued on such day. Each bond that is part of the fixed yield issue shall be treated as if issued on such day for the amount that (but for this paragraph (b)(3)(ii)) would have been taken into account with respect to the bond on such day under paragraph (d)(2)(ii) or (d)(3)(ii) of this section (without regard to any accrued interest that would be taken into account under paragraph (d)(2)(ii)(A)). The preceding sentence shall not apply for purposes of paragraph (d) of this section. No issue payment taken into account with respect to the variable yield issue under paragraph (d) of this section shall be taken into account with respect to the fixed yield issue under paragraph (c) of this section. See paragraph (d)(4) of this section (Examples (9)-(11)).

(4) *Yield-to-call bond*—(i) *In general.* A yield-to-call bond shall be treated as if the lowest yield date were the final maturity date and the stated retirement price on the lowest yield date were the stated retirement price on the final maturity date. If a bond to which the preceding sentence applies is not retired on or before the lowest yield date, the bond shall be treated as if it were retired on such date for the stated retirement price on such date, and shall be treated as if issued on such date (as part of the same issue) for an issue price equal to such price (less any amount included in such price and paid to discharge principal or interest on such date). See paragraph (c)(7) of this section (Examples (4), (5), and (6)) for fixed yield bonds and paragraph (d)(4) of this section (Example (3)) for current index bonds.

(ii) *Yield-to-call bond.* The term "yield-to-call bond" means—

(A) Any bond that is part of a fixed yield issue if the yield-to-maturity on the bond is more than one-fourth of one percent higher than the lowest yield;

(B) Any fixed yield bond or current index bond that is part of a variable yield issue if the yield-to-maturity on the bond is more than one-sixteenth of one percent higher than the lowest yield; and

(C) Any variable yield bond (other than a current index bond) that is part of a variable yield issue if the yield-to-maturity on the bond is higher than the lowest yield;

determined without regard to paragraph (b)(3)(ii) and (b)(4)(i) of this section.

Such term shall not include any tender bond. See §1.150-1T(b)(7) and (b)(8) for definitions of tender bond and current index bond.

(5) *Bond yield*—(i) *In general.* The term "yield" means, with respect to a bond, the discount rate that when used in computing the present value of all the unconditionally payable payments of principal and interest and all the payments for a qualified guarantee paid and to be paid with respect to the bond produces an amount equal to the present value of the issue price of the bond. Present value is computed as of the date of issue of the bond. See §1.148-8T(c) for definition of issue price (in general). For purposes of computing the yield, the stated retirement price of the bond on the assumed retirement date shall be treated as an unconditionally payable payment of principal and interest. If paragraph (b)(3) of this section applied to the bond, payments for a qualified guarantee with respect to the variable yield bond shall not be taken into account.

(ii) *Yield-to-maturity.* The term "yield-to-maturity" means, with respect to a bond, the yield on the bond determined by assuming the bond is retired on the final maturity date for the stated retirement price on such date. See §1.150-1T(d)(1) for definition of final maturity date. See paragraph (b)(4)(i) of this section for special rules for yield-to-call bonds.

(iii) *Lowest yield.* The term "lowest yield" means, with respect to a bond, the yield on the bond determined by assuming the bond is retired on the lowest yield date for the stated retirement price on such date. The lowest yield date is the date that when used in computing the yield on the bond produces the lowest yield.

(6) *Retirement prices*—(i) *In general.* The term "retirement price" means, with respect to a bond, the amount paid in connection with the retirement or redemption of the bond.

(ii) *Stated retirement price*—(A) *In general.* The stated retirement price of a bond on a date is the lowest price at which the issuer or any ultimate obligor (or related person, as defined in section 147(a)(2)) has a right (under the terms of the bond or pursuant to a separate agreement or option entered into in connection with the issuance of the bond) to retire or redeem the bond as of such date.

(B) *Right to retire.* A person has a right to retire or redeem a bond as of a date even if the exercise of the right is subject to a contingency; provided that, a right to redeem a bond only in the event of a remote contingency shall not be taken into account unless and until the remote contingency has occurred. An example of a remote contingency is the destruction or condemnation of facilities financed with proceeds of the issue of which the bond is a part. In no event shall any contingency related to the failure to spend proceeds of an issue be considered remote. See paragraph (d)(4) of this section (Example (3)).

(7) *Early retirement value*—(i) *In general.* Except as otherwise provided in this paragraph (b)(7), the early retirement value of a bond on any date is the lesser of—

(A) The present value of the bond on such date; and

(B) If the bond is part of a fixed yield issue (without regard to paragraph (b)(3)(ii) of this section) and the yield-to-maturity on the bond is higher than the lowest yield, the lowest stated retirement price (properly adjusted to take into account accrued interest) on any day during the period beginning one year before such date and ending 90 days after such date.

See paragraph (c)(7) of this section (Examples (1), (2), (4), (5), (7), and (9)) for fixed yield bonds and paragraph (c)(4) of this section (Examples (1)-(3)) for current index bonds.

(ii) *Tender bond.* The early retirement value of a tender bond on any date is the outstanding par amount of the bond on such date. See §1.150-1T(b)(7) for definition of tender bond. See paragraph (d)(4) of this section (Examples (4)-(11)).

(iii) *Special rules for certain discount bonds subject to mandatory early redemption*—(A) *In general.* If the yield to maturity on a bond that is subject to mandatory early redemption (determined without regard to any payment for a qualified guarantee) is more than one fourth of one percent lower than the composite yield-to-maturity determined as provided in paragraph (b)(8)(ii)(B) of this section (but without regard to any payment for a qualified guarantee)—

(*1*) Paragraph (b)(8)(ii)(B) of this section shall not apply for purposes of determining the issue payments to be paid on the bond under paragraph (c) of this section or for purposes of determining the early retirement value of the bond under paragraph (d)(2)(i)(F)(*1*) and (d)(3)(i)(E) of this section;

(*2*) For purposes of determining the issue payments paid on the bond under paragraph (c) of this section, the early retirement value of the bond on the date the bond is retired shall not exceed an amount equal to the greater of (*i*) the retirement price of the bond; and (*ii*) the present value of the bond on the retirement date (determined without regard to paragraph (b)(8)(ii)(B) of this section);

(*3*) For purposes of determining the early retirement value of the bond under paragraph (d) of this section on the date the bond is retired, the early retirement value of the bond shall not exceed an amount: equal to the greater of (*i*) the retirement price of the bond less interest paid in connection with the retirement; and (*ii*) the present value of the bond on the retirement date (determined without regard to paragraph (b)(8)(ii)(B) of this section); and

(*4*) The early retirement value of the bond on the date the bond is retired may be determined without regard to paragraph (b)(8)(ii)(B) of this section if the bond is or was part of a variable yield issue.

See paragraph (c)(7) of this section (Example (9)).

(B) *Mandatory early redemption.* A bond is subject to mandatory early redemption if the final maturity date of the bond is not the earliest date on which the final payment of principal and interest on the bond is actually and unconditionally due (without regard to any unanticipated event or optional retirement). See §1.150-1T(d)(1) and (d)(2) for definitions of final maturity date and actually and unconditionally due. Bonds evidenced by a single loan instrument and to which §§1.150-1T(d)(3) applies shall not be treated as subject to mandatory early redemption for purposes of paragraph (b)(7)(iii)(A) of this section.

(8) *Present value*—(i) *In general.* The present value of a bond on any date is the present value as of such date of all the unconditionally payable payments of principal and interest and all payments for a qualified guarantee to be paid on and after such date with respect to the bond. See §1.148-8T(b)(5) for formula for determining present value. See paragraph (b)(8)(iii) of this section for approximate method for determining present value of certain bonds. See paragraph (b)(8)(iv) of this section for special present value for large fixed yield issues.

(ii) *Discount rate, etc*—(A) *In general.* For purposes of computing the present value of a bond, the yield-to-maturity on the bond shall be used as the discount rate, the bond shall be assumed to be retired on the final maturity date for the stated retirement price on such date, and the stated retirement price on such date shall be treated as an unconditionally payable payment of principal and interest on the bond.

(B) *Bonds subject to mandatory early redemption.* For purposes of applying paragraph (b)(8)(i) and (b)(8)(ii)(A) of this section to substantially identical bonds that are subject to mandatory early redemption—

(*1*) The composite yield-to-maturity on all such bonds shall be treated as the yield-to-maturity on each bond;

(*2*) The composite yield-to-maturity shall be determined by assuming the bonds are retired on the scheduled early retirement dates and by treating such dates as the final maturity dates; and

(*3*) The present value of each bond retired in satisfaction of a mandatory early redemption requirement shall be determined by treating the mandatory early redemption date (in satisfaction of which the bond is retired) as the final maturity date and the stated retirement price on such date as the stated retirement price on the final maturity date.

For purposes of this paragraph (b)(8)(ii)-(B), the scheduled early retirement dates (and mandatory redemption dates) shall be determined on the basis of reasonable expectations as of the date of issue (if the dates are not fixed and determinable as of the date of issue). See paragraph (c)(7) of this section (Examples (7)-(10)).

(iii) *Approximate method*—(A) *In general.* If a bond is an eligible bond, the issuer may treat the outstanding par amount of the bond plus (if the bond is not a variable yield bond) unpaid accrued interest as of a date (including interest paid on such date) as the present value of the bond on such date. The preceding sentence shall not apply for purposes of paragraph (d)(3)(i)(E) of this section if there is unpaid accrued interest as of such date (not including interest paid on such date).

(B) *Eligible bond.* A bond is an eligible bond if—

(*1*) The issue price of the bond is par plus accrued interest on such par amount (if any) for the period that begins on a date that is less than one year before the date of issue and ends on the date of issue;

(*2*) All interest on the bond (other than such accrued interest) accrues on the outstanding par amount of the bond and is actually and unconditionally due at periodic intervals of one year or less;

(*3*) The first payment of interest on the bond (including such accrued interest) is due at the end of the first short compounding interval or at the end of the first whole compounding interval;

(*4*) The lowest stated retirement price of the bond is not less than the outstanding par amount of the bond plus accrued interest; and

(*5*) No payment for a qualified guarantee is taken into account with respect to the bond (without regard to paragraph (b)(13)(ii)(D) of this section).

(iv) *Special present value for large fixed yield issues.* If the aggregate issue price of the bonds issued as part of a fixed yield issue is $35 million or more, the present value of the bonds that are part of the issue shall be determined by substituting "one sixteenth of one percent" for "one fourth of one percent" in paragraph (b)(4)(ii)(A) of this section.

(9) *Special rules for variable yield bonds.* For purposes of determining whether a variable yield bond (other than a tender bond) is a yield-to-call bond and for purposes of computing the yield on and present value and early retirement value of the bond—

(i) Any interest that is unconditionally payable but that does not accrue at a rate that is fixed and determinable as of the date of issue shall not be taken into account;

(ii) The interest described in paragraph (b)(9)(i) of this section shall be treated as unconditionally payable at a rate that is fixed and determinable as of the date of issue and shall be fixed and determined on the basis of the rate established by the interest index or other interest rate setting mechanism as of such date;

(iii) Payments for a qualified guarantee shall be taken into account only for purposes of determining whether the bond is a yield-to-call bond and shall be treated as level payments for such purpose; and

(iv) Interest that accrued on the bond on or before a date and that is payable on or after such date (including the interest treated as so accruing under paragraph (b)(9)(ii) of this section) shall not be taken into account in determining the present value of the bond on such date.

See paragraph (d)(4) of this section (Examples (1)-(3)).

(10) *Actually paid*—(i) *In general.* Payments of principal and interest on a bond that are unconditionally payable shall be treated as if paid on the date actually and unconditionally due if—

(A) The rebatable arbitrage (with regard to this paragraph (b)(10)) is lower than the rebatable arbitrage (without regard to this paragraph (b)(10));

(B) As of the date of issue, it is reasonably expected that all payments of principal and interest payable on the bond will be paid no later than the date actually and unconditionally due; and

(C) As of the date of issue, the holders of all bonds that are part of the issue are reasonably assured that sufficient funds will be available to fully retire the bonds (after reduction for any amount required to be paid under §1.148-1T(b)(1)(i), determined without regard to this paragraph (b)(10)) in the event that none (or an insubstantial portion) of the proceeds of the issue are expended for a governmental purpose (not including the payment of the principal or interest on or the retirement price of any bond that is part of the issue).

The reasonable assurance must be predicated on a binding obligation (enforceable by or on behalf of the bondholders) of a person or persons with sufficient funds (and to the extent necessary the binding obligation must be enforced). See §1.150-1T(d)(2) for definition of actually and unconditionally due.

(ii) *Unconditionally payable*—(A) *In general.* A payment of principal or interest on a bond is unconditionally payable if the amount of the payment and date the amount is actually and unconditionally due is fixed and determinable as of the date of issue. The determination under the preceding sentence shall be made without regard to unanticipated events and by assuming that no payment is paid before the latest date the payment is actually and unconditionally due.

(B) *Variable yield bonds.* Any payment of interest on a variable yield bond that is determined by reference to market interest rates (including by reference to any index of such rates) after the date of issue shall be treated as unconditionally payable if the payment would be unconditionally payable if the payment were determined by reference to interest rates that were fixed and determinable as of the date of issue.

(11) *Compounding interval*—(i) *Bond.* The compounding interval used in computing the yield on and the present value of a bond is the accrual period

(within the meaning of section 1272 and the regulations thereunder) with respect to the bond.

(ii) *Issue*. The compounding interval used in computing the yield on an issue and the present value of amounts under paragraphs (c)(1) and (d)(1) of this section is the shortest accrual period (within the meaning of section 1272 and the regulations thereunder) with respect to any bond that is part of the issue.

(12) *Qualified guarantees*—(i) *In general*. The term "qualified guarantee" means, with respect to a bond, any guarantee of the bond if the guarantee meets each of the requirements of this paragraph (b)(12).

(ii) *Guarantee*—(A) *In general*. The term "guarantee" means, with respect to a bond, an unconditional and recourse obligation of a guarantor (enforceable by or on behalf of the holder of the bond) to pay all or part of any payment of principal or interest on the bond (or any payment of the tender price of the bond if the bond is a tender bond) that is actually and unconditionally due under the terms of the bond.

(B) *Secondary liability*. An obligation to pay shall not be treated as a guarantee unless—

(*1*) It is reasonably expected that the guarantor will not be called upon to make any payment under the guarantee (for which the guarantor will not be reimbursed immediately in cash); and

(*2*) The guarantor is entitled to be fully reimbursed immediately or upon commercially reasonable repayment terms (during a workout period that is not unreasonably long) for any payment under the guarantee.

In no event shall any hedging transaction described in section 1256(e)(2)(A)(i) or (ii) be treated as a guarantee. See paragraph (b)(14) of this section for treatment of hedging transactions.

(C) *Guarantor*. The term "guarantor" includes only—

(*1*) The United States (or any agency or instrumentality thereof, within the meaning of section 149(b));

(*2*) An entity that is not exempt from Federal income taxation and is either a bank (within the meaning of section 581 or 585(a)(2)(B)) or is rated in one of the two highest ("AA" or "AAA") categories for long-term debt by a nationally recognized rating agency; and

(*3*) A State insurance fund established before May 15, 1989, but only with respect to guarantees of obligations of persons other than State or local government units and of the type guaranteed by such fund before such date.

Such term shall not include any person that is to use 20 percent or more of the proceeds of the issue of which the bond is a part for a private business use (within the meaning of section 141(b)(6)) or a person related to such a person (within the meaning of section 144(a)(3)).

(D) *Risk shifting*. An obligation to pay shall be treated as a guarantee only to the extent that the obligation shifts ultimate credit risk with respect to the issue. An obligation to pay does not shift ultimate credit risk with respect to an issue to the extent that the guarantor or a person related to the guarantor (within the meaning of section 144(a)(3)) is obligated to pay any amount that is taken into account with respect to the issue under section 141(b)(2). For purposes of this paragraph (b)(12)(ii)(D), any person that owns a share of the beneficial ownership interests of another person shall be treated as owning a proportionate share of the beneficial ownership interests owned by such other person, any person a share of the beneficial ownership interests of which is owned by another person shall be treated as owning a proportionate share of the beneficial ownership interests owned by such other person, and any obligation to pay shall be treated as the obligation of any person that owns a proportionate share of the beneficial ownership interests of the obligor and of any person a proportionate share of the beneficial ownership interests of which is owned by the obligor in the same proportion as the proportionate share so owned. For purposes of the preceding sentence, proportionate shares shall be determined on the basis of fair market value, and no share shall be taken into account that is less than 10 percent of the total.

(E) *Form of guarantee*. A guarantee may be in the form of an insurance policy, surety bond, irrevocable letter or line of credit, or standby purchase agreement. A guarantee of the principal and interest on a bond may be in the form of a recourse loan to the guarantor if the loan is in substance a guarantee of the bond. A loan is not in substance a guarantee unless the terms of the loan and bond are substantially identical (without regard to any discrepancy in payment dates of no more than 15 business days).

(iii) *Reasonable charge*. A guarantee of a bond does not meet the requirements of this paragraph (b)(12) if the payments for the guarantee of the bond exceed a reasonable charge for the transfer of credit risk. In determining whether this requirement is met, there shall be taken into account payments charged by guarantors in comparable transactions (including transactions in which the guarantor has no involvement other than as a guarantor). In no event shall this requirement be considered met unless the present value of such payments is less than the present value of the interest to be saved as a result of the guarantee. Present value is computed by using the yield-to-maturity on the bond (with regard to payments for the guarantee) as the discount rate.

(iv) *Nonguarantee element*—(A) *In general*. A guarantee of a bond does not meet the requirements of this paragraph (b)(12) if any payment denominated as a payment for the guarantee or taken into account by the issuer as a payment for a qualified guarantee with respect to the bond includes direct or indirect payment for a cost, risk, or other element that is not customarily borne by guarantors of tax-exempt bonds (in transactions in which the guarantor has no involvement other than as a guarantor).

(B) *Nonguarantee charges must be separately stated*. A guarantee shall not be treated as meeting the requirements of paragraph (b)(12)(iv)(A) of this section if the guarantor (or a related person within the meaning of section 147(a)(2)) provides any nonguarantee service(s) the fee(s) for which are not separately stated. The preceding sentence shall not apply to any guarantee entered into on or before June 14, 1989.

(C) *Examples*. The following are examples of payments that include a nonguarantee element:

(*1*) Payments for the guarantee of the tender price of tender bonds include indirect payment for a noncustomary cost (the cost of remarketing the bonds) if the issuer or an ultimate obligor (or its agent) is not required to use best efforts to remarket bonds that are tendered for purchase and not retired.

(*2*) Payments for a guarantee include indirect payment for a noncustomary risk if the guarantor is not reasonably assured that sufficient funds will be available to fully retire the bonds (after reduction for any amount required to be paid under §1.148-1T(b)(1)(i), determined without regard to any payment for any qualified guarantee) in the event that none (or an insubstantial portion) of the proceeds of the issue are expended for a governmental purpose (not including the payment of the principal or interest on or the retirement price of any bond that is part of the issue). The reasonable assurance must be predicated on a binding obligation (enforceable by the guarantor) of a person or persons with sufficient funds (and to the extent necessary the binding obligation must be enforced).

(*3*) Payments for a guarantee include a nonguarantee element if the issuer is entitled to a refund in the event a guaranteed bond is retired before the final maturity date, and the amount of the refund exceeds the unearned portion of the payments for the guarantee.

(*4*) If a guarantee is in the form of a loan to the guarantor, payments to the guarantor include a nonguarantee element if the payment for any nonguarantee service performed by the guarantor does not fully and adequately compensate the guarantor for such service (or any portion of such payment is taken into account as a payment for a qualified guarantee). For purposes of determining whether the guarantor is fully and adequately compensated for such a service, the payments for the service are compared to payments that would be charged for the service if the service was performed by a person other than a guarantor.

(*5*) Payments to a guarantor of a revenue bond include a nonguarantee element if the property securing the bond normally would be insured against certain risks and the guarantee is used to replace such insurance. For example, if a bond is secured solely by a multifamily housing project and the revenues derived therefrom, and the project is not insured against any fire damage, payments to the guarantor of the bond would include a nonguarantee element. Similarly, payments to the guarantor of a qualified mortgage bond would include a nonguarantee element if the mortgage loans securing the bond did not satisfy minimum underwriting standards.

(v) *Purpose investment bond guarantee*. A guarantee of the principal or interest on an eligible purpose investment shall be treated as a guarantee of the related payments of principal or interest on bonds that are part of an issue and as if paid for a guarantee with respect to such bonds if (and only if)—

(A) All payments of principal and interest on the purpose investment that are original proceeds of the issue coincide (in all events) with payments on such bonds; and

(B) All such payments on the purpose investment (and all related payments under the guarantee) are at all times pledged unconditionally and exclusively to the payment of principal and interest on such bonds (without regard to any bond after the bond is legally defeased).

See paragraph (b)(12)(vi) of this section for when payments coincide. See paragraph (b)(12)(vii) of this section for special rule for parity issues. See paragraph (b)(12)(viii) of this section for definition of eligible purpose investment.

(vi) *When payments coincide*. For purposes of paragraph (b)(12)(v)(A) of this section—

(A) Regularly scheduled payments of interest on a purpose investment and a bond coincide if the payments are actually and unconditionally due during the same compounding interval used in computing the yield on the bond, determined by taking into account only payments of interest on the bond;

(B) Regularly scheduled payments of principal of a purpose investment and a bond coincide if the payments are actually and unconditionally due during the same compounding interval used in computing the yield on the bond, determined by taking into account only payments of principal of the bond; and

(C) Other payments on a purpose investment and a bond coincide if the payments on the bond are actually and unconditionally due no later than one month after the payments on the purpose investment.

In applying this paragraph (b)(12)(vi) to an issue, there shall not be taken into account any discrepancy of no more than one month, or any amount less than $250,000 that is required to be used to redeem bonds no later than the first available call date.

(vii) *Special rule for parity issues*. Payments on a purpose investment (and related payments under a guarantee) shall not be treated as failing to meet the requirement of paragraph (b)(12)(v)(B) of this section that such payments are pledged exclusively to the payment of principal or interest on bonds that are part of the issue solely by reason of the fact the payments are pledged to the payment of principal and interest on bonds that are part of one or more other issues if—

(A) The issue and all the other issues to which the payments are pledged are issued by the same issuer pursuant to the same master resolution or indenture;

(B) All bonds issued under the master resolution or indenture are equally and ratably secured at all times (without regard to any bond after the bond is legally defeased);

(C) Original proceeds of the issues of which such bonds are a part may be used only to make or finance purpose investments that are unconditionally and exclusively pledged to the payment of such bonds and guaranteed by the same guarantor (and to pay administrative expenses relating to the financing of such purpose investments); and

(D) The payments on the purpose investment are not guaranteed by the guarantor to any lesser extent than the payments on any purpose investment financed with original proceeds of any of the other issues.

(viii) *Eligible purpose investment*. The term "eligible purpose investment" means, with respect to an issue, any purpose investment (or portion thereof) that is allocated to sale proceeds of the issue (including sale proceeds allocated to the refunding portion of a refunding issue) if—

(A) The investment is an obligation that is not a student loan or for the financing of an owner-occupied residence; and

(B) The yield on the investment is not reasonably expected to be materially higher than the yield on the issue (within the meaning of §1.103-13(b)(5)(i)(A)) but determined—

(*1*) Without regard to any other purpose investment and without regard to any payment for a guarantee of any other purpose investment; and

(*2*) Except as otherwise provided in paragraph (b)(12)(ix)(A) of this section, by taking into account payments for the guarantee of the purpose investment as interest on the issue and as interest on the purpose investment and not as administrative costs for purposes of §1.103-13(c)(5).

(ix) *Transition rule*. The requirements of paragraph (b)(12)(viii)(B) of this section shall be treated as satisfied with respect to a purpose investment acquired on or before June 14, 1989, if the requirements are satisfied determined by taking into account—

(A) Payments for the guarantee of the purpose investment as administrative costs for purposes of §1.103-13(c)(5) and not as interest on the issue; and

(B) Any amendment to the terms of the purpose investment no later than the first date after June 14, 1989, that any amount with respect to the issue is paid or required to be paid to the United States under §1.148-1T(b)(1).

(13) *Special rules for guarantee payments*—(i) *Allocation to bonds*—(A) *Level payments*. A level payment for a guarantee shall be allocated to the bond to which the level payment properly relates.

(B) *Nonlevel payments*. Nonlevel payments for a guarantee shall be allocated to bonds in a manner that properly reflects the proportionate credit risk for which the guarantor is compensated. In the case of identical bonds (including bonds subject to mandatory early redemption), the proportionate credit risk with respect to each bond is the same. The proportionate credit risk with respect to bonds that are not identical shall be determined by reference to the proportionate interest reduction resulting from the guarantee (determined on a present value basis and with adjustments, if necessary, to take into account any level payments); provided that, in the case of bonds that are not readily marketable without a guarantee and for which the proportionate interest reduction cannot reasonably be estimated in such a way as to properly reflect the proportionate credit risk, the proportionate credit risk shall be determined by use of a reasonable method that properly reflects such risk.

(ii) *Special rules for variable yield bonds*—(A) *Level payments*. Level payments allocated to a variable yield bond shall be treated as paid when paid (but not earlier than when actually due). See paragraph (d)(4) of this section (Examples (4)-(11)). For purposes of this paragraph (b)(13)(ii), all payments for a guarantee allocated to a bond shall be treated as level payments if all such payments are paid during a single yield period, the bond is outstanding only during such yield period, and the bond is not retired before the final maturity date of the bond. See paragraph (c)(7) of this section (Example (11)).

(B) *Nonlevel payments*. Nonlevel payments allocated to a variable yield bond shall be treated as paid on the first day of each bond year. The amount treated as paid on the first day of each bond year (other than a short bond year) shall be the constant payment amount. The amount treated as paid on the first day of each short bond year shall be the product of the constant payment amount, and the fraction of a full year represented by the short bond year. See paragraph (d)(4) of this section (Examples (4)-(11)).

(C) *Early retirement*. If a variable yield bond is retired before the final maturity date, no payment for a guarantee shall be treated as paid with respect to the bond after the retirement date, and the amount or amounts treated as paid on any day during the 1-year period immediately preceding the retirement date (without regard to this sentence) shall not be treated as paid to the extent properly allocable to the period during which the bond is retired. For example, the constant payment amount treated as paid on the first day of the bond year during which the bond is retired is the product of the constant payment amount that would be treated as paid if the bond were not retired, and the fraction representing the portion of the bond year during which the bond is not retired. See paragraph (d)(4) of this section (Examples (6) and (10)).

(D) *Conversion to fixed yield bond*. If a fixed yield bond was a variable yield bond, amounts paid for a qualified guarantee with respect to the variable yield bond shall be treated as paid with respect to the fixed yield bond in the manner provided in this paragraph (b)(13)(ii) for purposes of paragraphs (c) and (d) of this section. See paragraph (d)(4) of this section (Examples (9)-(11)).

(iii) *Definitions and special rules*. For purposes of this paragraph (b)(13)—

(A) *Level payment*. A payment for a qualified guarantee of a bond is a level payment if—

(*1*) The payment is one of a series of payments with respect to the bond;

(*2*) Each payment in the series is the same percentage of the outstanding amount of the bond plus accrued interest for a period of no longer than one year, determined as of the date the payment is calculated;

(*3*) Each payment in the series is due no earlier than one year before and no later than one year after the date the payment is calculated; and

(*4*) The series of payments are due at periodic intervals (properly adjusted to take into account any short interval) and at least one payment is due each bond year while the guarantee of the bond is in effect.

The accrued interest referred to in paragraph (b)(13)(iii)(A)(*2*) may be based on a hypothetical interest rate (but not at a rate above a reasonable maximum rate) if the method of calculating such interest does not vary and is not designed to front-load or back-load payments. See paragraph (d)(4) of this section (Examples (4) and (7)).

(B) *Nonlevel payment*. Any payment for a qualified guarantee of a bond that is not a level payment is a nonlevel payment.

(C) *Constant payment amount*. The constant payment amount, with respect to a variable yield bond, is equal to the present value of all the nonlevel payments for a qualified guarantee allocated to the bond, divided by the present value of all the nominal amounts paid on the first day of each bond year while the guarantee of the bond is in effect (without regard to any retirement of the bond before the final maturity date). The nominal amount paid on the first day of each bond year (other than a short bond year) is $1. The nominal amount paid on the first day of a short bond year is the product of $1, and the fraction of a full year represented by the short bond year. Present value is computed as of the first day the guarantee is in effect by using as the discount rate the composite yield on all the variable yield bonds to which the nonlevel payments relate (determined with regard to level payments but without regard to any nonlevel payment and by applying rules similar to the rules in paragraph (d) of this section) during the period beginning on the first day the guarantee is in effect and ending on the last day of the first yield period that is at least one full year during which the guarantee is in effect (not taking into account any period after which the guarantee is no longer in effect). For purposes of the preceding sentence, the yield period for a fixed yield issue shall be the period determined under paragraph (b)(2)(ii)(A) of this section. See paragraph (d)(4) of this section (Examples (4)-(11)).

(D) *Bond year*. The first bond year shall be treated as beginning on the first day the guarantee of the bond is in effect, and the last bond year shall be treated as ending on the last day the guarantee of the bond is in effect (without regard to any retirement of the bond before the final maturity date). Any bond year that is less than 12 full months is a short bond year.

(E) *Aggregation rule*. All guarantees with respect to variable yield bonds that are part of the same issue and are entered into with the same guarantor (or a related person within the meaning of section 144(a)(3)) on or before the first computation date shall be treated as one guarantee. The preceding sentence shall not apply to guarantees that are not in effect and are not entered into within one year of each other.

(14) *Certain hedging transactions*. [Reserved]

(c) *Computation of yield on fixed yield issue*—(1) *General rule.* The yield on a fixed yield issue as of any computation date is the discount rate that produces the same present value when used in computing—

(i) *Issue payments.* The present value of all the issue payments paid and to be paid in connection with the bonds that are part of the issue; and

(ii) *Issue prices.* The present value of all the issue prices of the bonds that are part of the issue.

Present value is computed as of the date of issue of the fixed yield issue. See §1.148-8T(b)(5) for formula for determining present value. See paragraph (c)(2) of this section for determination of issue payments paid. See paragraph (c)(3) of this section for determination of issue payments to be paid. See paragraph (c)(4) of this section for special rule for small issues. See paragraph (c)(5) of this section for transition rule for fixed yield issues. See paragraph (c)(6) of this section for special rules for transitioned variable yield bonds. See paragraph (b) of this section for definitions and special rules.

(2) *Determination of issue payments paid.* For purposes of this paragraph (c), the issue payments paid as of any computation date in connection with the fixed yield bonds that are part of a fixed yield issue are—

(i) *Principal and interest.* Any amounts paid on or before the computation date to discharge principal or interest on the bonds (not including the retirement price or any amount taken into account in computing the early retirement value of a bond on the retirement date);

(ii) *Qualified guarantee.* Any amounts paid on or before the computation date for a qualified guarantee with respect to the bonds (not including any amount taken into account in computing the early retirement value of the bond on the retirement date);

(iii) *Early retirement value.* If any bond is retired before the final maturity date and on or before the computation date, an amount equal to the early retirement value of the bond on the retirement date; and

(iv) *Retirement price.* If any bond is retired on the final maturity date and on or before the computation date, an amount equal to the retirement price of the bond.

(3) *Determination of issue payments to be paid.* For purposes of this paragraph (c), the issue payments to be paid as of any installment computation date in connection with the bonds that are part of a fixed yield issue shall be determined—

(i) *Scheduled early retirements.* By assuming that bonds are retired on the scheduled early retirement date if—

(A) Bonds are subject to mandatory early redemption or are to be retired before the final maturity date pursuant to a binding obligation that exists on the computation date; or

(B) Bonds are to be retired before the final maturity date with proceeds of a refunding issue issued on or before the computation date.

(ii) *Optional retirements.* Except as otherwise provided in paragraph (c)(3)(i) of this section, by assuming that bonds are retired on the final maturity date for the stated retirement price on such date.

(4) *Special rule for small issues*—(i) *In general.* Unless the issuer otherwise elects, the yield on an eligible small issue shall be the yield on the issue determined by treating the date of issue as the only computation date if—

(A) The issue is a fixed yield issue (without regard to paragraphs (b)(1)(ii) and (b)(3)(ii) of this section);

(B) As of the date of issue, it is reasonably expected that no bond that is part of the issue would be an arbitrage bond (as defined in section 148(a), but without regard to section 148(d)(3)) if all the proceeds of the issue (exclusive of amounts reasonably set aside to pay any amount required to be paid with respect to the issue under §1.148-1T(b)(1)(i)) to be used to acquire investments (other than purpose investments) were used to acquire higher yielding investments (as defined in section 148(b)(1));

(C) At least 75 percent of the net sale proceeds are allocated to expenditures (other than expenditures for the payment of the principal or interest on or the retirement price of any bond) no later than the date that is 3 years after the date of issue (and no later than the final computation date); and

(D) No hedging transaction to which paragraph (b)(14) of this section applies is entered into with respect to the issue which would increase the rebatable arbitrage if taken into account in computing the yield on the issue.

See paragraph (c)(7) of this section (Examples (3), (6), (8), and (10)). See §1.148-8T(d)(6) for expenditure of net sale proceeds.

(ii) *Eligible small issue*—(A) *In general.* For purposes of paragraph (c)(4)(i) of this section, an issue is an eligible small issue if the aggregate issue price of the bonds issued as part of the issue does not exceed $5 million.

(B) *Certain governmental issues.* Paragraph (c)(4)(ii)(A) of this section shall be applied by substituting "$10 million" for "$5 million" if—

(*1*) No bond issued as part of the issue is a private activity bond; and

(*2*) The aggregate issue price of all tax-exempt bonds (other than private activity bonds) issued by the issuer during the calendar year in which the issue is issued and during the immediately preceding calendar year does not exceed $30 million.

For purposes of paragraph (c)(4)(ii)(B)-(*2*), an issuer and all entities that issue bonds on behalf of the issuer shall be treated as one issuer.

(5) *Transition rule for fixed yield issues.* Unless the issuer otherwise elects, the yield on an issue shall be the yield on the issue determined by treating the date of issue as the only computation date if—

(i) The issue is a fixed yield issue (without regard to paragraphs (b)(1)(ii) and (b)(3)(ii) of this section);

(ii) The issue is sold on or before May 15, 1989, and issued on or before June 14, 1989;

(iii) At least 25 percent of the net sale proceeds are allocated to expenditures (other than expenditures for the payment of the principal or interest on or the retirement price of any bond) no later than the date that is 3 years after the date of issue (and no later than the final computation date); and

(iv) No hedging transaction to which paragraph (b)(14) of this section applies is entered into with respect to the issue which would increase the rebatable arbitrage if taken into account in computing the yield on the issue.

See paragraph (c)(7) of this section (Examples (3), (6), (8), and (10)). See §1.148-8T(d)(6) for expenditure of net sale proceeds.

(6) *Special rules for transitioned variable yield bonds.* For purposes of this paragraph (c)—

(i) *Issue payments paid.* The provisions of paragraph (d)(2) of this section shall apply in determining the issue payments paid as of any computation date in connection with the variable yield bonds that are part of a fixed yield issue. For purposes of applying such provisions, the yield period for the issue shall begin on the date of issue and end on the final computation date.

(ii) *Issue payments to be paid.* The issue payments to be paid as of any installment computation date in connection with the variable yield bonds that are part of a fixed yield issue shall be determined by assuming that market interest rates in effect on the computation date do not later change, and that no discretionary action is taken after the computation date to affect the interest rate on (or any other term of) the bonds.

(iii) *Tender bond remarketing.* The provisions of paragraph (d)(2)(ii)(A) of this section shall apply in determining the issue price to be taken into account under paragraph (c)(1)(ii) of this section when a tender bond is remarketed.

See paragraph (c)(7) of this section (Example (11)).

(7) *Examples.* The following examples illustrate the application of this paragraph (c):

Example (1). (i) On March 1, 1988, City A issues an issue consisting of identical fixed yield bonds. The final maturity date of each bond is July 1, 1998. Interest is payable on July 1 of each year at a rate of 10 percent per annum on the outstanding principal amount. The aggregate principal amount of the bonds is $20 million. The aggregate issue price of the bonds (determined under §1.148-8T(c)) is $21,333,333.33 (including $1,333,333.33 for accrued interest from July 1, 1987 to March 1, 1988). The bonds are subject to optional redemption on July 1, 1994 at 103 percent of par plus accrued interest, and on July 1 of any year thereafter at par plus accrued interest. The issuer elected under paragraph (c)(5) of this section not to apply the transition rule for fixed yield issues.

(ii) All the bonds are outstanding on the first installment computation date (7/01/92). The yield on the issue as of the first installment computation date is 9.983 percent per annum compounded annually, computed as follows:

Date	*Issue Payments*	*PV (9.9830505029%)*
7/01/88	$ 2,000,000.00	$ 1,937,558.13
7/01/89	2,000,000.00	1,761,687.94
7/01/90	2,000,000.00	1,601,781.30
7/01/91	2,000,000.00	1,456,389.23
7/01/92	2,000,000.00	1,324,194.25
7/01/93	2,000,000.00	1,203,998.47
7/01/94	2,000,000.00	1,094,712.75
7/01/95	2,000,000.00	995,346.78
7/01/96	2,000,000.00	905,000.15
7/01/97	2,000,000.00	822,854.20
7/01/98	22,000,000.00	8,229,810.13
	PV Issue Prices (3/01/88)	$ 21,333,333.33

See paragraph (c)(2)(i), (c)(2)(iv), and (c)(3)(ii) of this section. The bonds are not yield-to-call bonds because the yield-to-maturity on the bonds (9.983%, the same as the yield on the issue to maturity computed above) is not more than one-fourth of one percent higher than the lowest yield on the bonds (9.979%, the same as the yield on the issue to the first par call date computed in subdivision (iii) below). See paragraph (b)(4)(ii)(A), (b)(5)(ii), and (b)(5)(iii) of this section.

(iii) All the bonds are redeemed on July 1, 1995 at par plus accrued interest ($22 million). The aggregate issue payment taken into account as of July 1, 1995 is the aggregate early retirement value of the bonds on July 1, 1995. See paragraph (c)(2)(iii) of this section. Since the yield-to-maturity on the bonds is higher than the lowest yield, the aggregate early retirement value of the bonds is the lesser of the aggregate present value of the bonds on July 1, 1995, and the lowest aggregate stated retirement price of the bonds at any time during the period beginning July 1, 1994 and ending September 29, 1995 (par plus accrued interest). See paragraph (b)(7)(i) of this section. The aggregate present value of the bonds on July 1, 1995 determined by using the exact method is $22,008,457.83, computed as follows:

Date	*Payments*	*PV (9.983%)*
7/01/95	$ 2,000,000.00	$ 2,000,000.00
7/01/96	2,000,000.00	1,818,462.85
7/01/97	2,000,000.00	1,653,403.57
7/01/98	22,000,000.00	16,536,591.40
	PV (7/01/95)	$ 22,008,457.83

See paragraph (b)(8)(i) of this section. The aggregate present value of the bonds determined by using the approximate method is par plus accrued interest ($22 million), which is lower. See paragraph (b)(8)(iii) of this section. Since the lowest aggregate stated retirement price of the bonds during the relevant period ($22 million) is lower than the aggregate present value of the bonds on July 1, 1995 ($22,008,457.83), the aggregate issue payment taken into account on July 1, 1995 is $22 million. See paragraphs (b)(7)(i) and (c)(2)(iii) of this section. The yield on the issue as of the final computation date (7/01/95) is 9.979 percent per annum compounded annually, computed as follows:

Date	*Issue Payments*	*PV (9.9788917222%)*
7/01/88	$ 2,000,000.00	$ 1,937,582.56
7/01/89	2,000,000.00	1,761,776.76
7/01/90	2,000,000.00	1,601,922.64
7/01/91	2,000,000.00	1,456,572.81
7/01/92	2,000,000.00	1,324,411.25
7/01/93	2,000,000.00	1,204,241.31
7/01/94	2,000,000.00	1,094,974.95
7/01/95	22,000,000.00	10,951,851.06
	PV Issue Prices (3/01/88)	$ 21,333,333.33

See paragraphs (c)(2)(i) and (c)(2)(iii) of this section.

Example (2). The facts are the same as in Example (1), except that all the bonds are retired on September 15, 1991 for $17.5 million. Since the bonds are not subject to redemption at any time during the period beginning September 15, 1990 and ending December 14, 1991, the aggregate early retirement value of the bonds on September 15, 1991 is the aggregate present value of the bonds on that date. See paragraph (b)(7)(i) of this section. The aggregate present value of the bonds on September 15, 1991 determined by using the exact method is $20,411,935.28, computed as follows:

Date	*Payments*	*PV (9.983%)*
7/01/92	$ 2,000,000.00	$ 1,854,381.70
7/01/93	2,000,000.00	1,686,062.12
7/01/94	2,000,000.00	1,533,020.67
7/01/95	2,000,000.00	1,393,870.57
7/01/96	2,000,000.00	1,267,350.92
7/01/97	2,000,000.00	1,152,315.29
7/01/98	22,000,000.00	11,524,934.01
	PV (9/15/91)	$ 20,411,935.28

See paragraph (b)(8)(i) of this section. The aggregate present value of the bonds determined by using the approximate method is par plus accrued interest ($20,411,111.11), which is lower. See paragraph (b)(8)(iii) of this section. The yield on the issue as of the final computation date (9/15/91) is 9.983 percent per annum compounded annually, computed as follows:

Date	*Issue Payments*	*PV (9.9831105266%)*
7/01/88	$ 2,000,000.00	$ 1,937,557.78
7/01/89	2,000,000.00	1,761,686.66
7/01/90	2,000,000.00	1,601,779.26
7/01/91	2,000,000.00	1,456,386.58
9/15/91	20,411,935.28	14,575,923.05
	PV Issue Prices (3/01/88)	$ 21,333,333.33

See paragraph (c)(2)(i) and (c)(2)(iii) of this section.

Example (3). The facts are the same as in Examples (1) and (2), except that the transition rule for fixed yield issues applies. The yield on the issue for purposes of computing the rebatable arbitrage as of each computation date is the yield on the issue determined by treating the date of issue as the only computation date. See paragraph (c)(5) of this section. This yield (9.983%) is the same as the yield computed as of the first installment computation date in Example (1)(ii) when all the bonds were outstanding.

Example (4). (i) On July 1, 1988, City A issues an issue consisting of two fixed yield bonds. The final maturity dates of the bonds are July 1, 2003 (the "2003 bond") and July 1, 2008 (the "2008 bond"). Interest on the 2003 bond is payable on July 1 of each year at a rate of 8 percent per annum on the outstanding principal amount. The principal amount of the 2003 bond is $10 million. The issue price of the 2003 bond is $11 million (including $1 million issue premium). The 2003 bond is subject to optional redemption on or after July 1, 1998, at par ($10 million) plus accrued interest. Interest on the 2008 bond is payable on July 1 of each year at a rate of 10 percent per annum on the outstanding principal amount. The principal amount and issue price of the 2008 bond are $10 million. The 2008 bond is subject to optional redemption on or after July 1, 1998, at 103 percent of par ($10.3 million) plus accrued interest. The issuer elected under paragraph (c)(5) of this section not to apply the transition rule for fixed yield issues.

(ii) The 2003 bond is a yield-to-call bond, because the yield-to-maturity (6.908%) is more than one-fourth of one percent higher than the lowest yield (6.602%). See paragraph (b)(4)(ii)(A) of this section. The yield-to-maturity and lowest yield are computed as follows:

Date	*Payments*	*PV (6.90839766673%)*
7/01/89	$ 800,000.00	$ 748,304.17
7/01/90	800,000.00	699,948.92
7/01/91	800,000.00	654,718.37
7/01/92	800,000.00	612,410.61
7/01/93	800,000.00	572,836.77
7/01/94	800,000.00	535,820.18
7/01/95	800,000.00	501,195.59
7/01/96	800,000.00	468,808.44
7/01/97	800,000.00	438,514.14
7/01/98	800,000.00	410,177.45
7/01/99	800,000.00	383,671.87
7/01/00	800,000.00	358,879.08
7/01/01	800,000.00	335,688.39
7/01/02	800,000.00	313,996.28
7/01/03	10,800,000.00	3,965,029.74
	Issue Price	11,000,000.00

Date	Payments	PV (6.6022869808%)
7/01/89	$ 800,000.00	$ 750,452.94
7/01/90	800,000.00	703,974.52
7/01/91	800,000.00	660,374.69
7/01/92	800,000.00	619,475.16
7/01/93	800,000.00	581,108.70
7/01/94	800,000.00	545,118.42
7/01/95	800,000.00	511,357.15
7/01/96	800,000.00	479,686.85
7/01/97	800,000.00	449,978.01
7/01/98	10,800,000.00	5,698,473.55
	Issue Price	$ 11,000,000.00

See paragraph (b)(5)(ii) and (b)(5)(iii) of this section. The 2003 bond is treated as if the lowest yield date (7/01/98) were the final maturity date, the stated retirement price on such date ($10.8 million) were the stated retirement price on the final maturity date, and the yield-to-maturity were the lowest yield (6.602%). See paragraph (b)(4)(i) of this section.

(iii) Both bonds are outstanding on the first installment computation date (7/01/93). The yield on the issue as of the first installment computation date is 8.554 percent per annum compounded annually, computed as follows:

Date	Issue Payments	PV (8.5542432566%)
7/01/89	$ 1,800,000.00	$ 1,658,157.20
7/01/90	1,800,000.00	1,527,491.83
7/01/91	1,800,000.00	1,407,123.10
7/01/92	1,800,000.00	1,296,239.61
7/01/93	1,800,000.00	1,194,093.91
7/01/94	1,800,000.00	1,099,997.45
7/01/95	1,800,000.00	1,013,315.94
7/01/96	1,800,000.00	933,465.07
7/01/97	1,800,000.00	859,906.57
7/01/98	11,800,000.00	5,192,947.90
7/01/99	1,000,000.00	405,401.32
7/01/00	1,000,000.00	373,455.06
7/01/01	1,000,000.00	344,026.22
7/01/02	1,000,000.00	316,916.42
7/01/03	1,000,000.00	291,942.91
7/01/04	1,000,000.00	268,937.36
7/01/05	1,000,000.00	247,744.68
7/01/06	1,000,000.00	228,222.01
7/01/07	1,000,000.00	210,237.76
7/01/08	11,000,000.00	2,130,377.67
	PV Issue Prices (7/01/88)	$ 21,000,000.00

See paragraphs (b)(4)(i), (c)(2)(i), (c)(2)(iv), and (c)(3)(ii) of this section.

(iv) The 2003 yield-to-call bond is retired on July 1, 1994. The present value of the 2003 yield-to-call bond on July 1, 1994 is $11,277,818.08, computed as follows:

Date	Payments	PV (6.602%)
7/01/94	$ 800,000.00	$ 800,000.00
7/01/95	800,000.00	750,454.96
7/01/96	800,000.00	703,978.31
7/01/97	800,000.00	660,380.03
7/01/98	10,800,000.00	8,363,004.77
	PV (7/01/94)	$ 11,277,818.08

See paragraph (b)(4)(i) and (b)(8)(i) of this section. The 2008 bond is redeemed on July 1, 1998 for 103 percent of par plus accrued interest ($11.3 million). The present value of the 2008 bond on July 1, 1998 is par plus accrued interest ($11 million). See paragraph (b)(8) of this section. In the case of both bonds, the yield-to-maturity is not higher than the lowest yield (and the present value is not higher than the stated retirement price). Accordingly, the early retirement value of each bond is the present value. See paragraph (b)(7)(i) of this section. The yield on the issue as of the final computation date (7/01/98) is 8.542 percent per annum compounded annually, computed as follows:

Date	Issue Payments	PV (8.5424831007%)
7/01/89	$ 1,800,000.00	$ 1,658,336.85
7/01/90	1,800,000.00	1,527,822.85
7/01/91	1,800,000.00	1,407,580.52
7/01/92	1,800,000.00	1,296,801.47
7/01/93	1,800,000.00	1,194,740.93
7/01/94	12,277,818.08	7,507,972.59
7/01/95	1,000,000.00	563,380.40
7/01/96	1,000,000.00	519,041.38
7/01/97	1,000,000.00	478,191.91
7/01/98	11,000,000.00	4,846,131.10
	PV Issue Prices (7/01/88)	$ 21,000,000.00

See paragraph (c)(2)(i) and (c)(2)(iii) of this section.

Example (5). The facts are the same as in Example (4), except that the 2003 bond is retired on July 1, 2000, and the 2008 bond is retired on July 1, 2001. Since the 2003 bond is outstanding after the lowest yield date (7/01/98), the 2003 bond is treated as if it were retired for $10.8 million (the stated retirement price on such date) and reissued on the same date (as part of the same issue) for $10 million (the stated retirement price less the interest payable on such date). See paragraph (b)(4)(i) of this section. The early retirement value of each bond is the present value. See paragraph (b)(7)(i) of this section. The present value of the reissued 2003 bond on July 1, 2000 is $10.8 million. See paragraph (b)(8)(i) of this section. The present value of the 2008 bond on July 1, 2001 is $11 million. See paragraph (b)(8) of this section. The yield on the issue as of the final computation date (7/01/01) is 8.363 percent per annum compounded annually, computed as follows:

Date	Issue Payments	PV (8.3629495686%
7/01/89	$ 1,800,000.00	$ 1,661,084.35
7/01/90	1,800,000.00	1,532,889.57
7/01/91	1,800,000.00	1,414,588.27
7/01/92	1,800,000.00	1,305,416.91
7/01/93	1,800,000.00	1,204,670.89
7/01/94	1,800,000.00	1,111,699.98
7/01/95	1,800,000.00	1,025,904.14
7/01/96	1,800,000.00	946,729.62
7/01/97	1,800,000.00	873,665.42
7/01/98	11,800,000.00	5,285,350.95
7/01/98	(10,000,000.00)	(4,479,110.97)
7/01/99	1,800,000.00	744,018.12
7/01/00	11,800,000.00	4,501,032.97
7/01/01	11,000,000.00	3,872,059.79
	PV Issue Prices (7/01/88)	$ 21,000,000.00

See paragraphs (b)(4)(i), (c)(2)(i), and (c)(2)(iii) of this section. In the above computation, the $10 million issue price of the 2003 bond on July 1, 1998 is taken into account as a negative issue payment on that date. The result would be the same if the negative issue payment were not taken into account, and the present value of the issue prices on July 1, 1988 included the present value of the $10 million issue price of the 2003 bond. The result also would be the same if neither the retirement nor the reissuance of the 2003 bond on July 1, 1998 was taken into account.

Example (6). The facts are the same as in Examples (4) and (5), except that the transition rule for fixed yield issues applies. The yield on the issue for purposes of computing the rebatable arbitrage as of each computation date is the yield on the issue determined by treating the date of issue as the only computation date. See paragraph (c)(5) of this section. This yield (8.554%) is the same as the yield computed as of the first installment computation date in Example (4)(iii) when all the bonds were outstanding.

Example (7). (i) On July 1, 1988, City B issues an issue consisting of five fixed yield bonds. The final maturity date of each bond is July 1, 1998. Interest on the bonds is payable on July 1 of each year at a rate of 7 percent per annum on the outstanding principal amount. The principal amount of each bond is $5 million. The issue price of each bond is 99.5 percent of par ($4.975 million). The bonds are subject to mandatory sinking fund redemption on July 1 of each year beginning July 1, 1994. On each sinking fund redemption date, one of the bonds is chosen by lottery and is required to be redeemed at par plus accrued interest ($5.35 million). The issuer elected under paragraph (c)(5) of this section not to apply the transition rule for fixed yield issues.

(ii) All the bonds are outstanding on the first installment computation date (7/01/93). The bonds are assumed to be retired on each scheduled mandatory early redemption date for purposes of determining the issue payments to be paid after the first installment computation date. See paragraph (c)(3)(i)(A) of this section. The issue payment taken into account on each mandatory early redemption date is the early retirement value of a bond on such date. See paragraph (c)(2)(iii) of this section. The early retirement value of a bond assumed to be retired on each mandatory early redemption date is the present value of the bond on such date. See paragraph (b)(7)(i) of this section. This present value is computed by treating the scheduled early retirement date (in satisfaction of which the bond is to be retired) and the stated retirement price on such date as the final maturity date and stated retirement price of the bond on the final maturity date. See paragraph (b)(8)(ii)(B)(*3*) of this section. The present value of each bond on the assumed retirement date (determined in this manner) is equal to the stated retirement price of the bond on the assumed retirement date ($5.35 million). Accordingly, the yield on the issue as of the first installment computation date (7/01/93) is 7.085 percent per annum compounded annually, computed as follows:

Date	Issue Payments	PV (7.0845525262%)
7/01/89	$ 1,750,000.00	$ 1,634,222.64
7/01/90	1,750,000.00	1,526,104.93
7/01/91	1,750,000.00	1,425,140.13
7/01/92	1,750,000.00	1,330,855.01
7/01/93	1,750,000.00	1,242,807.65
7/01/94	6,750,000.00	4,476,543.57
7/01/95	6,400,000.00	3,963,621.64
7/01/96	6,050,000.00	3,498,974.40
7/01/97	5,700,000.00	3,078,459.32
7/01/98	5,350,000.00	2,698,270.71
	PV Issue Prices (7/01/88)	$ 24,875,000.00

See paragraph (c)(2)(i), (c)(2)(iii), (c)(2)(iv), (c)(3)(i)(A), and (c)(3)(ii) of this section. The special rule in paragraph (b)(7)(iii)(A) of this section for determining the early retirement value of certain discount bonds does not apply, because the yield-to-maturity is not more than one fourth of one percent lower than the composite yield-to-maturity. See subdivision (v) below.

(iii) All the bonds are redeemed on July 1, 1994 pursuant to an optional redemption provision for par plus accrued interest ($5.35 million). Since all the bonds are retired before the final maturity date (7/01/98), the issue payment taken into account on the retirement date (7/01/94) is the early retirement value of the bonds. See paragraph (c)(2)(iii) of this section. The early retirement value of each bond on July 1, 1994 is the present value of the bond on that date. See paragraph (b)(7)(i) of this section. The discount rate used in computing this present value is the composite yield-to-maturity on all 5 bonds, determined by assuming the bonds are retired on the scheduled early retirement dates and by treating those dates as the final maturity dates of the bonds. See paragraph (b)(8)(ii)(B) of this section. The composite yield-to-maturity on the bonds (determined in this manner) is 7.085 percent per annum compounded annually (the same as the yield as of the first installment computation date computed in subdivision (ii) above). Four of the five bonds are retired in satisfaction of the mandatory early redemption requirements. The present value of each of these bonds on July 1, 1994 is determined by treating the mandatory early redemption date (in satisfaction of which the bond is retired) and the stated retirement price on such date ($5.35 million) as the final maturity date and stated retirement price on the final maturity date. See paragraph (b)(8)(ii)(B)(3) of this section. The present value of the bond retired in satisfaction of the July 1, 1994 mandatory early date is $5.35 million. The present value of each of the other four bonds is computed as follows:

Date	*Payments*	*PV (7.085%)*
7/01/94	$ 350,000.00	$ 350,000.00
7/01/95	5,350,000.00	4,996,031.19
	PV (7/01/94)	$ 5,346,031.19

Date	*Payments*	*PV (7.085%)*
7/01/94	$ 350,000.00	$ 350,000.00
7/01/95	350,000.00	326,843.16
7/01/96	5,350,000.00	4,665,481.80
	PV (7/01/94)	$ 5,342,324.97

Date	*Payments*	*PV (7.085 %)*
7/01/94	$ 350,000.00	$ 350,000.00
7/01/95	350,000.00	326,843.16
7/01/96	350,000.00	305,218.44
7/01/97	5,350,000.00	4,356,802.36
	PV (7/01/94)	$ 5,338,863.96

Date	*Payments*	*PV (7.085%)*
7/01/94	$ 350,000.00	$ 350,000.00
7/01/95	350,000.00	326,843.16
7/01/96	350,000.00	305,218.44
7/01/97	350,000.00	285,024.45
7/01/98	5,350,000.00	4,068,545.88
	PV (7/01/94)	$ 5,335,631.93

(iv) The yield on the issue as of the final computation date (9/01/94) is 7.084 percent per annum compounded annually, computed as follows:

Date	*Issue Payments*	*PV (7.08444316237%)*
7/01/89	$ 1,750,000.00	$ 1,634,224.31
7/01/90	1,750,000.00	1,526,108.05
7/01/91	1,750,000.00	1,425,144.50
7/01/92	1,750,000.00	1,330,860.45
7/01/93	1,750,000.00	1,242,814.00
7/01/94	5,350,000.00	3,548,097.01
7/01/94	5,346,031.19	3,545,464.91
7/01/94	5,342,324.97	3,543,006.97
7/01/94	5,338,863.96	3,540,711.64
7/01/94	5,335,631.93	3,538,568.17
	PV Issue Prices (7/01/88)	$ 24,875,000.00

See paragraph (c)(2)(i) and (c)(2)(iii) of this section. The discrepancy between this yield (7.084%) and the yield computed as of the first installment computation date (7.085%) is due solely to rounding of the discount rate used in computing the present values of the bonds.

(v) The special rule in paragraph (b)(7)(iii)(A) of this section for determining the early retirement value of certain discount bonds did not apply to the bonds, because the yield-to-maturity on the bonds is not more than one fourth of one percent lower than the composite yield-to-maturity determined as provided in paragraph (b)(8)(ii)(B) of this section (7.085%). The yield-to-maturity on the bonds is 7.071 percent per annum compounded annually, computed as follows:

Dates	*Payments*	*PV (7.07142396776%)*
7/01/89	$ 350,000.00	$ 326,884.60
7/01/90	350,000.00	305,295.84
7/01/91	350,000.00	285,132.89
7/01/92	350,000.00	266,301.57
7/01/93	350,000.00	248,713.95
7/01/94	350,000.00	232,287.89
7/01/95	350,000.00	216,946.67
7/01/96	350,000.00	202,618.65
7/01/97	350,000.00	189,236.91
7/01/98	5,350,000.00	2,701,581.02
	Issue Price	$ 4,975,000.00

See paragraph (b)(5)(ii) of this section.

Example (8). The facts are the same as in Example (7), except that the transition rule for fixed yield issues applies. The yield on the issue for purposes of computing the rebatable arbitrage as of each computation date is the yield on the issue determined by treating the date of issue as the only computation date. See paragraph (c)(5) of this section. This yield (7.085%) is the same as the yield computed as of the first installment computation date in Example (7)(ii) when all the bonds were outstanding.

Example (9). (i) The facts are the same as in Example (7), except that the issue price of each bond is 80 percent of par ($4 million).

(ii) The special rule in paragraph (b)(7)(iii)(A) of this section for determining the early retirement value of the bonds applies to the bonds, because the yield-to-maturity on the bonds is more than one fourth of one percent lower than the composite yield-to-maturity determined as provided in paragraph (b)(8)(ii)(B) of this section. The yield-to-maturity and composite yield-to-maturity are 10.296 percent and 10.906 percent per annum compounded annually, computed as follows:

Date	*Payments*	*PV (10.2964780071%)*
7/01/89	$ 350,000.00	$ 317,326.54
7/01/90	350,000.00	287,703.24
7/01/91	350,000.00	260,845.36
7/01/92	350,000.00	236,494.73
7/01/93	350,000.00	214,417.30
7/01/94	350,000.00	194,400.86
7/01/95	350,000.00	176,253.01
7/01/96	350,000.00	159,799.31
7/01/97	350,000.00	144,881.60
7/01/98	5,350,000.00	2,007,878.06
	Issue Price	$ 4,000,000.00

See paragraph (b)(5)(ii) of this section.

Date	*Payments*	*PV (10.9059654240%)*
7/01/89	$ 1,750,000.00	$ 1,577,913.32
7/01/90	1,750,000.00	1,422,748.82
7/01/91	1,750,000.00	1,282,842.47
7/01/92	1,750,000.00	1,156,693.84
7/01/93	1,750,000.00	1,042,950.06
7/01/94	6,750,000.00	3,627,223.64
7/01/95	6,400,000.00	3,100,956.17
7/01/96	6,050,000.00	2,643,115.38
7/01/97	5,700,000.00	2,245,332.67
7/01/98	5,350,000.00	1,900,223.63
	Issue Prices (7/01/88)	$ 20,000,000.00

See paragraph (b)(8)(ii)(B) of this section.

(iii) The yield on the issue as of the first installment computation date is determined by assuming the bonds are retired on the scheduled early retirement dates for the early retirement value of the bonds on such dates. See paragraphs (c)(2)(iii) and (c)(3)(i)(A) of this section. The early retirement value is equal to the present value of the bonds, determined by using a discount rate equal to the yield-to-maturity on the bonds (10.296%). See paragraphs (b)(7)(i) and (b)(8)(ii)(A) of this section. The present value of a bond on each mandatory early redemption date is computed as follows:

Date	*Payments*	*PV (10.296%)*
7/01/94	$ 350,000.00	$ 350,000.00
7/01/95	350,000.00	317,327.92
7/01/96	350,000.00	287,705.74
7/01/97	350,000.00	260,848.75
7/01/98	5,350,000.00	3,615,053.52
	PV (7/01/94)	$ 4,830,935.92

Date	*Payments*	*PV (10.296%)*
7/01/95	$ 350,000.00	$ 350,000.00
7/01/96	350,000.00	317,327.92
7/01/97	350,000.00	287,705.74
7/01/98	5,350,000.00	3,987,259.43
	PV (7/01/95)	$ 4,942,293.09

Date	*Payments*	*PV (10.296%)*
7/01/96	$ 350,000.00	$ 350,000.00
7/01/97	350,000.00	317,327.92
7/01/98	5,350,000.00	4,397,787.67
	PV (7/01/96)	$ 5,065,115.58

Date	*Payments*	*PV (10.296%)*
7/01/97	$ 350,000.00	$ 350,000.00
7/01/98	5,350,000.00	4,850,583.88
	PV (7/01/97)	$ 5,200,583.88

The yield on the issue as of the first installment computation date (7/01/93) is 10.297 percent per annum compounded annually, computed as follows:

Date	*Issue Payments*	*PV (10.2965625327%)*
7/01/89	$ 1,750,000.00	$ 1,586,631.50
7/01/90	1,750,000.00	1,438,514.00
7/01/91	1,750,000.00	1,304,223.78
7/01/92	1,750,000.00	1,182,470.02
7/01/93	1,750,000.00	1,072,082.39
7/01/94	6,230,935.92	3,460,839.19
7/01/95	5,992,293.09	3,017,582.86
7/01/96	5,765,115.58	2,632,159.47
7/01/97	5,550,583.88	2,297,634.12
7/01/98	5,350,000.00	2,007,862.67
	Issue Prices (7/01/88)	$20,000,000.00

See paragraphs (c)(2)(i), (c)(2)(iii), (c)(2)(iv), (c)(3)(i)(A), and (c)(3)(ii) of this section. The issue payment taken into account on each mandatory early redemption date includes the early retirement value of the bond assumed to be retired on that date and interest on any other bond still outstanding on that date. The discrepancy between this yield (10.297%) and the yield-to-maturity on the bonds (10.296%) is due solely to rounding of the discount rate used in computing the present values of the bonds.

Example (10). The facts are the same as in Examples (7), (8), and (9), except that the bonds are subject to mandatory early redemption at par plus accrued interest ($5.35 million) on July 1 of each year beginning July 1, 1994 only to the extent there are excess revenues available for such purpose in a special redemption fund established under the indenture securing the bonds. On the date of issue and the first installment computation date, the issuer is reasonably certain that the excess revenues will be sufficient to redeem one bond on each July 1 beginning July 1, 1994. The results are the same as in Examples (7), (8), and (9). See paragraph (b)(8)(ii)(B) of this section (last sentence) and §1.148-8T(b)(4).

Example (11). (i) The facts are the same as in Example (4) in paragraph (d)(4) of this section, except that the issuer of the tender bonds elected to treat the variable yield issue as a fixed yield issue. See paragraph (b)(1)(ii) of this section.

(ii) The yield on the issue as of the first installment computation date (9/01/93) is 6.518 percent per annum compounded semiannually, computed as follows:

Date	Debt Service	Guarantee	PV (6.5181030537%)
9/01/88		$175,000.00	$ 175,000.00
9/01/89	$ 1,393,750.00	140,000.00	1,438,461.73
9/01/90	1,393,750.00	140,000.00	1,349,093.50
9/01/91	1,393,750.00	140,000.00	1,265,277.50
9/01/92	1,651,250.00	140,000.00	1,385,897.63
9/01/93	1,651,250.00	140,000.00	1,299,795.08
9/01/94	1,522,500.00	140,000.00	1,131,420.58
9/01/95	1,522,500.00	140,000.00	1,061,128.09
9/01/96	1,522,500.00	140,000.00	995,202.71
9/01/97	1,522,500.00	140,000.00	933,373.11
9/01/98	26,522,500.00		13,965,350.07
		PV Issue Prices (9/01/88)	$ 25,000,000.00

See paragraphs (c)(3)(ii), (c)(6), (d)(2)(i)(A), (d)(2)(i)(B), and (d)(2)(i)(E) of this section. The interest rate on the tender bonds after the first installment computation date (9/01/93) is assumed to be 6 percent per annum (the same as the interest rate on the bonds for the period beginning on that date). See paragraph (c)(6)(ii) of this section. All payments for the qualified guarantee are treated as paid when paid (but not earlier than when actually due). See paragraph (b)(13)(ii)(A) of this section.

(iii) All the bonds are redeemed on September 1, 1995 at par ($25 million) plus accrued interest ($1,651,250). The yield on the issue as of the final computation date is 6.614 percent per annum compounded semiannually, computed as follows:

Date	Debt Service	Guarantee	PV (6.6135975396%)
9/01/88		$144,579.16	$ 144,579.16
9/01/89	$ 1,393,750.00	144,579.16	1,441,423.06
9/01/90	1,393,750.00	144,579.16	1,350,621.49
9/01/91	1,393,750.00	144,579.16	1,265,539.92
9/01/92	1,651,250.00	144,579.16	1,384,311.37
9/01/93	1,651,250.00	144,579.16	1,297,107.53
9/01/94	1,651,250.00	144,579.16	1,215,397.03
9/01/95	26,651,250.00		16,901,020.44
		PV Issue Prices (9/01/88)	$ 25,000,000.00

See paragraphs (c)(6), (d)(2)(i)(A), (d)(2)(i)(B), (d)(2)(i)(D), and (b)(7)(ii) of this section. The initial fee for the guarantee is a nonlevel payment and is treated as paid on the first day of each bond year in amounts equal to the constant payment amount ($4,579.16). See paragraph (b)(13)(ii)(B) of this section and paragraph (d)(4) of this section (Example (4)).

(d) *Computation of yield on variable yield issue*—(1) *General rule.* The yield on a variable yield issue during any yield period is the discount rate that produces the same present value when used in computing—

(i) *Issue payments.* The present value of all the issue payments in connection with the bonds that are part of the variable yield issue that are attributable to the yield period; and

(ii) *Issue prices.* The present value of all the issue prices of the bonds issued as part of the variable yield issue during the yield period.

Present value is computed as of the first day of the yield period. See §1.148-8T(b)(5) for formula for determining present value. See paragraph (d)(2) of this section for rules for variable yield bonds. See paragraph (d)(3) of this section for rules for fixed yield bonds. See paragraph (b) of this section for definitions and special rules.

(2) *Variable yield bonds*—(1) *Issue payments.* For purposes of paragraph (d)(1)(i) of this section, the issue payments in connection with a variable yield bond that are attributable to a yield period are—

(A) *Interest.* Any amounts paid during the yield period to discharge interest that accrued on the bond during the yield period;

(B) *Qualified guarantee.* Any amounts paid during the yield period for a qualified guarantee with respect to the bond;

(C) *Tender price.* If the bond is a tender bond and is purchased pursuant to the tender right during the yield period, the amount paid pursuant to the tender right to purchase the bond;

(D) *Early retirement.* If the bond is retired before the final maturity date and during the yield period, an amount equal to the early retirement value of the bond on the retirement date;

(E) *Retirement price.* If the bond is retired on the final maturity date and during the yield period, an amount equal to the retirement price of the bond (not including any payment of interest taken into account under paragraph (d)(2)(i)(A) or (d)(2)(i)(C) of this section); and

(F) *End-of-period (and conversion) value.* If the bond is outstanding at the close of business on the last day of the yield period or is treated under paragraph (b)(3)(i) of this section as a fixed yield bond immediately after the close of business on a day (and is not a tender bond that is purchased pursuant to the tender right on such day)—

(*1*) An amount equal to the early retirement value of the bond at such time; and

(*2*) An amount equal to any unpaid interest at such time that accrued on the bond during the yield period (taken into account as of the next regular interest payment date when such amount is scheduled to be paid).

(ii) *Issue prices.* For purposes of paragraph (d)(1)(ii) of this section—

(A) *Tender bond remarketing.* A tender bond to which paragraph (d)(2)(i)(C) of this section applied on a day shall be treated as if issued immediately after the close of business on the day the bond is remarketed for an issue price equal to the issue price of the bond (determined under §1.148-8T(c)); and

(B) *Start-of-period (and conversion) value.* A bond to which paragraph (d)(2)(i)(F) of this section applied on a day shall be treated as if issued immediately after the close of business on such day for an issue price equal to the early retirement value of the bond taken into account on such day under paragraph (d)(2)(i)(F)(*1*) of this section.

(3) *Fixed yield bonds*—(i) *Issue payments.* For purposes of paragraph (d)(1)(i) of this section, the issue payments in connection with a fixed yield bond that are attributable to a yield period are—

(A) *Principal and interest.* Any amounts paid during the yield period to discharge principal or interest on the bond;

(B) *Qualified guarantee.* Any amounts paid during the yield period for a qualified guarantee with respect to the bond;

(C) *Early retirement value.* If the bond is retired before the final maturity date and during the yield period, an amount equal to the early retirement value of the bond on the retirement date;

(D) *Retirement price.* If the bond is retired on the final maturity date and during the yield period, an amount equal to the retirement price of the bond; and

(E) *End-of-period value.* If the bond is outstanding at the close of business on the last day of the yield period, the early retirement value of the bond on such day.

The amount taken into account under paragraphs (d)(3)(i)(C), (d)(3)(i)(D), and (d)(3)(i)(E) on a date shall not include any amount taken into account under paragraph (d)(3)(i)(A) or (d)(3)(i)(B) on such date.

(ii) *Issue prices.* For purposes of paragraph (d)(1)(ii) of this section, a bond to which paragraph (d)(3)(i)(E) of this section applied on the last day of a yield period shall be treated as if issued on the first day of the next succeeding yield period for an issue price equal to the amount taken into account with respect to the bond on such last day under paragraph (d)(3)(i)(E) of this section.

(4) *Examples.* The following examples illustrate the application of this paragraph (d):

Example (1). (i) On December 1, 1988, County C issues an issue consisting of identical current index bonds. The aggregate principal amount and issue price of the bonds (determined under §1.148-8T(c)) is $10 million. The final maturity date of each bond is December 1, 1995. The bonds are not subject to redemption or purchase before maturity. Interest on the bonds is payable on December 1 of each year. The interest rate on the bonds for each 1-year period beginning December 1 is 85 percent of the prime rate of Bank B as of such December 1. The prime rate of Bank B as of the date of issue is 7 percent per annum. Therefore, the assumed interest rate for purposes of computing the yield on and present value of the bonds is 5.95 percent (85% of 7%). See paragraph (b)(9)(ii) of this section. The prime rate of Bank B as of each December 1 beginning December 1, 1989 is 6 percent per annum. Therefore, the actual rate of interest on the bonds after the first 1-year period is 5.1 percent for each year. All the bonds are outstanding at the end of the first yield period (12/01/93).

(ii) The yield-to maturity on the bonds is 5.950 percent per annum compounded annually, computed as follows:

Date	*Issue Payments*	*PV (5.950000000%)*
12/01/89	$ 595,000.00	$ 561,585.65
12/01/90	595,000.00	530,047.81
12/01/91	595,000.00	500,281.08
12/01/92	595,000.00	472,186.02
12/01/93	595,000.00	445,668.73
12/01/94	595,000.00	420,640.61
12/01/95	10,595,000.00	7,069,590.10
PV Issue Prices (12/01/88)		$ 10,000,000.00

See paragraphs (b)(5)(ii), (b)(9)(i), and (b)(9)(i) of this section. The aggregate present value of the bonds on the last day of the first yield period (12/01/93) determined by using the exact method is $10,000,000, computed as follows:

Date	*Payments*	*PV (5.950%)*
12/01/94	$ 595,000.00	$ 561,585.65
12/01/95	10,595,000.00	9,438,414.35
	PV (12/01/93)	$ 10,000,000.00

See paragraphs (b)(8)(i) and (b)(9) of this section. The present value on December 1, 1993 is determined without regard to interest at the assumed rate that accrued on or before that date and is payable on or after that date (*i.e.*, without regard to the $595,000 payable on 12/01/93). See paragraph (b)(9)(iv) of this section. The present value would be the same if the issuer used the approximate method to determine the present value. See paragraph (b)(8)(iii) of this section. The aggregate early retirement value of the bonds on the last day of the first yield period is the aggregate present value of the bonds. See paragraph (b)(7)(i) of this section.

(iii) The aggregate early retirement value of the bonds on the last day of the first yield period ($10 million) and the actual interest paid on that date ($510,000) are taken into account as issue payments on that date for purposes of computing the yield on the issue during the first yield period (the period ending 12/01/93). See paragraph (d)(2)(i)(A) and (d)(2)(i)(F)(1) of this section. The yield on the issue during the first yield period is 5.288 percent per annum compounded annually, computed as follows:

Date	*Payments*	*PV (5.2879549712%)*
12/01/89	$ 595,000.00	$ 565,116.87
12/01/90	510,000.00	460,058.22
12/01/91	510,000.00	436,952.38
12/01/92	510,000.00	415,006.99
12/01/93	10,510,000.00	8,122,865.54
PV Issue Prices (12/01/88)		$ 10,000,000.00

(iv) Assume all the bonds are retired on December 1, 1994 for 99.9 percent of par ($9.99 million) plus accrued interest ($510,000). For purposes of computing the yield on the issue during the second yield period (the period ending 12/01/94), the aggregate issue price of the bonds taken into account on the first day of the second yield period is the same as the early retirement value of the bonds taken into account on the last day of the first yield period ($10 million). See paragraph (d)(2)(ii)-(B) of this section. The issue payments taken into account on the early retirement date (12/01/94) are the accrued interest paid on that date ($510,000) and the aggregate early retirement value of the bonds on that date. See paragraph (d)(2)(i)(A) and (d)(2)(i)(D) of this section. The aggregate early retirement value of the bonds on the early retirement date is the present value of the bonds on that date, which is $10 million (determined by using the exact or the approximate method). See paragraph (b)(7)(i), (b)(8)(i), (b)(8)(iii), and (b)(9) of this section. The yield on the issue during the second yield period is 5.100 percent per annum compounded annually, computed as follows:

Date	*Issue Payment*	*PV (5.1000000000%)*
12/01/94	$10,510,000.00	$ 10,000,000.00
PV Issue Prices (12/01/93)		$ 10,000,000.00

Example (2). (i) The facts are the same as in Example (1), except that the aggregate issue price of the bonds is $10,025,000, and the bonds are subject to optional redemption at par plus accrued interest on or after December 1, 1993.

(ii) The bonds are not yield-to-call bonds, because the yield-to-maturity on the bonds is not more than one sixteenth of one percent higher than the lowest yield. See paragraph (b)(4)(ii)(B) of this section. The yield-to-maturity on the bonds is 5.905 percent per annum compounded annually, computed as follows:

Date	*Payments*	*PV (5.9053667634%)*
12/01/89	$ 595,000.00	$ 561,822.33
12/01/90	595,000.00	530,494.67
12/01/91	595,000.00	500,913.87
12/01/92	595,000.00	472,982.52
12/01/93	595,000.00	446,608.64
12/01/94	595,000.00	421,705.39
12/01/95	10,595,000.00	7,090,472.57
PV Issue Prices (12/01/88)		$ 10,025,000.00

See paragraph (b)(5)(ii) and (b)(9) of this section. The lowest yield on the bonds is 5.891 percent per annum compounded annually, computed as follows:

Date	*Payments*	*PV (5.8908270554%)*
12/01/89	$ 595,000.00	$ 561,899.47
12/01/90	595,000.00	530,640.37
12/01/91	595,000.00	501,120.24
12/01/92	595,000.00	473,242.35
12/01/93	10,595,000.00	7,958,097.57
PV Issue Prices (12/01/88)		$ 10,025,000.00

See paragraph (b)(5)(iii) and (b)(9) of this section.

(iii) The aggregate present value and early retirement value of the bonds on the last day of the first yield period (12/01/93) is $10,008,261.26, computed as follows:

Date	*Payments*	*PV (5.905%)*
12/01/94	$ 595,000.00	$ 561,824.28
12/01/95	10,595,000.00	9,446,436.99
	PV (12/01/93)	$ 10,008,261.26

See paragraph (b)(7)(i), (b)(8)(i) and (b)(9) of this section.

The yield on the issue during the first yield period (the period ending 12/01/93) is 5.245 percent per annum compounded annually, computed as follows:

Date	*Issue Payments*	*PV (5.2445513152%)*
12/01/89	$ 595,000.00	$ 565,349.93
12/01/90	510,000.00	460,437.76
12/01/91	510,000.00	437,493.21
12/01/92	510,000.00	415,692.02
12/01/93	10,518,261.26	8,146,027.07
PV Issue Prices (12/01/88)		$ 10,025,000.00

See paragraph (d)(2)(i)(A) and (d)(2)(i)(F)(1) of this section.

(iv) Assume that all the bonds remain outstanding to maturity (12/01/95). The aggregate issue price taken into account on the first day of the second yield period is the aggregate early retirement value of the bonds on such date ($10,008,261.26, computed in subdivision (iii) above). See paragraph (d)(2)(ii)(B) of this section. The aggregate issue payments taken into account on the final maturity date are the accrued interest paid on the retirement date ($510,000) and the aggregate retirement price of the bonds less such accrued interest ($10 million). See paragraph (d)(2)(i)(A) and (d)(2)(i)(E) of this section. The yield on the issue during the second yield period is 5.056 percent per annum compounded annually, computed as follows:

Date	*Issue Payments*	*PV (5.0555355756%)*
12/01/94	$ 510,000.00	$ 485,457.52
12/01/95	10,510,000.00	9,522,803.74
PV Issue Prices (12/01/93)		$ 10,008,261.26

Example (3). (i) The facts are the same as in Example (2), except that the bonds are subject to extraordinary optional or mandatory redemption at par plus accrued interest on December 1, 1990 with proceeds of the issue that have not been spent before that date. County C spent all the proceeds of the issue before such date.

(ii) The bonds are yield-to-call bonds, because the yield-to-maturity on the bonds is more than one sixteenth of one percent higher than the lowest yield. See paragraph (b)(4)(ii)(B) of this section. The yield-to-maturity on the bonds is the same as the yield-to-maturity computed in Example (2) (5.905%). The lowest yield on the bonds is 5.814 percent per annum compounded annually, computed as follows:

Date	*Payments*	*PV (5.8139961083%)*
12/01/89	$ 595,000.00	$ 562,307.47
12/01/90	10,595,000.00	9,462,692.53
PV Issue Prices (12/01/88)		$ 10,025,000.00

See paragraph (b)(5)(iii) and (b)(9) of this section. The bonds are treated as if the final maturity date of the bonds were December 1, 1990, and as if the stated retirement price on the final maturity date were $10.595 million. See paragraph (b)(4)(i) of this section. Since the bonds are not actually retired on or before December 1, 1990, the bonds are treated as if issued on that date for $10 million. See paragraph (b)(4)(i) of this section. The yield-to-maturity on the reissued bond is 5.950 percent per annum compounded annually, computed as follows:

Date	*Payments*	*PV (5.9500000000%)*
12/01/91	$ 595,000.00	$ 561,585.65
12/01/92	595,000.00	530,047.81
12/01/93	595,000.00	500,281.08
12/01/94	595,000.00	472,186.02
12/01/95	10,595,000.00	7,935,899.44
PV Issue Prices (12/01/90)		$ 10,000,000.00

See paragraph (b)(4)(i), (b)(5)(ii), and (b)(9) of this section. The early retirement value of the reissued bond on the last day of the first yield period (12/01/93) is $10 million, computed as follows:

Date	*Payments*	*PV (5.950%)*
12/01/94	$ 595,000.00	$ 561,585.65
12/01/95	10,595,000.00	9,438,414.35
	PV (12/01/93)	$ 10,000,000.00

See paragraph (b)(7)(i) and (b)(9) of this section.

(iii) The yield on the issue during the first yield period is 5.230 percent per annum compounded annually, computed as follows:

Date	*Issue Payments*	*PV (5.2296467486%)*
12/01/89	$ 595,000.00	$ 565,430.01
12/01/90	10,510,000.00	9,491,317.27
12/01/90	(10,000,000.00)	(9,030,749.07)
12/01/91	510,000.00	437,679.13
12/01/92	510,000.00	415,927.59
12/01/93	10,510,000.00	8,145,395.07
PV Issue Prices (12/01/88)		$ 10,025,000.00

See paragraph (d)(2)(i)(A), (d)(2)(i)(E), and (d)(2)(i)(F)(1) of this section. The yield on the issue during the second yield period is 5.100 percent per annum compounded annually, computed as follows:

Date	*Issue Payments*	*PV (5.1000000000%)*
12/01/94	$ 510,000.00	$ 485,252.14
12/01/95	10,510,000.00	9,514,747.86
PV Issue Prices (12/01/93)		$ 10,000,000.00

See paragraph (d)(2)(i)(A), (d)(2)(i)(E), and (d)(2)(ii)(B) of of this section.

Example (4). (i) On September 1, 1988, City A issues an issue consisting of identical tender bonds. The aggregate principal amount and issue price of the bonds (determined under §1.148-8T(c)) is $25 million, and the final maturity date of the bonds is September 1, 1998. Interest on the bonds is payable on September 1 of each year. The bondholders are entitled to tender the bonds at par (plus accrued interest if the tender date is not an interest payment date) to an independent remarketing agent on March 1 and September 1 of each year. On February 20 and August 20 of each year, the remarketing agent determines the lowest interest rate on the bonds that would enable the bonds that will be tendered on the next tender date to be remarketed on such date at par (plus any accrued interest). Under the terms of the bonds, this interest rate will be the interest rate for the next 6-month period beginning on the tender date (unless such rate exceeds 12 percent, which is the maximum interest rate payable on the bonds). Interest is compounded on each tender date. The remarketing agent is required to use best efforts to remarket tendered bonds at par (plus any accrued interest) on each tender date and, if any tendered bonds cannot be remarketed on such date, to continue to use best efforts to remarket the bonds. The tender price of tendered bonds is to be paid with proceeds received from remarketing the bonds. If the remarketing proceeds (and other available funds) are insufficient to make full payment, the remarketing agent is required to draw on an irrevocable letter of credit issued by Bank A to the extent necessary to make full payment. The letter of credit also guarantees regular payments of principal and interest on the bonds. Any bond that cannot be remarketed on a tender date is delivered to Bank A as security for repayment of the letter of credit advance. Advances under the letter of credit bear interest at the maximum interest rate payable on the bonds (compounded semiannually and payable each September 1). Any interest due on the bonds held by Bank A is paid to Bank A and credited against the interest accruing on the letter of credit advance. Bank A is entitled to reimbursement for any advances under the letter of credit and interest thereon from proceeds of any subsequent remarketing of the bonds delivered to Bank A (and from other available funds). The term of the letter of credit ends on the final maturity date of the bonds. The initial fee for providing the letter of credit is $35,000 payable on the date of issue. Annual fees for providing the letter of credit are payable in advance on the date of issue and on each September 1 thereafter in an amount equal to one-half of one percent of the sum of the outstanding par amount of the bonds on such date and simple interest for one year at the maximum interest rate.

(ii) Assume that the letter of credit is a qualified guarantee, that all bonds tendered on each tender date are remarketed at par (plus any accrued interest) on the same date, and that no draws are made under the letter of credit. Assume further that if all the bonds remain outstanding until maturity, the interest rates and payments for debt service and for the qualified guarantee are as follows:

Date	*Interest Rate*	*Debt Service*	*Guarantee*
9/01/88	5%		$ 175,000.00
3/01/89	6%		
9/01/89	5%	$1,393,750.00	140,000.00
3/01/90	6%		
9/01/90	5%	1,393,750.00	140,000.00
3/01/91	6%		
9/01/91	6%	1,393,750.00	140,000.00
3/01/92	7%		
9/01/92	6%	1,651,250.00	140,000.00
3/01/93	7%		
9/01/93	6%	1,651,250.00	140,000.00
3/01/94	7%		
9/01/94	6%	1,651,250.00	140,000.00
3/01/95	7%		
9/01/95	5%	1,651,250.00	140,000.00
3/01/96	6%		
9/01/96	6%	1,393,750.00	140,000.00
3/01/97	5%		
9/01/97	7%	1,393,750.00	140,000.00
3/01/98	6%		
9/01/98		26,651,250.00	

(iii) The annual letter of credit fees are level payments and are treated as paid when actually paid (but not earlier than when actually due). See paragraphs (b)(13)(ii)(A) and (b)(13)(iii)(A) of this section. The initial fee for the letter of credit ($35,000) is a nonlevel payment and is treated as paid on the first day of each bond year during the term of the letter of credit. See paragraphs (b)(13)(ii)(B) and (b)(13)(iii)(B) of this section. The amount of the initial letter of credit fee treated as paid on each September 1 is the constant payment amount. The aggregate constant payment amount is the present value of the initial fee on September 1, 1988 ($35,000), divided by the sum of the present values on September 1, 1988 of $1 paid on each September 1. For this purpose, the yield on the tender bonds during the first yield period (without regard to the initial fee) is used as the discount rate. See paragraph (b)(13)(iii)(C) of this section.

(iv) Assume all the bonds are outstanding on the last day of the first yield period (9/01/93). For purposes of computing the yield on the issue during the first yield period, the aggregate issue payments taken into account as of the last day of the first yield period are the early retirement value of the bonds ($25 million) and the accrued interest paid on such day ($1,651,250). See paragraphs (d)(2)(i)(A) and (d)(2)(i)(F)(*1*) of this section. The aggregate early retirement value of the bonds is the outstanding par amount of the bonds. See paragraph (b)(7)(ii) of this section. The yield on the tender bonds during the first yield period (determined without regard to the initial letter of credit fee) is 6.441 percent per annum compounded semiannually, computed as follows:

Date	*Debt Service*	*Guarantee*	*PV (6.4412399054%)*
9/01/88		$40,000.00	$ 140,000.00
9/01/89	$ 1,393,750.00	140,000.00	1,439,533.08
9/01/90	1,393,750.00	140,000.00	1,351,103.82
9/01/91	1,393,750.00	140,000.00	1,268,106.70
9/01/92	1,651,250.00	140,000.00	1,390,031.04
9/01/93	26,651,250.00		19,411,225.36
		PV Issue Prices (9/01/88)	$25,000,000.00

See paragraphs (d)(2)(i)(A), (d)(2)(i)(B), (d)(2)(i)(F)(*1*), and (b)(13)(ii)(A) of this section. Since the amounts paid to purchase tendered bonds were exactly offset on the same date by amounts received from remarketing the tendered bonds, both amounts may be disregarded in computing the yield. See paragraphs (d)(2)(i)(C) and (d)(2)(ii)(A) of this section. The present value of $1 paid on each September 1 is $7.64332, computed as follows:

Date	*Payment*		*PV (6.441%)*
9/01/88	$1		$1.00000
9/01/89	1		.93857
9/01/90	1		.88092
9/01/91	1		.82681
9/01/92	1		.77602
9/01/93	1		.72835
9/01/94	1		.68361
9/01/95	1		.64162
9/01/96	1		.60221
9/01/97	1		.56521
		PV (9/01/88)	$7.64332

The aggregate constant payment amount is $4,579.16 ($35,000 divided by $7.64332). See paragraph (b)(13)(iii)(C) of this section. The yield on the issue during the first yield period is 6.460 percent per annum compounded semiannually, computed as follows:

Date	*Debt Service*	*Guarantee*	*PV (6.4601482415%)*
9/01/88		$144,579.16	$ 144,579.16
9/01/89	$ 1,393,750.00	144,579.16	1,443,566.50
9/01/90	1,393,750.00	144,579.16	1,354,641.31
9/01/91	1,393,750.00	144,579.16	1,271,194.01
9/01/92	1,651,250.00	144,579.16	1,392,563.81
9/01/93	26,651,250.00		19,393,455.21
		PV Issue Prices (9/01/88)	$25,000,000.00

See paragraphs (d)(2)(i)(A), (d)(2)(i)(B), (d)(2)(i)(F)(*1*), (b)(13)(ii)(A), and (b)(13)(ii)(B) of this section.

(v) Assume all the bonds are outstanding until maturity (9/01/98). For purposes of computing the yield on the issue during the second yield period (the period ending 9/01/98), the bonds are treated as if issued for an aggregate issue price equal to the early retirement value of the bonds that was taken into account on the last day of the first yield period ($25 million). See paragraph (d)(2)(ii)(B) of this section. The aggregate issue payment taken into account on the final maturity date is the retirement price of the bonds ($26,651,250). See paragraphs (d)(2)(i)(A) and (d)(2)(i)(E) of this section. The yie]d on the issue during the second yield period is 6.713 percent per annum compounded semiannually, computed as follows:

Date	*Debt Service*	*Guarantee*	*PV (6.7130248542%)*
9/01/93		$144,579.16	$ 144,579.16
9/01/94	$ 1,651,250.00	144,579.16	1,681,083.66
9/01/95	1,651,250.00	144,579.16	1,573,669.88
9/01/96	1,393,750.00	144,579.16	1,261,892.02
9/01/97	1,393,750.00	144,579.16	1,181,262.73
9/01/98	26,651,250.00		19,157,512.55
		PV Issue Prices (9/01/93)	$25,000,000.00

See paragraphs (d)(2)(i)(A), (d)(2)(i)(B), (d)(2)(i)(F)(*1*), (b)(13)(ii)(A), and (b)(13)(ii)(B) of this section.

Example (5). The facts are the same as in Example (4), except that all the bonds are redeemed on the first installment computation date (9/01/93) at par ($25 million) plus accrued interest ($1,651,250). The aggregate issue payments taken into account on September 1, 1993 total $26,651,250. See paragraphs (d)(2)(i)(A), (d)(2)(i)(D), and (b)(7)(ii) of this section. The yield on the issue during the first yield period is 6.460 percent per annum compounded semiannually (the same as the yield on the issue during the first yield period computed in Example (4)(iv)).

Example (6). (i) The facts are the same as in Example (4), except that $10 million of the bonds are redeemed on September 1, 1992 at par ($10 million) plus accrued interest ($660,500), and all the remaining bonds are redeemed on June 1, 1996 at par ($15 million) plus accrued interest ($605,625). The annual letter of credit fee paid on each September 1 annual letter of credit fee paid on each September 1 on and after September 1, 1992 (when $10 million of the bonds are retired) is $84,000 (the product of $140,000 and 15 divided by 25). The last annual letter of credit fee is paid on September 1, 1995 (the last September 1 before the remaining $15 million of bonds are retired).

(ii) The yield on the tender bonds during the first yield period (without regard to the initial letter of credit fee) is 6.393 percent per annum compounded semiannually, computed as follows:

Date	Debt Service	Guarantee	PV (6.3931795670%)
9/01/88		$40,000.00	$ 140,000.00
9/01/89	$ 1,393,750.00	140,000.00	1,440,203.57
9/01/90	1,393,750.00	140,000.00	1,352,362.73
9/01/91	1,393,750.00	140,000.00	1,269,879.46
9/01/92	11,651,250.00	84,000.00	9,123,670.21
9/01/93	15,990,750.00		11,673,884.03
		PV Issue Prices (9/01/88)	$25,000,000.00

See paragraphs (d)(2)(i)(A), (d)(2)(i)(B), (d)(2)(i)(D), (d)(2)(i)(F)(*1*), and (b)(13)(ii)(A) of this section. The present value as of September 1, 1988 (using a discount rate equal to 6.393%) of $1 paid on each September 1 on which an annual letter of credit fee is payable (*i.e.*, each September 1 beginning 9/01/88 and ending 9/01/97) is $7.65749. The aggregate constant payment amount is $4,570.69 ($35,000 divided by $7.65749). See paragraph (b)(13)(iii)(C) of this section. The aggregate constant payment amount taken into account on September 1, 1992 includes only the portion of such amount attributable to the $15 million of bonds remaining outstanding after September 1, 1992 ($2,742.41; the product of $4,570.69 and 15 divided by 25). See paragraph (b)(13)(ii)(C) of this section. The yield on the issue during the first yield period is 6.412 percent per annum compounded semiannually, computed as follows:

Date	Debt Service	Guarantee	PV (6.4120605006%)
9/01/88		$44,570.69	$ 144,570.69
9/01/89	$ 1,393,750.00	144,570.69	1,444,231.24
9/01/90	1,393,750.00	144,570.69	1,355,896.65
9/01/91	1,393,750.00	144,570.69	1,272,964.93
9/01/92	11,651,250.00	86,742.41	9,119,126.41
9/01/93	15,990,750.00		11,663,210.08
		PV Issue Prices (9/01/88)	$25,000,000.00

See paragraphs (d)(2)(i)(A), (d)(2)(i)(B), (d)(2)(i)(D), (d)(2)(i)(F)(*1*), (b)(13)(ii)(A), (b)(13)(ii)(B), and (b)(13)(ii)(C) of this section. .

(iii) For purposes of computing the yield on the issue during the second yield period, both the annual letter of credit fee paid on September 1, 1995 and the aggregate constant payment amount normally treated as paid on September 1, 1995 are reduced to reflect the fact that the bonds were retired before the end of the bond year. The aggregate amount taken into account on September 1, 1995 is the product of $86,742.41 and 9 divided by 12 (the portion of the bond year during which the bonds were not retired). See paragraph (b)(13)(ii)(C) of this section. The yield on the issue during the second yield period is 6.807 percent per annum compounded semiannually, computed as follows:

Date	Debt Service	Guarantee	PV (6.8066199593%
9/01/93		$86,742.41	$ 86,742.41
9/01/94	$ 990,750.00	86,742.41	1,007,732.67
9/01/95	990,750.00	65,056.81	923,520.83
6/01/96	15,605,625.00		12,982,004.09
		PV Issue Prices (9/01/93)	$15,000,000.00

See paragraphs (d)(2)(i)(A), (d)(2)(i)(B), (d)(2)(i)(D), (d)(2)(ii)(B), (b)(13)(ii)(A), (b)(13)(ii)(B), and (b)(13)(ii)(C) of this section.

Example (7). (i) The facts are the same as in Example (4), except that the annual letter of credit fee for each of the first five years is an amount equal to two-thirds of one percent of the sum of the outstanding par amount of the bonds and simple interest for one year at the maximum interest rate and thereafter is an amount equal to one third of one percent of such sum.

(ii) All the bonds are outstanding on the first installment computation date (9/01/93). Both the initial and the annual letter of credit fees are nonlevel payments and must be reallocated. See paragraph (b)(13)(iii)(B) of this section. The aggregate constant payment amount is the present value of all the fees on September 1, 1988, divided by the sum of the present values as of September 1, 1988 of $1 paid on each September 1. See paragraph (b)(13)(iii)(C) of this section. The yield on the tender bonds during the first yield period (without regard to any of the fees) is used as the discount rate. The yield on the tender bonds during the first yield period (as so determined) is 5.866 percent per annum compounded semiannually, computed as follows:

Date	Debt Service	PV (5.8656597372%)
9/01/89	$ 1,393,750.00	$ 1,315,458.21
9/01/90	1,393,750.00	1,241,564.34
9/01/91	1,393,750.00	1,171,821.34
9/01/92	1,651,250.00	1,310,332.55
9/01/93	26,651,250.00	19,960,823.56
	PV Issue Prices (9/01/88)	$25,000,000.00

See paragraph (d)(2)(i)(A) and (d)(2)(i)(F)(*1*) of this section. The present value of all the fees as of September 1, 1988 is $1,181,584.35, computed as follows:

Date	Guarantee	PV (5.866%)
9/01/88	$ 221,666.67	$ 221,666.67
9/01/89	186,666.67	176,180.37
9/01/90	186,666.67	166,283.16
9/01/91	186,666.67	156,941.93
9/01/92	186,666.67	148,125.47
9/01/93	93,333.33	69,902.14
9/01/94	93,333.33	65,975.27
9/01/95	93,333.33	62,269.01
9/01/96	93,333.33	58,770.94
9/01/97	93,333.33	55,469.39
	PV (9/01/88)	$ 1,181,584.35

The present value as of September 1, 1988 of $1 paid on each September 1 during the term of the guarantee is $7.81592. The aggregate constant payment amount is $151,176.62 ($1,181,584.35 divided by $7.81592). See paragraph (b)(13)(iii)(C) of this section. The yield on the issue during the first yield period is 6.487 percent per annum compounded semiannually, computed as follows:

Date	Debt Service	Guarantee	PV (6.4873997624%)
9/01/88		$151,176.62	$ 151,176.62
9/01/89	$ 1,393,750.00	151,176.62	1,449,374.90
9/01/90	1,393,750.00	151,176.62	1,359,732.94
9/01/91	1,393,750.00	151,176.62	1,275,635.21
9/01/92	1,651,250.00	151,176.62	1,396,204.76
9/01/93	26,651,250.00		19,367,875.57
		PV Issue Prices (9/01/88)	$25,000,000.00

See paragraphs (d)(2)(i)(A), (d)(2)(i)(B), (d)(2)(i)(F)(*1*), and (b)(13)(ii)(B) of this section.

Example (8). (i) The facts are the same as in Example (7), except that the bonds are issued on March 1, 1989, and the annual letter of credit fee payable on March 1, 1989 (for the first bond year) is one half of the regular annual fee ($93,333.34).

(ii) The yield on the tender bonds during the first yield period (without regard to any of the fees) is 5.974 percent per annum compounded semiannually, computed as follows:

Date	Debt Service	PV (5.9752161006%)
9/01/89	$ 750,000.00	$ 728,246.49
9/01/90	1,393,750.00	1,275,957.74
9/01/91	1,393,750.00	1,203,013.68
9/01/92	1,651,250.00	1,343,794.28
9/01/93	26,651,250.00	20,448,987.81
	PV Issue Prices (3/01/89)	$25,000,000.00

See paragraphs (d)(2)(i)(A) and (d)(2)(i)(F)(*1*) of this section. The present value of all the fees as of March 1, 1989 (the first day of the first bond year) is $1,112,913.51, computed as follows:

Date	Guarantee	(PV (5.974%)
3/01/89	$ 128,333.34	$ 128,333.34
9/01/89	186,666.67	181,252.65
9/01/90	186,666.67	170,891.14
9/01/91	186,666.67	161,121.96
9/01/92	186,666.67	151,911.25
9/01/93	93,333.33	71,613.53
9/01/94	93,333.33	67,519.67
9/01/95	93,333.33	63,659.83
9/01/96	93,333.33	60,020.64
9/01/97	93,333.33	56,589.50
	PV (3/01/89)	$ 1,112,913.51

The present value as of March 1, 1989 of $0.50 paid on March 1, 1989 and $1 paid on each September 1 thereafter is $7.48563, computed as follows:

Date	Payment	PV (5.974%)
3/01/89	$0.50	$ .50000
9/01/89	1.00	.97100
9/01/90	1.00	.91549
9/01/91	1.00	.86315
9/01/92	1.00	.81381
9/01/93	1.00	.76729
9/01/94	1.00	.72343
9/01/95	1.00	.68207
9/01/96	1.00	.64308
9/01/97	1.00	.60632
	PV (3/01/89)	$7.48563

The aggregate constant payment amount is $148,673.33 ($1,112,913.51, divided by $7.48563). See paragraph (b)(13)(iii)(C) of this section. The amount treated as paid on March 1, 1989 (the first day of the short bond year) is $74,336.67 ($148,673.33, divided by 2). See paragraph (b)(13)(ii)(B) of this section. The yield on the issue during the first yield period is 6.587 percent per annum compounded semiannually, computed as follows:

Date	Debt Service	Guarantee	PV (6.586752004%)
3/01/89		$ 74,336.56	$ 74,336.57
9/01/89	$ 750,000.00	148,673.33	870,020.10
9/01/90	1,393,750.00	148,673.33	1,399,542.57
9/01/91	1,393,750.00	148,673.33	1,311,720.09
9/01/92	1,651,250.00	148,673.33	1,434,652.28
9/01/93	26,651,250.00		19,909,728.39
		PV Issue Prices (3/01/89)	$25,000,000.00

See paragraphs (d)(2)(i)(A), (d)(2)(i)(B), (d)(2)(i)(F)(*1*), and (b)(13)(ii)(B) of this section.

Example (9). (i) The facts are the same as in Example (4), except that the final maturity date of the bonds is September 1, 2003, and the bonds provide that the issuer may elect to convert the tender bonds to fixed rate bonds without a tender right. If the issuer so elects, (A) the remarketing agent determines the lowest interest rate at which tendered bonds could be remarketed on the next tender date at par without the tender right and this interest rate is the interest rate on the fixed rate bonds from that date until maturity; (B) interest on the fixed rate bonds is still payable on September 1 of each year but is not compounded semiannually; and (C) the fixed rate bonds are subject to optional redemption at 103 percent of par plus accrued interest 5 years after the conversion date or at any time thereafter. Principal and interest on the fixed rate bonds is not secured by the letter of credit issued by Bank A.

(ii) The issuer elects to convert all the tender bonds to fixed rate bonds on September 1, 1991. The interest rate on the fixed rate bonds is 8.5 percent per annum. All the bonds are outstanding on the first installment computation date (9/01/93). The bonds are treated as fixed yield bonds after the close of business on September 1, 1991. See paragraph (b)(3)(i) of this section. The aggregate issue payments taken into account on September 1, 1991 with respect to the tender bonds are the outstanding par amount of the bonds ($25 million) and accrued interest paid on that date ($1,393,750). See paragraphs (d)(2)(i)(A), (d)(2)(i)(F)(*1*), and (b)(7)(ii) of this section. The composite yield on the tender bonds (without regard to the nonlevel initial letter of credit fee) is 6.077 percent per annum compounded semiannually, computed as follows:

Date	*Debt Service*	*Guarantee*	*PV (6.0772180296%)*
9/01/88		$140,000.00	$ 140,000.00
9/01/89	$ 1,393,750.00	140,000.00	1,444,623.25
9/01/90	1,393,750.00	140,000.00	1,360,675.69
9/01/91	26,393,750.00		22,054,701.05
		PV Issue Prices (9/01/88)	$25,000,000.00

See paragraphs (d)(2)(i)(A), (d)(2)(i)(B), (d)(2)(i)(F)(*1*), (b)(13)(ii)(A), and (b)(7)(ii) of this section. The present value as of September 1, 1988 of $1 paid on each September 1 an annual letter of credit fee is payable (*i.e.*, on each September 1 beginning 9/01/88 and ending 9/01/97) is $7.75185. The aggregate constant payment amount is $4,515.05 ($35,000 divided by $7.75185). See paragraph (b)(13)(iii)(C) of this section. This amount is taken into account as an issue payment with respect to the variable yield bonds before the conversion and with respect to the fixed yield bonds after the conversion. See paragraphs (b)(13)(ii)(B) and (b)(13)(ii)(D) of this section. The fixed yield bonds are treated as if issued immediately after the close of business on September 1, 1991 for par. See paragraphs (b)(3)(i) and (d)(2)(ii) of this section. The aggregate issue payments taken into account with respect to the fixed yield bonds on the last day of the first yield period (9/01/93) are the accrued interest paid on such date ($2,125,000) and the aggregate early retirement value of the fixed yield bonds as of such date less the interest paid on such date ($25 million). See paragraphs (d)(3)(i)(A), (d)(3)(i)(E), (b)(7)(i), (b)(8)(i), and (b)(8)(iii) of this section. The yield on the issue during the first yield period is 6.911 percent per annum compounded semiannually, computed as follows:

Date	*Debt Service*	*Guarantee*	*PV (6.9110284128%)*
9/01/88		$144,515.05	$ 144,515.05
9/01/89	$ 1,393,750.00	144,515.05	1,437,222.10
9/01/90	1,393,750.00	144,515.05	1,342,816.28
9/01/91	26,393,750.00	4,515.05	21,530,470.64
9/01/91	(25,000,000.00)		(20,390,043.25)
9/01/92	2,125,000.00	4,515.05	1,622,749.80
9/01/93	27,125,000.00		19,312,269.38
		PV Issue Prices (9/01/88)	$25,000,000.00

See paragraphs (d)(2)(i)(A), (d)(2)(i)(B), (d)(2)(i)(F)(*1*), (d)(2)(ii)(B), (d)(3)(i)(A), (d)(3)(i)(B), (d)(3)(i)(E), (b)(13)(ii)(A), (b)(13)(ii)(B), (b)(3)(i), (b)(7)(i), (b)(8)(i), and (b)(8)(iii) of this section.

(iii) All the bonds are outstanding on the second installment computation date (9/01/98). The issue is treated as a fixed yield issue issued as of the first day of the second yield period (9/01/93), and each fixed yield bond that is part of the issue is treated as if issued after the close of business on such date for an issue price equal to the outstanding par amount of the bond on such date. See paragraphs (b)(3)(ii), (d)(3)(ii), (b)(7)(i), (b)(8)(i), and (b)(8)(iii) of this section. The yield on the fixed yield issue as of the second installment computation date is 8.512 percent per annum compounded annually, computed as follows:

Date	*Debt Service*	*Guarantee*	*PV (8.5117724651%)*
9/01/93		$ 4,515.05	$ 4,515.05
9/01/94	$ 2,125,000.00	4,515.05	1,962,473.75
9/01/95	2,125,000.00	4,515.05	1,808,535.34
9/01/96	2,125,000.00	4,515.05	1,666,672.01
9/01/97	2,125,000.00	4,515.05	1,535,936.58
9/01/98	2,125,000.00		1,412,455.09
9/01/99	2,125,000.00		1,301,660.69
9/01/00	2,125,000.00		1,199,557.12
9/01/01	2,125,000.00		1,105,462.65
9/01/02	2,125,000.00		1,018,749.05
9/01/03	27,125,000.00		11,983,982.67
		PV Issue Prices (9/01/93)	$25,000,000.00

See paragraphs (b)(3)(ii), (c)(2)(i), (c)(2)(ii), (c)(2)(iv), (c)(3)(ii), (b)(13)(ii)(B), (b)(13)(ii)(C), (b)(7)(i), (b)(8)(i), (b)(8)(iii), and (b)(11)(ii) of this section.

(iv) All the bonds are redeemed on September 1, 2000 at 103 percent of par ($25,750,000) plus accrued interest ($2,125,000). The aggregate early retirement value of the fixed yield bonds on September 1, 2000 is the aggregate present value, which is par ($25 million) plus accrued interest ($2,125,000). See paragraphs (b)(7)(i), (b)(8)(i), and (b)(8)(iii) of this section. The yield on the fixed yield issue as of the final computation date (9/01/00) is 8.515 percent per annum compounded annually, computed as follows:

Date	*Debt Service*	*Guarantee*	*PV (8.5150899027%)*
9/01/93		$ 4,515.05	$ 4,515.05
9/01/94	$ 2,125,000.00	4,515.05	1,962,413.75
9/01/95	2,125,000.00	4,515.05	1,808,424.76
9/01/96	2,125,000.00	4,515.05	1,666,519.16
9/01/97	2,125,000.00	4,515.05	1,535,748.77
9/01/98	2,125,000.00		1,412,239.20
9/01/99	2,125,000.00		1,301,421.95
9/01/00	27,125,000.00		15,308,717.36
		PV Issue Prices (9/01/93)	$25,000,000.00

See paragraphs (c)(2)(i), (c)(2)(ii), (c)(2)(iii), (b)(13)(ii)(B), and (b)(13)(ii)(C) of this section.

Example (10). The facts are the same as in Example (9), except that all the bonds are retired on March 1, 1997. The aggregate early retirement value of the fixed yield bonds on March 1, 1997 is the aggregate present value of the bonds. See paragraph (b)(7)(i) of this section. The aggregate present value of the bonds determined by using the exact method is $26,040,833.32, computed as follows:

Date	*Debt Service*		*PV (8.500%)*
9/01/97	$ 2,125,000.00		$ 2,040,065.28
9/01/98	2,125,000.00		1,880,244.50
9/01/99	2,125,000.00		1,732,944.24
9/01/00	2,125,000.00		1,597,183.63
9/01/01	2,125,000.00		1,472,058.65
9/01/02	2,125,000.00		1,356,736.08
9/01/03	27,125,000.00		15,961,600.94
		PV (3/01/97)	$26,040,833.32

See paragraph (b)(8)(i) of this section. The aggregate present value of the bonds determined by using the approximate method is $26,062,500, which is higher. See paragraph (b)(8)(iii) of this section. The yield on the fixed yield issue as of the final computation date (3/01/97) is 8.542 percent per annum compounded annually, computed as follows:

Date	*Debt Service*	*Guarantee*	*PV (8.5419391395%)*
9/01/93		$ 4,515.05	$ 4,515.05
9/01/94	$ 2,125,000.00	4,515.05	1,961,928.33
9/01/95	2,125,000.00	4,515.05	1,807,530.20
9/01/96	2,125,000.00	2,257.53	1,663,517.37
3/01/97	26,062,500.00		19,562,509.05
		PV Issue Prices (9/01/93)	$25,000,000.00

See paragraphs (c)(2)(i), (c)(2)(ii), (c)(2)(iii), (b)(13)(ii)(B), (b)(13)(ii)(C), and (b)(13)(ii)(D) of this section.

Example (11). (i) The facts are the same as in Example (9), except that the issuer elected to convert all the tender bonds to fixed rate bonds on March 1, 1991 (instead of September 1, 1991), the interest rate on the fixed rate bonds is 8.5 percent per annum, $20 million of the bonds are tendered and remarketed at par on March 1, 1991, and all the bonds are outstanding on the first installment computation date (9/01/93).

(ii) The aggregate issue payment taken into account on March 1, 1991 with respect to the tendered bonds is par ($20 million) plus accrued interest paid on March 1, 1991 ($500,000). See paragraph (d)(2)(i)(C) of this section. The aggregate issue payments taken into account with respect to the nontendered bonds on March 1, 1991 is par ($5 million) on March 1, 1991 and accrued interest to March 1, 1991 (to be paid on 9/01/91) as of September 1, 1991 ($125,000). See paragraph (d)(2)(i)(F) of this section. The yield on the tender bonds (without regard to the initial letter of credit fee) is 5.978 percent per annum compounded semiannually, computed as follows:

Date	*Debt Service*	*Guarantee*	*PV (5.9782082303%)*
9/01/88		$140,000.00	$ 140,000.00
9/01/89	$ 1,393,750.00	140,000.00	1,446,012.39
9/01/90	1,393,750.00	70,000.00	1,301,073.37
3/01/91	25,500,000.00		22,008,162.24
9/01/91	125,000.00		104,752.00
		PV Issue Prices (9/01/88)	$25,000,000.00

The present value as of September 1, 1988 of $1 paid on each September 1 an annual letter of credit fee is payable is $7.78180. The aggregate constant payment amount is $4,497.67 ($35,000 divided by $7.78180). See paragraph (b)(13)(iii)(C) of this section. The fixed yield bonds are treated as if issued on March 1, 1991 for par ($25 million). The accrued interest to be paid on the bonds that were not tendered on March 1, 1991 is not treated as interest on the fixed yield bonds issued on March 1, 1991. See paragraph (b)(3)(i) of this section. The early retirement value of the fixed yield bonds on the first installment computation date (9/01/93) is the present value of the bonds on that date. See paragraph (b)(7)(i) of this section. The yield-to-maturity on the fixed yield bonds is 8.511 percent per annum compounded annually, computed as follows:

Date	*Payments*	*PV (8.5110819458%)*
9/01/91	$ 1,062,500.00	$ 1,019,980.55
9/01/92	2,125,000.00	1,879,956.47
9/01/93	2,125,000.00	1,732,501.82
9/01/94	2,125,000.00	1,596,612.80
9/01/95	2,125,000.00	1,471,382.25
9/01/96	2,125,000.00	1,355,974.18
9/01/97	2,125,000.00	1,249,618.15
9/01/98	2,125,000.00	1,151,604.18
9/01/99	2,125,000.00	1,061,277.94
9/01/00	2,125,000.00	978,036.46
9/01/01	2,125,000.00	901,324.03
9/01/02	2,125,000.00	830,628.55
9/01/03	27,125,000.00	9,771,102.62
	PV Issue Prices (3/01/91)	$25,000,000.00

See paragraph (b)(5)(ii) of this section. The aggregate present value of the fixed yield bonds on September 1, 1993 determined by using the exact method is $27,106,965.13, computed as follows:

Date	*Payments*	*PV (8.511%)*
9/01/93	$ 2,125,000.00	$ 2,125,000.00
9/01/94	2,125,000.00	1,958,326.81
9/01/95	2,125,000.00	1,804,726.53
9/01/96	2,125,000.00	1,663,173.81
9/01/97	2,125,000.00	1,532,723.69
9/01/98	2,125,000.00	1,412,505.36
9/01/99	2,125,000.00	1,301,716.29
9/01/00	2,125,000.00	1,199,616.90
9/01/01	2,125,000.00	1,105,525.61
9/01/02	2,125,000.00	1,018,814.32
9/01/03	27,125,000.00	11,984,835.81
	PV (9/01/93)	$27,106,965.13

See paragraph (b)(8)(i) of this section. The aggregate present value of the bonds determined by using the approximate method is $27,125,000, which is higher. See paragraph (b)(8)(iii) of this section. The Yield on the variable yield issue as of the first installment computation date is 7.149 percent per annum compounded semiannually, computed as follows:

Date	*Debt Service*	*Guarantee*	*PV (7.1485008956%)*
9/01/88		$144,497.67	$ 144,497.67
9/01/89	$ 1,393,750.00	144,497.67	1,433,912.56
9/01/90	1,393,750.00	144,497.67	1,336,654.21
3/01/91	25,500,000.00		21,393,467.67
3/01/91	(25,000,000.00)		(20,973,987.91)
9/01/91	1,187,500.00	4,497.67	965,527.42
9/01/92	2,125,000.00	4,497.67	1,607,913.85
9/01/93	27,125,000.00		19,092,014.53
		PV Issue Prices (9/01/88)	$25,000,000.00

§1.148-4T Allocation and accounting rules (temporary).

(a) *General rule.* An investment is allocated to an issue for the period that—

(1) Begins on the date gross proceeds are allocated to the issue and to the investment; and

(2) Ends on the date such gross proceeds cease to be allocated to the issue or to the investment.

See §1.148-8T for definitions and special rules relating to required rebate. See §1.150-1T for definitions and special rules relating to tax-exempt bond requirements in general.

(b) *Allocation of gross proceeds to issue.* [Reserved]

(c) *Allocation of gross proceeds to expenditures*—(1) *In general.* [Reserved]

(2) *Expenditures from checking account.* An expenditure of proceeds in a checking or similar account may be treated as made—

(i) On the date a negotiable check is written on the account if the check is delivered or mailed no later than one business day after such date; or

(ii) On the date the check is delivered or mailed; if the payor has no reason to believe that the check will not clear within a reasonable period of time thereafter.

(d) *Allocation of gross proceeds to investments.* [Reserved]

(e) *Special allocation rules for refundings*—(1) *Allocation of excess gross proceeds of refunded issue*—(1) *Allocation of excess gross proceeds to escrow.* Excess replacement funds and excess proceeds of a refunded issue shall be allocated to investments the receipts from which are to be used to discharge the principal or interest on or the retirement price of bonds that are part of the refunded issue.

(ii) *Allocation of excess gross proceeds in escrow.* Excess replacement funds and excess proceeds of a refunded issue shall be allocated to investments described in paragraph (e)(1)(i) of this section in such manner as to ensure that the expenditure of such funds and proceeds does not occur later than the expenditure of any sale proceeds of the refunding issue that are allocated to investments described in paragraph (e)(1)(i) of this section.

(iii) *Excess replacement funds.* The term "excess replacement funds" means, with respect to a refunded issue, amounts that at the time of the issuance of the refunding issue or at any time within 6 months thereof are or were gross proceeds (other than proceeds) of the refunded issue if—

(A) The amounts are or were to be used to discharge the principal or interest on or the retirement price of any bond that is part of the refunded issue (or a related issue that is equally and ratably secured) without regard to this paragraph (e)(1);

(B) The amounts are not gross proceeds of the refunding issue after the date of issue of the refunding issue and at all times thereafter until used to discharge the principal or interest on or the retirement price of any bond that is part of the refunding issue (or until such time as this paragraph (e)(1) applies to such amounts by reason of a subsequent refunding);

(C) The amounts were not used to defease bonds (legally or economically) that are part of the refunded issue on a date earlier than the date that is 6 months before the date of issue of the refunding issue in a transaction unrelated to the issuance of the refunding issue; and

(D) The amounts are not part of a reasonably required reserve or replacement fund or bona fide debt service fund for the refunded issue after the date of issue of the refunding issue.

No amount that was part of a bona fide debt service fund for the refunded issue shall be treated as described in paragraph (e)(1)(iii)(B).

(iv) *Excess proceeds.* The term "excess proceeds" means, with respect to a refunded issue, amounts that at the time of issuance of the refunding issue are proceeds of the refunded issue if—

(A) The amounts are allocated to investments described in paragraph (e)(1)(i) of this section and are described in paragraph (e)(1)(iii)(C) or (e)(1)(iii)(D) of this section; or

(B) The amounts were to be used to pay interest on the refunded portion of the refunded issue that accrues within the period of time described in §1.103-15(b)(2) and are described in paragraph (e)(1)(iii)(C) of this section.

(v) *Transition rule.* If a refunding issue is sold on or before May 15, 1989, and issued on or before June 14, 1989—

(A) Paragraph (e)(1)(i) of this section shall not apply;

(B) Paragraph (e)(1)(ii) of this section shall not apply to any refunding issue to which section 149(d)(4) does not apply;

(C) In the case of any refunding issue to which section 149(d)(4)applies, paragraph (e)(1)(ii) of this section—

(*1*) Shall not apply to excess replacement funds that were not gross proceeds of the refunded issue or that were part of a reasonably required reserve or replacement fund (other than a bona fide debt service fund) before the date of issue of the refunding issue or that were used to defease bonds (legally or economically) before such date;

(*2*) Shall not apply to excess proceeds of the refunded issue that were not to be used to pay interest on the refunded portion of the refunded issue that accrues within the period of time described in §1.103-15(b)(2); and

(*3*) Shall apply only for purposes of applying paragraph (e)(2) of this section (including §1.103-14(e)(2)(ii) if paragraph (e)(2)(iii)(A) of this section applies).

(2) *Transferred proceeds*-(i) *In general.* At the close of business on the date that any amount of the proceeds of a refunding issue are used to discharge the principal or interest on or the retirement price of any bond that is part of a refunded issue, the same amount of the proceeds of the refunded issue shall cease to be treated as proceeds of the refunded issue and shall be treated as transferred proceeds of the refunding issue.

(ii) *Special rules*—(A) *Unspent proceeds transfer first.* Proceeds of the refunded issue not allocated to expenditures shall cease to be proceeds (and become transferred proceeds) under paragraph (e)(2)(i) of this section before any other proceeds of the refunded issue.

(B) *Transfer otherwise is ratable.* Except as otherwise provided in paragraph (e)(2)(ii)(A) of this section, proceeds of the refunded issue ratably cease to be proceeds (and become transferred proceeds) under paragraph (e)(2)(i) of this section.

(C) *Transfer cap.* In the case of a refunding issue to which section 149(d)(4) applies, paragraph (e)(2)(i) of this section shall not apply on a date to the extent that it would cause the value of the nonpurpose investments allocated to the refunding portion of the issue to exceed by more than 10 percent the value of the bonds allocated (on a pro rata basis) to such portion of the issue.

The value of an investment is the receipt that would be taken into account under §1.148-2T(b)(2)(iii) on the following date if such date were an installment computation date. The value of a bond is the excess of the issue payments that would be taken into account under §1.148-3T on the following date if the bond were retired on such date, over any amounts actually paid on such date with respect to the bond. For purposes of this paragraph (e)(2)(ii)(C), tax-exempt investments shall be treated as nonpurpose investments.

(D) *No transfer in abusive cases.* Paragraph (e)(2)(i) of this section shall not apply to the extent that the principal purpose for issuing any portion of the refunding issue is to cause proceeds of the refunded issue to cease to be treated as proceeds of the refunded issue (or to become transferred proceeds of the refunding issue).

(iii) *Transition rule*—(A) *In general.* Section 1.103-14(e)(2)(ii) shall apply (and paragraph (e)(2)(i) and (e)(2)(ii) of this section shall not apply) for purposes of determining the extent to which proceeds of a refunded issue cease to be proceeds of the refunded issue (and become transferred proceeds of the refunding issue) if the refunding issue is sold on or before May 15, 1989, and issued on or before June 14, 1989. In applying §1.103-14(e)(2)(ii), the definition of refunding issue in §1.148-8T(f)-(2)(i) shall apply (in lieu of the definition in §1.103-14(e)(2)(i)).

(B) *Exception.* Paragraph (e)(2)(iii)-(A) of this section shall not apply to a refunding issue to which section 149(d)-(4) applies if (*1*) the weighted average maturity of the refunding issue is greater than 10 years and greater than 105 percent of the remaining weighted average maturity of the refunded bonds (as of the date of issue of the refunding issue but without regard to the refunding); (*2*) less than 35 percent of the original and investment proceeds of the refunding issue to be used to pay the principal of or interest on or the retirement price of the refunded bonds is to be used to pay principal; and (*3*) a forward purchase contract was entered into in connection with the issuance of the refunding issue in order to invest amounts other than such proceeds and to use such amounts to discharge principal of bonds that are part of a refunded issue. The preceding sentence shall not apply if the Commissioner determines that the refunding issue is not described in section 149(d)(4) (without regard to this paragraph (e)(2)(iii)(B)).

(C) *Average maturity, etc.* For purposes of paragraph (e)(2)(iii)(B) of this section (*1*) the term "refunded bonds" means bonds the principal of or interest on or the retirement price of which is to be discharged with proceeds of the refunding issue; (*2*) the weighted average maturity is determined by taking into account the respective issue prices of the bonds; and (*3*) if the present value of a bond (determined as provided in §1.148-3T) is at any time greater than 110 percent of the issue price of the bond, the average of the present values of the bond as of the first day of each bond year shall be treated as the issue price.

§1.148-5T Transactions giving rise to imputed receipts (temporary).

(a) *In general.* [Reserved]

(b) *Certain temporary investment accounts*—(1) *No receipt imputed.* No receipt shall be imputed with respect to investments of gross proceeds of an issue in a nonpurpose receipt account on any day during a calendar month if the average daily balance in the account during the month does not exceed the greater of—

(i) $10,000; and

(ii) The lesser of (A) 10 percent of the unspent gross proceeds of the issue, and (B) $50,000.

(2) *Bond yield limit.* No receipt shall be imputed with respect to investments of gross proceeds of an issue in a nonpurpose receipt account, a purpose receipt account, or a checking account on any day during a calendar month to the extent that the receipt would cause the yield on the investments of gross proceeds of the issue in such account during such month to exceed the yield on the issue if the average daily balance in the account during the month does not exceed the greater of—

(i) $250,000; and

(ii) The lesser of (A) 10 percent of the unspent gross proceeds of the issue, and (B) $2.5 million.

(3) *Qualified accounts.* For purposes of paragraphs (b)(1) and (b)(2) of this section—

(i) *Nonpurpose receipt account.* The term "nonpurpose receipt account" means a demand deposit or similar account with a bank, trust company, or broker if—

(A) The account is used for the purpose of holding amounts received with respect to investments (other than purpose investments) for a short period of time until the amounts can be reinvested at an arm's length interest rate;

(B) Substantially all such amounts are in the account for five business days or less before being used for such purpose; and

(C) Substantially all investments acquired with such amounts are not demand deposits and are held, on the average, for a period of 30 days or more.

(ii) *Purpose receipt account.* The term "purpose receipt account" means an account that would be a nonpurpose receipt account if paragraph (b)(3)(i)(A) of this section were applied by substituting "purpose investments" for "investments (other than purpose investments)".

(iii) *Checking account.* The term "checking account" means a checking or similar account if—

(A) The account is used for the purpose of holding funds for a short period of time until the funds are used to pay expenditures; and

(B) Substantially all such funds are transferred to the account no earlier than five business days before such funds are used to pay expenditures.

(iv) *Disqualified account.* Paragraphs (b)(1) and (b)(2) of this section shall not apply to an account if all or any portion of the account is formed or availed of for the principal purpose of taking advantage of this paragraph (b).

(4) *Aggregation of accounts.* For purposes of applying paragraphs (b)(1) and (b)(2) of this section—

(i) All nonpurpose receipt accounts in which gross proceeds of an issue are invested shall be treated as one separate account;

(ii) All purpose receipt accounts in which gross proceeds of an issue are invested shall be treated as one separate account;

(iii) All checking accounts in which gross proceeds of an issue are invested shall be treated as one separate account; and

(iv) *Gross proceeds* of an issue and funds (other than gross proceeds of the issue) shall not be treated as in the same account.

(5) *Gross proceeds.* For purposes of paragraphs (b)(1) and (b)(2) of this sec-

tion, the term "gross proceeds" shall not include—

(i) Any amount that may not be invested in higher yielding investments (as defined in section 148(b)(1)) without causing bonds that are part of the issue to be arbitrage bonds (as defined in section 148(a)); and

(ii) Any amount that is part of a reserve or replacement fund that is not a bona fide debt service fund.

(c) *Certain imputed escrow receipts*—(1) *Defeasance receipt*—(i) *In general.* Any interest saving with respect to a bond that is directly attributable to an investment in an escrow shall be treated as an imputed receipt with respect to such investment. The preceding sentence shall not apply to the extent that the interest saving is eliminated by payment of a similar amount with respect to a refunding bond. No interest saving is eliminated by a similar payment if the similar payment may be taken into account under §1.148-3T in computing the yield on the issue of which the refunding bond is a part.

(ii) *Interest saving.* The term "interest saving" means, with respect to a bond—

(A) Any reduction in a payment of interest on the bond;

(B) Any reduction in a payment for a guarantee with respect to a bond or a purpose investment; and

(C) Any recovery of a payment described in paragraph (c)(2)(ii)(A) or (c)(2)(ii)(B) of this section.

(iii) *Transition rule.* This paragraph (c)(1) shall apply to an issue sold on or before May 15, 1989, and issued on or before June 14, 1989, only to the extent that the interest saving is attributable to an investment in an escrow established after June 14, 1989. The preceding sentence shall not apply to a refunding issue to which section 149(d)(4) applies if any interest saving described in paragraph (c)(1)(ii)(A) or (c)(1)(ii)(C) of this section that is attributable to investments (other than transferred investments) that are allocated to the issue and in an advance refunding escrow is not taken into account in computing the yield on such issue for purposes of §1.148-3T.

(iv) *Savings treated as paid in computing yield on defeased bond.* A payment with respect to a bond that is reduced or recovered shall nonetheless be treated as paid with respect to the bond for purposes of §1.148-3T if the interest saving from the reduction or recovery is treated as an imputed receipt with respect to an investment under paragraph (c)(1)(i) of this section (or is taken into account in computing the yield on a refunding issue under paragraph (c)(1)(iii) of this section).

(2) *Excess tax-exempt receipt*—(i) *In general.* Any excess receipts from tax-exempt investments in an escrow established after June 14, 1989, shall be treated as imputed receipts with respect to the nonpurpose investments in the same escrow.

(ii) *Excess receipts.* There are excess receipts from tax-exempt investments in an escrow if—

(A) The composite yield on the tax-exempt investments in the escrow exceeds the composite yield on the nonpurpose investments in the same escrow by more than one-eighth of one percent; and

(B) The weighted average maturity of the tax-exempt investments in the escrow (determined as provided in §1.148-4T(e)(2)(iii)(C)(*2*) and (*3*) but without regard to any investment that is in the escrow for 3 months or less) is more than 25 percent greater or less than the weighted average maturity of the nonpurpose investments in the escrow (determined in the same manner).

The excess receipts are all the receipts with respect to the tax-exempt investments in excess of the receipts that produce a composite yield on the tax-exempt investments no greater than one-eighth of one percent higher than the composite yield on the nonpurpose investments.

(3) *Escrow.* An investment is in an escrow if the investment is in an advance refunding escrow or an excess proceeds escrow. For purposes of the preceding sentence, §1.148-8T(g) shall be applied by treating every investment (other than a purpose investment) as a nonpurpose investment, and §1.148-8T(g)(3) and (g)(4) shall be applied by substituting "gross proceeds" for "proceeds" each place it appears.

(4) *Examples.* The following examples illustrate the application of this paragraph (c):

Example (1). (i) In June 1989 City E issues a refunding issue the proceeds of which are to be used (together with other available funds) to defease all the outstanding bonds that are part of a refunded issue. The other available funds to be used to defease the outstanding bonds are proceeds of the refunded issue that were in a reasonably required reserve fund for the refunded issue, gross proceeds of the refunded issue that were in a bona fide debt service fund for the refunded issue, and other available funds that were not gross proceeds of the refunded issue before the date of issue of the refunding issue. A portion of the investments acquired with the proceeds of the refunding issue and the other available funds are tax-exempt investments. All of the investments allocated to the proceeds of the refunding issue that are to be used to defease the outstanding bonds are in the same advance refunding escrow. All of the investments allocated to the other available funds are in the same excess proceeds escrow. See paragraph (c)(3) of this section.

(ii) The terms of the outstanding bonds provide that the 9 percent interest rate otherwise payable on any bond that is defeased is reduced by one percent per annum. All of the reduced payments of interest resulting from the defeasance of the outstanding bonds are interest savings described in paragraph (c)(1)(ii)(A) of this section. Since the interest savings are directly attributable to the investments in the escrows, the savings are treated as imputed receipts with respect to the investments for purposes of §1.148-2T. The allocation rules in §1.148-4T(e)(1) apply for purposes of determining the portion of the interest savings that are allocated to each investment. The reduction in the 9 percent interest rate on the outstanding bonds is not taken into account in computing the yield on the outstanding bonds (or the issue of which such bonds are a part) under §1.148-3T. See paragraph (c)(1)-(iv) of this section.

Example (2). The facts are the same as in Example (1), except that (instead of a one percent reduction in payments of interest on the outstanding bonds), the defeasance results in a one percent reduction in payments for a guarantee with respect to the outstanding bonds. The outstanding bonds were secured by a letter of credit. The letter of credit is not a qualified guarantee (within the meaning of §1.148-3T(b)(12)). The annual letter of credit fee payable each year is equal to one percent of the outstanding principal amount of the bonds. The terms of the outstanding bonds provide that the letter of credit is not required to secure bonds that have been defeased. As a result of the defeasance, City E is no longer required to pay the annual letter of credit fees. Assume that City E will pay identical annual letter of credit fees for a letter of credit to secure the refunding issue, and that this letter of credit is a qualified guarantee (within the meaning of §1.148-3T(b)(12)). The reductions in the payments for the letter of credit fees with respect to the outstanding bonds are interest savings described in paragraph (c)(1)(ii)(B) of this section that are directly attributable to the investments in the escrows. These interest savings are treated as imputed receipts with respect to the escrow investments. The interest savings would not be treated as imputed receipts if the letter of credit securing the refunding issue was not a qualified guarantee (within the meaning of §1.148-3T(b)(12)).

Example (3). The facts are the same as in Example (2), except that the entire letter of credit fee was prepaid on the date of issue of the outstanding bonds, and a portion of the prepaid fee is refunded by the guarantor when the outstanding bonds are defeased. The portion of the refunded fee that is properly allocable to the period that begins on the date the outstanding bonds are defeased and that ends on the date the outstanding bonds are retired is an interest saving directly attributable to the investments in the escrows. The portion of the refunded fee properly allocable to the period beginning on the date the outstanding bonds are retired and ending on the final maturity date of the outstanding bonds is not attributable to the investments in the escrows. The constant payment allocation method is a proper method of allocating the refund for this purpose. See §1.148-3T(b)(13)(iii)(C).

§1.148-6T 6-month temporary investment exception and other special rules (temporary). [Reserved]

§1.148-7T Exception for small issuers with general taxing powers (temporary). [Reserved]

§1.148-8T Definitions and special rules relating to required rebate (temporary).

(a) *Applicability.* The definitions and rules in this section apply for purposes of this section and §§1.148-0T through §1.148-7T except to the extent otherwise provided. See §1.150-1T for definitions and special rules relating to tax-exempt bond requirements in general.

(b) *Computations and determinations*—(1) *Computation dates*—(i) *In general.* The term "computation date" means an installment computation date or the final computation date.

(ii) *Installment date.* The term "installment computation date" means, with respect to an issue, the last day of the fifth and each succeeding fifth bond year.

(iii) *Final date.* The term "final computation date" means, with respect to an issue, the date the last bond that is part of the issue is discharged.

(iv) *Other date.* If the Commissioner determines that an issue is likely to fail to meet the requirements of §1.148-1T and that a failure to serve a notice of demand for payment on the issuer will jeopardize the assessment or collection of tax on interest paid or to be paid on the issue, the date the Commissioner serves such notice on the issuer shall be treated as a computation date. The Commissioner shall designate in the notice whether such date shall be treated as an installment computation date or a final computation date (whichever is necessary to carry out the purposes of this paragraph (b)(1)(iv)).

(2) *Bond year.* The term "bond year" means, with respect to an issue, each 1-year period (or shorter period from the date of issue) that ends at the close of business on the day in the calendar year that is selected by the issuer. The day selected by the issuer must be the last day of a compounding interval used in computing the yield on the issue under §1.148-3T.

(3) *Discharge.* A bond is discharged on the date all amounts due thereunder are actually and unconditionally due if cash is available at the place of payment, and no interest accrues with respect to the bond after such date. See §1.150-1T(d)(2) for definition of actually and unconditionally due. An amount is paid or used to discharge the principal or interest on or the retirement price of a bond on the date such principal or interest or retirement price is actually and unconditionally due if cash is available at the place of payment, and no interest accrues with respect to such payment after such date.

(4) *Actual facts.* Except as otherwise provided, all computations and determinations shall be made on the basis of actual facts as of the computation date and reasonable expectations as to future events.

(5) *Present value.* The present value of an amount to be received or paid is determined by using the following formula:

$$PV = \frac{FV}{(1 + i)^n)}$$

where:

PV = The present value of the amount to be received or paid.

FV = The amount to be received or paid.

i = The discount rate (expressed as a decimal) divided by the number of compounding intervals in a year.

n = The sum of the number of whole compounding intervals during the period beginning on the date as of which the present value is computed and ending on the date the amount is to be received or paid, and a fraction, the numerator of which is the length of any short compounding interval during such period, and the denominator of which is the length of a whole compounding interval.

(6) *Conventions*—(i) *Whole intervals.* All whole intervals and compounding intervals, whether expressed annually, semiannually, monthly, or with reference to any other regular interval, shall be treated as having equal length.

(ii) *Short intervals.* In computing the length of any short interval or compounding interval, either the 30 days per month/360 days per year convention or the actual days per month/actual days per year convention shall be consistently used; provided that, either convention may be consistently used for each investment. The examples herein use the 30 days per month/360 days per year convention.

(iii) *Yield.* Yield is an annual percentage rate and, when expressed as a decimal, shall be accurate to at least six places (and rounded to at least five).

(iv) *Other conventions.* Other standard financial conventions may be used. For example, amounts payable on the first business day of a month may be treated as if payable on the first day of the month.

(c) *Issue price*—(1) *In general.* The term "issue price" has the meaning given such term by sections 1273 and 1274. Thus, if bonds are publicly offered (*i.e.*, sold by the issuer to a bond house, broker, or similar persons acting in the capacity of underwriters or wholesalers) and are not issued for property, the issue price of the bonds is determined on the basis of the initial offering price to the public at which price a substantial amount of the bonds was sold to the public. Such price shall be determined separately for bonds that are not substantially identical. Such price also shall be determined separately for substantially identical bonds that are sold at one price to the general public and to institutional or other investors at a discount from that price. If a bond is sold to the public after the date of issue, the price at which the bond is sold must be adjusted to reflect the price at which the bond would have been sold on the date of issue. This adjustment shall eliminate any change in the fair market value of the bond after the date of issue (including any change attributable to interest and premium or discount that accrues on the bond after such date). If a bond is issued for property, appropriate adjustments shall be made to the applicable Federal rate to take into account the tax exemption of the bond in applying section 1274. See section 1288(b)(1).

(2) *Special rules.* For purposes of determining the issue price of a bond under paragraph (c)(1) of this section—

(i) *Reasonable expectations.* Except as otherwise provided in this paragraph (c)(2), the issue price of a bond that is publicly offered shall be determined on the basis of actual facts and reasonable expectations as of the sale date and shall not be adjusted to take into account actual facts after such date. See §1.150-1T(c)(1) for definition of sale date.

(ii) *Bonds offered at a discount.* If substantially identical bonds are offered at one price to the general public and at a discount from that price to institutional or other investors, the determination as to which bonds are sold at each price shall be made on the basis of actual facts and reasonable expectations as of the date of issue. See §1.150-1T(c)(2) for definition of date of issue.

(iii) *Bona fide offering required.* Paragraph (c)(2)(i) and (c)(2)(ii) of this section shall not apply to any bond that is not actually offered to the general public in a bona fide public offering for the issue price of the bond (determined without regard to this sentence).

(iv) *Tender bond remarketing.* For purposes of determining the issue price of a tender bond under §1.148-3T(d)(2)-(ii)(A) when the bond is remarketed, this paragraph (c) shall be applied by treating the date on which the interest rate is reset as the sale date and the date on which the bond is remarketed as the date of issue.

(3) *Fair market value limit.* In no event shall the issue price of a bond determined under this paragraph (c) exceed the fair market value of the bond as of the sale date.

(4) *Aggregate issue price.* The term "aggregate issue price" refers to the sum of the issue prices of the bonds issued as part of the issue as determined under this paragraph (c) (but without regard to any tender bond remarketing).

(d) *Gross proceeds*—(1) *In general.* The term "gross proceeds" means, with respect to an issue, any proceeds of the issue and any funds (other than proceeds of the issue) that are part of a reserve or replacement fund for the issue.

(2) *Proceeds.* The term "proceeds" means, with respect to an issue, any original proceeds, any discount proceeds, and any transferred proceeds of the issue.

(3) *Original proceeds.* The term "original proceeds" means, with respect to an issue, any sale proceeds and any investment proceeds of the issue. Such term shall also include any amount recovered with respect to the issue under §1.148-1T(d). Such term shall not include amounts actually or constructively received with respect to a purpose investment to the extent such amounts are properly allocated to administrative costs recoverable under §1.103-13(c)(5) or to the higher yield permitted under §1.103-13(b)(5)(i)(A). For purposes of the preceding sentence, a purpose investment that is a tax-exempt bond shall not be treated as tax-exempt.

(4) *Sale proceeds.* The term "sale proceeds" means, with respect to an issue, any amounts actually or constructively received from the sale (or other disposition) of any bond that is part of the issue.

(5) *Investment proceeds.* The term "investment proceeds" means, with respect to an issue, any amounts actually or constructively received from investing original proceeds of the issue.

(6) *Net sale proceeds*—(i) *In general.* The term "net sale proceeds" means, with respect to an issue, any sale proceeds of the issue (without regard to §1.148-4T(e)(2) and §1.103-14(e)(2)(ii)) other than—

(A) Sale proceeds that are part of a reasonably required reserve or replacement fund;

(B) Sales proceeds used to pay accrued interest included in the issue price of any bond that is part of the issue no later than the date that is less than one year after the date of issue;

(C) Sale proceeds used to pay capitalized interest on the issue that accrues no later than the date that is 3 years after the date of issue; and

(D) Sale proceeds received with respect to a purpose investment that are allocated to an expenditure no later than 13 months after the date of receipt thereof.

(ii) *Capitalized interest.* The term "capitalized interest" means, with respect to an issue, interest paid on the sale proceeds of the issue that have been allocated to an expenditure if—

(A) The expenditure is not for the payment of the principal or interest on or the retirement price of any bond; and

(B) The expenditure is of a type that is chargeable to capital account for Federal income tax purposes (with or without an election by a taxpayer).

Such term shall also include interest on the sale proceeds of the issue that are allocated to expenditures for the payment of capitalized interest on the issue.

(iii) *Special rules for refunded and refunding issues.* For purposes of applying any requirement relating to the expenditure of the net sale proceeds of a refunded issue or refunding issue—

(A) Net sale proceeds properly allocated to the refunding portion of an issue shall not be treated as net sale proceeds;

(B) Net sale proceeds properly allocated to the refunded portion of an issue shall be treated as net sale proceeds of the refunded issue and of the refunding issue; and

(C) The requirement shall be treated as met with respect to a refunding issue only if the requirement is met separately with respect to the nonrefunding portion of the issue and each refunding portion of the issue.

(7) *Discount proceeds.* [Reserved]

(8) *Transferred proceeds.* The term "transferred proceeds" means, with respect to a refunding issue, proceeds that have ceased to be proceeds of a refunded issue and are transferred proceeds of the refunding issue by reason of §1.148-4T(e)(2) (including amounts actually or constructively received from investing such proceeds).

(9) *Indirect use*—(i) *In general.* Any reference to proceeds shall be construed to include a reference to proceeds used directly or indirectly. Such reference has the same meaning as when used in section 148(a). If proceeds are used directly and indirectly, the proceeds shall be treated as used directly or indirectly (whichever produces the larger amount of rebatable arbitrage).

(ii) *Examples.* The following examples illustrate the application of this paragraph (d)(9):

Example (1). The facts are the same as in Example (1) in paragraph (g)(5) of this section, except that $1 million of the proceeds of the 1985 issue are not used directly to discharge the 1983 issue. Instead, as part of the very same transaction or a series of closely related and interdependent transactions, City A deposited this $1 million of proceeds of the 1985 issue into its General Fund and transferred approximately the same amount from its General Fund to the trustee for the 1983 issue. City A had been advised by its tax counsel that this substitution of fully fungible dollars would result in greater debt service savings from the refunding. A nonpurpose investment is in an advance refunding escrow if the investment is allocated to proceeds to which §1.103-13(b)(5)(iii) applies. See paragraph (g)(2)(i) of this section. Section 1.103-13(b)(5)(iii) applies to proceeds used directly or indirectly to discharge the 1983 issue. See §1.103-13(b)(1) and (f)(4)(ii). City A used proceeds of the 1985 issue indirectly to discharge the 1983 issue and to purchase the investments purchased directly with the money transferred from the General Fund. Consequently, if the 1985 issue is refunded in 1987 and the larger amount of rebatable arbitrage is produced by allocating these proceeds of the 1985 issue to the investments indirectly acquired with such proceeds, the result is the same as in Example (1) in paragraph (g)(5) of this section.

Example (2). The facts are the same as in Example (1), except that the proceeds of the 1985 issue were not transferred to the General Fund and money in the General Fund was not transferred to the trustee for the 1983 issue. Instead, the same substitution of fully fungible dollars was arranged with respect to funds that were in a General Construction Fund or Pension Fund, proceeds of the 1983 issue that were in the City Office Building Construction Fund established with proceeds of the 1983 issue, gross proceeds in a restricted escrow established with proceeds of a 1980 issue, or gross proceeds in a debt service reserve or replacement fund allocated to an issue other than the 1983 issue. The result is the same as in Example (1).

(10) *Reserve or replacement fund*—(i) *In general.* [Reserved]

(ii) *Certain perpetual trust funds*—(A) *In general.* A fund described in paragraph (d)(10)(ii)(B) of this section shall not be treated as a reserve or replacement fund solely by reason of the fact that the fund is used to guarantee the payment of the principal or interest on or the tender or retirement price of a bond described in paragraph (d)(10)(ii)(D) of this section. The preceding sentence shall not apply to a guarantee if any fee is charged for the guarantee in excess of a nominal charge for administrative costs, shall not apply to a fund unless the fund is described in paragraph (d)(10)(ii)(B) of this section on August 31, 1986, and shall not apply to a fund on or after the date the fund is no longer described in paragraph (d)(10)(ii)(B) of this section.

(B) *Fund described.* A fund established pursuant to a State constitutional provision is described in this paragraph (d)(10)(ii)(B) if—

(*1*) Substantially all of the corpus of the fund consists of long-term nonfinancial assets, revenues derived from such assets, gifts, and bequests;

(*2*) Pursuant to such constitutional provision, the corpus of the fund may not be invaded for any purpose other than for the support of specifically designated essential governmental functions carried on by political subdivisions of the State with general taxing powers; and

(*3*) Pursuant to such constitutional provision, substantially all of the available income of the fund is required to be applied annually for the support of such functions.

(C) *Treatment of additions to fund*—(*1*) *In general.* For purposes of paragraph (d)(10)(ii)(A) of this section, no addition to the corpus of a fund described in paragraph (d)(10)(ii)(B) of this section on or after May 15, 1989, shall be considered part of a fund described in paragraph (d)(10)(ii)(B) of this section. For purposes of the preceding sentence, all revenues derived from assets that are part of the corpus of a fund (exclusive of amounts received from the sale or other disposition of such assets) shall be treated as additions to the corpus of a fund.

(*2*) *Allocation rule.* Additions to which paragraph (d)(10)(ii)(C)(*1*) of this section applies shall be considered used to guarantee bonds described in paragraph (d)(10)(ii)(D) of this section only to the extent that the outstanding amount of the bonds guaranteed by the fund exceeds 250 percent of the lower of the amortized cost or fair market value of the fund (without regard to the additions).

(D) *Bond described.* A bond is described in this paragraph (d)(10)(ii)(D) if—

(*1*) The bond is a general obligation of a political subdivision referred to in paragraph (d)(10)(ii)(B)(*2*) of this section and is not a private activity bond;

(*2*) No income referred to in paragraph (d)(10)(ii)(B)(*3*) of this section is reasonably expected (as of the date of issuance of the bond) to be used (directly or indirectly) for the payment of the principal or interest on or the tender or retirement price of any bond of such political subdivision or to fund a reserve or replacement fund for any such bond; and

(*3*) Substantially all of the proceeds of the issue of which the bond is a part is to be used to provide facilities necessary to carry on the functions referred to in paragraph (d)(10)(ii)(B)(*2*) of this section.

(e) *Investments*—(1) *In general.* The term "investment" means any investment property or tax-exempt bond. The purpose of acquiring or holding an investment is not a governmental purpose, and the use of gross proceeds to acquire an investment is not an expenditure. If an investment is allocated to more than one source, all payments and receipts with respect to the investment shall be allocated ratably to each source.

(2) *Investment property.* The term "investment property" means any security, obligation, annuity contract, or investment-type property. Such term shall not include any tax-exempt bond or qualified exempt investment. In the case of any bond (other than a private activity bond) issued after October 21, 1988 and to which section 148(b)(2)(E) applies, such term shall also include any residential rental property for family units not located within the jurisdiction of the issuer unless such property is acquired to implement a court ordered or approved housing or segregation plan.

(*3*) *Tax-exempt* bond. For purposes of paragraphs (e)(2) and (e)(3)(iii) of this section—

(i) *In general.* The term "tax-exempt bond" shall not include any bond owned by a person if the person had reason to believe (at the time the person entered into a binding contract to acquire the bond) that interest on the bond is not excluded from gross income.

(ii) *AMT bond.* The term "tax-exempt bond" shall not include a specified private activity bond (as defined in section 57(a)(5)(C)) in the case of an issue that is issued after March 31, 1988 and a part of which is not a specified private activity bond (as so defined). The preceding sentence shall not apply for purposes of paragraph (e)(3)(iii) of this section if the requirements of paragraph (e)(3)(iii) are satisfied, determined without regard to paragraph (e)(3)(iii)(C) and by substituting "85 percent" for "98 percent" in paragraph (e)(3)(iii)(D).

(iii) *Tax-exempt mutual fund.* The term "tax-exempt bond" shall include stock of a corporation during any quarter of the taxable year of the corporation that—

(A) The corporation is a regulated investment company (as defined in section 851(a)) which, for the taxable year, meets the requirements of section 852(a);

(B) The corporation has authorized and outstanding only one class of stock;

(C) The corporation to the extent practicable invests all its assets in tax-exempt bonds;

(D) At least 98 percent of—

(*1*) The gross income of the corporation (without regard to the exclusion of interest from gross income under section 103) is derived from interest on or gains from the sale or other disposition of tax-exempt bonds; or

(*2*) The weighted average value of the assets of the corporation is represented by investments in tax-exempt bonds.

The Commissioner may for good cause waive one or more of the requirements of this paragraph (e)(3)(iii).

(4) *Qualified exempt investment*—(i) *In general.* The term "qualified exempt investment" means any exempt demand deposit and any exempt temporary investment.

(ii) *Exempt demand deposit.* The term "exempt demand deposit" means any obligation acquired with gross proceeds of an issue if—

(A) The obligation is a one-day certificate of indebtedness issued by the United States Treasury pursuant to the Demand Deposit State and Local Government Series program described in 31 CFR Part 344; and

(B) The issuer in good faith attempts to comply with all the requirements of such program relating to the investment of the gross proceeds of the issue.

(iii) *Exempt temporary investment.* [Reserved]

(5) *Security.* [Reserved]

(6) *Obligation.* [Reserved]

(7) *Annuity contract.* [Reserved]

(8) *Investment-type property.* [Reserved]

(9) *Nonpurpose investment.* The term "nonpurpose investment" means any investment property that is not a purpose investment.

(10) *Purpose investment.* The term "purpose investment" means any investment that is allocated to gross proceeds of an issue and that is acquired in order to carry out the governmental purpose of the issue. Such term does not include any temporary investment until the proceeds of the issue are needed for the governmental purpose of the issue, any investment that is acquired in order to fund a reserve or replacement fund, or any other investment if the principal purpose for acquiring the investment is to earn arbitrage.

(11) *Transferred investment.* The term "transferred investment" means, with respect to an issue, any investment allocated to transferred proceeds of the issue.

(12) *SLG.* The term "SLG" means a time deposit security issued by the United States Treasury pursuant to the Time Deposit State and Local Government Series program described in 31 CFR Part 344.

(13) *Fixed rate investment.* The term "fixed rate investment" means any investment that is a fixed yield bond and is not purchased pursuant an investment contract. See §1.150-1T(b)(5) for definition of fixed yield bond.

(14) *Investment contract.* The term "investment contract" means, with respect an issue, a contract entered into for the purpose of investing gross proceeds of the issue (and related amounts) from time to time in obligations of the other party to the contract at an interest rate or rates specified in the contract if all such obligations are purchased at par and retired or redeemed at par plus accrued interest.

(f) *Issues*—(1) *In general.* [Reserved]

(2) *Refundings*—(i) *Refunding issue.* The term "refunding issue" means an issue any portion of the proceeds of which are used to discharge the principal or interest on or the retirement price of any bond that is part of another issue.

(ii) *Refunded issue.* The term "refunded issue" means an issue if any portion of the principal or interest on or the retirement price of any bond that is part of the issue is discharged with proceeds of another issue.

(g) *Restricted escrows*—(1) *In general.* An investment is in a restricted escrow if the investment is a nonpurpose investment that is in an advance refunding escrow or an excess proceeds escrow.

(2) *Advance refunding escrow.* An investment is in an advance refunding escrow if the investment is a nonpurpose investment—

(i) That is allocated to proceeds to which §1.103-13(b)(5)(iii) applies (without regard to an initial temporary period of no longer than 30 days or the effective date of such provision); and

(ii) That is not properly allocated to the nonrefunding portion of the refunding issue.

In applying §1.103-13(b)(5)(iii) for purposes of paragraph (g)(2)(i) of this section, the definition of refunding issue in paragraph (f)(2)(i) of this section shall apply (in lieu of the definition in §1.103-14(e)(2)(i)).

(3) *Excess proceeds escrow.* An investment is in an excess proceeds escrow if—

(i) The investment is a nonpurpose investment that is not in an advance refunding escrow;

(ii) The proceeds allocated to the investment are to be used to discharge the principal or interest on or the retirement price of any bond that is part of the issue to which such proceeds are allocated (without regard to §1.148-4T(e)(2) and §1.103-14(e)(2)(ii)); and

(iii) Such proceeds are not part of a reasonably required reserve or replacement fund and may not be invested in higher yielding investments for a reasonable temporary period under section 148(c) (or under section 103(c)(4) of the 1954 Code).

(4) *Same escrow.* Except as otherwise provided in this paragraph (g)(4), investments are in the same restricted escrow (whether or not held concurrently) if the investments are (or were or will be) allocated to proceeds of the same issue (without regard to §1.148-4T(e)(2) and §1.103-14(e)(2)(ii)). Investments in an advance refunding escrow are not in the same restricted escrow as investments in an excess proceeds escrow. Investments in excess proceeds escrows that were not established at or around the same time are not in the same restricted escrow.

(5) *Examples.* The following examples illustrate the application of this paragraph (g):

Example (1). (i) In 1983, City A issues an issue (the "1983 issue") to finance the construction of a City office building and to refund two prior issues. A portion of the proceeds of the 1983 issue (including investment proceeds) are to be used to discharge the prior issues in 1995. Prior to the discharge date, such proceeds will be held by the respective trustees for the two prior issues. All nonpurpose investments allocated to such proceeds are and will continue to be (until the 1995 discharge date) in the same advance refunding escrow (the "1983 advance refunding escrow"). See paragraph (g)(2) and (g)(4) of this section.

(ii) In 1985, City A issues an issue (the "1985 issue") to refund a portion of the 1983 issue. Proceeds of the 1985 issue (including investment proceeds) are to be used to discharge interest on the 1983 issue, to discharge principal of and call premium on the 1983 issue in 1990, and to fund a reasonably required reserve fund for the 1985 issue. Amounts that were in a bona fide debt service fund for the 1983 issue also will be used to discharge principal of the 1983 issue in 1990. The proceeds of the 1985 issue and amounts that were in the bona fide debt service fund for the 1983 issue that are to be used to discharge the 1983 issue will be held by the trustee for the 1983 issue, and the proceeds of the 1985 issue in the reserve fund will be held by the trustee for the 1985 issue. All nonpurpose investments allocated to these proceeds of the 1985 issue are and will continue to be (until the 1990 discharge date) in the same advance refunding escrow (the "1985 advance refunding escrow"). See paragraph (g)(2) and (g)(4) of this section. The proceeds in the 1985 advance refunding escrow are not (and never will be) in the same advance refunding escrow as the proceeds in the 1983 advance refunding escrow. See paragraph (g)(4) of this section. Investments allocated to amounts that were in the bona fide debt service fund for the 1983 issue are not in a restricted escrow.

(iii) A transfer occurs in 1990 when a portion of the 1983 issue is discharged with proceeds of the 1985 issue. To the extent of this transfer, a ratable portion of the proceeds (and investments and expenditures) of the 1983 issue cease to be treated as proceeds (and investments and expenditures) of the 1983 issue and become transferred proceeds (and transferred investments and expenditures) of the 1985 issue. See §1.148-4T(e)(2)(iii)(A). The nonpurpose receipt with respect to the 1983 issue and the nonpurpose payment with respect to the 1985 issue that arise by reason of this transfer equal the present value of the transferred investments at the time of the transfer. See §1.148-2T(b)(2)(ii), (b)(3)(ii), and (d)(3)(i)(B). The discount rate used in computing this present value is the yield on all nonpurpose investments (including the transferred investments) in the 1983 advance refunding escrow. That yield is not affected by this (or any other) transfer. See §1.148-2T(e)(2)(ii).

(iv) After the 1990 discharge date, nonpurpose investments allocated to the proceeds of the 1985 issue in the reserve fund for the 1985 issue cease to be in the 1985 advance refunding escrow. See paragraph (g)(2)(i) of this section. These investments are at the same time treated as if sold and purchased for present value. The receipt arising from this sale is a receipt with respect to an investment in the 1985 advance refunding escrow; the payment arising from this purchase is a payment with respect to an investment that is not in a restricted escrow. See §1.148-2T(b)(5)(i)(A).

Example (2). (i) The facts are the same as in Example (1), except that City A issues an issue in 1987 (the "1987 issue") to refund a portion of the 1985 issue. Proceeds of the 1987 issue (including investment proceeds) are to be used to discharge a portion of the 1985 issue in 1989. Proceeds of the 1985 issue that were in the reserve fund for the 1985 issue (including investment proceeds) are to be used to discharge a portion of the 1985 issue in 1991.

(ii) In 1989, a ratable portion of the investments allocated to the proceeds of the 1985 issue (including the proceeds that were in the reserve fund for the 1985 issue) transfer to the 1987 issue. See §1.148-4T(e)(2)(iii)(A).

(iii) In 1990, the investments allocated to the proceeds of the 1985 issue that were in the reserve fund for the 1985 issue (including the investments that transferred in 1989) cease to be in the 1985 advance refunding escrow. See paragraph (g)(2)(i) of this section. These investments at the same time become investments in an excess proceeds escrow. See paragraph (g)(3) of this section. These investments at the same time are treated as if sold and purchased for present value. See §1.148-2T(b)(5)-(i)(A) and (b)(5)(i)(B) (last sentence). This present value is computed by using the yield on all the investments in the 1985 advance refunding escrow as the discount rate. This is the same yield referred to in Example (1)(iii) (the yield on the investments in the excess proceeds escrow also is the same). The investments in the excess proceeds escrow that are transferred investments of the 1987 issue are treated as in an advance refunding escrow for purposes of the first sentence of §1.148-2T(b)(5)(i)-(A).

(h) *Elections*—(1) *In general.* Any election with respect to an issue must be in writing and must be signed by an authorized representative of the issuer on or before the later of—

(i) The date of issue; and

(ii) If the issue is issued on or before November 15, 1989, the first date after June 14, 1989, that any amount with respect to the issue is paid or required to be paid to the United States under §1.148-1T(b)(1).

An election, once made, shall be irrevocable after such date.

(2) *Procedural requirements.* If the rebatable arbitrage with respect to an issue (determined by taking into account an election) is smaller than the rebatable arbitrage (determined without taking into account the election), the election shall be effective only if the election identifies the issue to which it applies and is maintained as part of the official transcript of the proceedings relating to the issuance of the issue until 6 years after the final computation date. The Commissioner may waive the requirements of this paragraph (h)(2) if the Commissioner determines that the failure to meet the requirements was inadvertent.

(3) *Special rules.* For purposes of this paragraph (h)—

(i) *Issue.* The term ''issue'' shall include all issues that are treated by the issuer as one issue under §1.149(e)-1T(d)(2)(ii) or (iii), and any election with respect to one of such issues shall apply equally to all of such issues.

(ii) *Extension of time.* The Commissioner may extend the time to make an election if—

(A) The Commissioner determines that the failure to make the election in a timely manner was due to reasonable cause;

(B) The Commissioner determines that as of the date of issue (and without regard to later facts) it was in the best interests of the issuer to make the election, and the failure to make the election was not deliberate; and

(C) The aggregate issue price of the bonds issued as part of the issue is less than $50 million.

(4) *Cross reference.* The elections to which this paragraph (h) applies are in §1.148-0T(b)(2)(ii)(C) and §1.148-3T(b)(1)(ii), (b)(2)(ii)(B), (b)(3)(i), (b)-(3)(ii), (c)(4)(i), and (c)(5).

§1.148-9T Certain rules applicable for purposes of section 148 generally (temporary).

(a) *Computation of yield on fixed yield issue.* Section 1.148-3T shall apply for purposes of determining the yield on a fixed yield issue for purposes of section 148(a) and (d)(3). For purposes of computing such yield, the date of issue of the fixed yield issue shall be treated as the only computation date. See §1.148-3T(c)(7) (Examples (3), (6), (8), and (10)).

(b) *Computation of yield on investments.* The yield on a nonpurpose investment that is not directly purchased with gross proceeds to which the investment is allocated shall be determined on the basis of a purchase price equal to the fair market value of the investment on the date the investment is allocated to the issue for purposes of section 148 (a) and (d)(3). Fair market value has the same meaning as when used in §1.148-2T(b)-(3)(ii).

(c) *Refunding allocation rules.* Section 1.148-4T(e) shall apply for purposes of applying the requirements of section 148.

(d) *Certain imputed escrow receipts.* Any receipt imputed under §1.148-5T(c) to an investment in an escrow shall be treated as interest on the investment for purposes of section 148(a).

(e) *Certain perpetual trust funds.* Section 1.148-8T(d)(10)(ii) shall apply for purposes of section 148.

(f) *Investment property.* The definition of the term ''investment property'' in §1.148-8T(e)(2) shall apply for purposes of section 148.

(g) *Effective date*—(1) *In general.* Except as otherwise provided in this paragraph (g), the provisions of this section apply to any issue sold after May 15, 1989, or issued after June 14, 1989.

(2) *Computation of yield on investments.* Paragraph (b) of this section may be applied in the case of any issue to which §1.148-1T applies that is not described in paragraph (g)(1) of this section.

(3) *Investment property.* Paragraph (f) of this section shall apply to any bond that is not described in paragraph (g)(1) of this section to the same extent that section 148(b)(2) applies to such bond.

§1.149(d)-1T Restrictions on advance refundings (temporary).

(a) *General rule.* Under section 149(d) and this section, nothing in section 103(a) or in any other provision of law shall be construed to provide an exemption from Federal income tax for interest on any bond issued as part of an issue described in paragraph (b), (c), or (d) of this section.

(b) *Certain private activity bonds.* [Reserved]

(c) *Other bonds.* [Reserved]

(d) *Abusive transactions prohibited*—(1) *In general.* [Reserved]

(2) *Failure to pay required rebate.* Any issue to which section 149(d)(4) and §1.148-1T apply that fails to meet the requirements of §1.148-1T is described in this paragraph (d). Section 149(d)(4) and this paragraph (d)(2) apply to any bond issued after August 31, 1986 if any bond issued as part of the issue (of which such bond is a part) is issued to advance refund another bond (within the meaning of section 149(d)(5)). See §1.148-0T(b)-(2)(ii) for bonds to which 1.148-1T applies.

§1.150-0T Table of contents (temporary).

This section lists the paragraphs, subparagraphs, and subdivisions contained in 1.150-1T.

(5) Fixed yield bond.
(6) Variable yield bond.
(7) Tender bond.
(i) In general.
(ii) Tender right.
(iii) Tender rate.
(8) Current index bond.
(i) In general.
(ii) Interest index.
(iii) Current rate.
(c) Sale and issue date.
(1) Sale date.
(2) Date of issue.
(d) Final maturity date.
(1) In general.
(2) Actually and unconditionally due.
(3) Single loan with partial principal repayments.
(e) Internal Revenue Code.

§1.150-1T Definitions and special rules relating to tax-exempt bond requirements in general (temporary).

(a) *Applicability.* Except to the extent otherwise provided, the definitions and rules in this section apply for purposes of the regulations under sections 141 through 150.

(b) *Bonds*—(1) *Bond.* The term "bond" includes any obligation. Whenever necessary or appropriate to carry out the purposes of a provision, a single bond shall be treated as separate bonds (or separate bonds shall be treated as a single bond).

(2) *Tax-exempt bond (or issue).* The term "tax-exempt bond (or issue)" means any bond (or issue) the interest on which is excluded from gross income under any provision of law. Any bond (or issue) that (when issued) purported to be a tax-exempt bond (or issue) shall be treated as a tax-exempt bond (or issue).

(3) *State or local bond.* The term "State or local bond" means any bond that is (or would be) a tax-exempt bond (without regard to the last sentence of paragraph (b)(2) of this section) if the appropriate requirements of sections 141-150 are (or were) met.

(4) *Private activity bond*—(i) *In general.* The term "private activity bond" includes any bond that is a private activity bond (as defined in section 141). Such term shall not include any bond described in section 1312(c)(2) of the Tax Reform Act of 1986 to which section 141(a) does not apply by reason of section 1312 or 1313 of such Act.

(ii) *Qualified bond.* The term "qualified bond" means any private activity bond that is a qualified bond (within the meaning of section 141(e)). Each bond described in a subparagraph of section 141(e)(1) has the same meaning as when used in such subparagraph. Any bond to which section 141(a) does not apply by reason of section 1312 or 1313 of the Tax Reform Act of 1986 shall be treated as a bond described in the subparagraph of section 141(e)(1) to which the use of the proceeds of such bond most closely relates.

(5) *Fixed yield bond.* The term "fixed yield bond" means any bond that is not a variable yield bond.

(6) *Variable yield bond.* The term "variable yield bond" means any bond if any interest or other amount payable on the bond (other than in the event of an unanticipated contingency) is determined by reference to (or by reference to an index that reflects) market interest rates or stock or commodity prices after the date of issue.

(7) *Tender bond*—(i) *In general.* The term "tender bond" means any variable yield bond that is subject to a tender right if—

(A) All interest on the bond (other than in the event of a remote contingency) accrues at a tender rate; and

(B) Such interest is actually and unconditionally due at periodic intervals of one year or less.

(ii) *Tender right.* A bond is subject to a tender right if the holder of the bond is entitled (or required) to tender the bond for purchase or redemption at par on one or more tender dates before the final maturity date (plus accrued interest to the tender date if the tender date is not a regular interest payment date).

(iii) *Tender rate.* Interest on a bond that is subject to a tender right accrues at a tender rate if—

(A) In the case of interest accruing to the first tender date, the interest rate is set on or after the sale date at the lowest rate that would enable the bond to be marketed at par (plus accrued interest, if any) on the date of issue; and

(B) In the case of interest accruing for each period between tender dates (and for the final period to maturity), under the terms of the bond the interest rate is reset for such period at the lowest rate that would enable the bond to be remarketed at par (plus accrued interest, if any) at the beginning of the period.

The interest accruing for each period may be subject to a minimum and/or maximum rate if the minimum and/or maximum rate is not designed to front-load or back-load interest.

(8) *Current index bond*—(i) *In general.* The term "current index bond" means any variable yield bond if—

(A) All interest on the bond (other than in the event of a remote contingency) accrues at the current rate established by a single interest index or at a rate that is fixed and determinable as of the date of issue; and

(B) Such interest is actually and unconditionally due at periodic intervals of one year or less.

The rate may vary from the current rate established by the interest index if the variation is based on a percentage or multiple of the current rate and/or a number of percentage or basis points more or less than the current rate and the variation is the same at all times.

(ii) *Interest index.* The term "interest index" means a series of interest rates that reflect either—

(A) The rate that is currently publicly offered by a financial institution for a particular type of loan to a significant class of unrelated borrowers; or

(B) The average of a statistically significant sample of current yields on a class of publicly traded bonds.

Examples of interest indexes include the prime rate of a designated financial institution, LIBOR, the applicable Federal rate, and the average yield on United States Treasury securities of a particular class.

(iii) *Current rate.* The interest rate in effect on a bond accrues at the current rate if it is based on a rate that is established by the interest index no earlier than six months before and no later than six months after the rate first is in effect.

(c) *Sale and issue date*—(1) *Sale date.* The sale date of a bond is the first day on which there is a binding contract in writing for the sale or exchange of the bond on specific terms that are not later modified or adjusted in any material respect. The sale date is the date on which the bond is sold by the issuer.

(2) *Date of issue.* The date of issue of a bond is the first day on which there is a physical delivery of the written evidence of the bond in exchange for the purchase price. Such day shall not be earlier than the first day on which interest begins to accrue on the bond for federal income tax purposes.

(d) *Final maturity date*—(1) *In general.* The final maturity date of a bond is the latest date on which any principal or interest on the bond is actually and unconditionally due.

(2) *Actually and unconditionally due.* A payment of principal or interest on or the tender price or retirement price of a bond is actually and unconditionally due on the first day on which the failure to make the payment on a timely basis results in significant remedies and consequences to the issuer that are normal in similar lending transactions.

(3) *Single loan with partial principal repayments.* If a single debt instrument requires one or more payments of principal before the latest date that the final payment of principal and interest is actually and unconditionally due, each payment of principal (and related payments of interest) shall be treated as a separate bond. The final maturity date of each separate bond shall be the latest date on which any payment of principal or interest under the debt instrument is actually and unconditionally due.

(e) *Internal Revenue Code.* The term "1954 Code" means the Internal Revenue Code of 1954 as in effect before the enactment of the Tax Reform Act of 1986. Any reference to a section of the Internal Revenue Code (other than the 1954 Code) is to a section of the Internal Revenue Code of 1986.

PART 602—[AMENDED]

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

Authority: 26 U.S.C. 7805.

Par. 4. Section 602.101(c) is amended by inserting in the appropriate place in the table "§1.148-0T through §1.148-9T ... 1545-1098."

There is a need for immediate guidance with respect to the provisions contained in this Treasury decision. For this reason, it is found impractical to issue this Treasury decision with notice and public procedure under subsection (b) of section 553 of Title 5 of the United States Code or subject to the effective date limitation of subsection (d) of that section.

Lawrence B. Gibbs,
Commissioner of Internal Revenue.

Approved: January 31, 1989.

O. Donaldson Chapoton,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on May 12, 1989, 8:45 a.m., and published in the issue of the Federal Register for May 15, 1989, 54 F.R. 20787)

Part VI.—Itemized Deductions for Individuals and Corporations

Section 162.—Trade or Business Expenses

26 CFR 1.162-1: Business expenses.
(Also Section 831; 1.831-3.)

Wholly owned insurance subsidiary. Rev. Rul. 88-72, which holds that a parent corporation and its subsidiaries cannot deduct under section 162 of the Code amounts paid to the parent's wholly owned insurance subsidiary as "insurance premiums" notwithstanding the insurance subsidiary's acceptance of insurance risks from unrelated parties, is clarified.

Rev. Rul. 89-61

This revenue ruling clarifies the LAW AND ANALYSIS portion of Rev. Rul. 88-72, 1988-2 C.B. 31. In its discussion of the economics of insurance, Rev. Rul. 88-72 states that the increase in average loss predictability resulting from the acceptance of additional risks "helps protect the [insurance] company's solvency." This statement could cause confusion. The improved average loss predictability indeed may allow the insurance company to use its capital more efficiently in protecting its solvency. However, in the absence of some additional capital, the improved predictability is normally accompanied by a reduced probability of the insurance company's solvency.

When additional statistically independent risk exposure units are insured, an insurance company's potential total loss increases, as does the uncertainty of the amount of that loss. As the uncertainty regarding the company's total loss increases, however, there is an increase in the predictability of the insurance company's average loss (total loss divided by the number of exposure units). That is, by insuring a large number of statistically independent risk exposure units, a company takes advantage of the statistical phenomenon known as the law of large numbers. (When the sample number increases, the probability density function of the *average* loss tends to become more concentrated around the mean.) Due to this increase in predictability, there is a downward trend in the amount of capital that the company needs *per risk unit* to remain at a given level of solvency. In this sense, the additional insureds may make a company more efficient in the way its capital provides security, and thus may "help protect the company's solvency." Without an increase in capital, however, the increase in the predictability of the average loss is at the cost of an upward trend in the company's risk of ruin (the probability that total losses may exceed total premiums and capital).

In the absence of an addition to the insurance company's aggregate capital, insuring additional risk exposure units at competitive rates normally increases the company's risk of ruin. To avoid such an increase, when an insurance company expands its business, there is an addition to the amount of capital that state insurance regulators require the company to hold. The grater need for capital when risks are added demonstrates that the new insureds do not take on any risks previously assumed by the company. If some of the company's risks were transferred to the new insureds, the company would not need more capital to keep its risk of ruin from increasing.

Accordingly, the LAW AND ANALYSIS portion of Rev. Rul. 88-72 is clarified by deleting from the sixth paragraph the sentence "This increase in predictability helps protect the company's solvency."

EFFECT ON OTHER REVENUE RULINGS

Rev. Rul. 88-72 is clarified. This clarification of Rev. Rul. 88-72 will appear in that revenue ruling when it is republished in 1988-2 C.B.

26 CFR 1.162-1: Business expenses.

If expenditures are incurred after December 31, 1986, in connection with the development and design of product packages, are those expenditures deductible as ordinary and necessary business expenses under section 162(a) of the Code in the tax year in which the expenditures are incurred, or must they be capitalized under section 263A of the Code. If expenditures are incurred prior to January 1, 1987, must they be capitalized under section 263. If such expenditures must be capitalized under section 263 or section 263A of the Code, are they amortizable under section 1.167(a)-3 of the Regulations. See Rev. Rul. 89-23, page 85.

Section 163.—Interest

26 CFR 1.163-1: Interest deduction in general.

If an accrual method corporate taxpayer remits the total amount of unassessed tax proposed in a 30-day letter, plus appropriate interest, does not designate the amount remitted as a deposit in the nature of a cash bond, and contests the proposed tax and related interest, is the portion of the remittance that is attributable to interest deductible under sections 163(a) and 461(f) of the Code in the tax year of the remittance. See Rev. Rul. 89-6, page 119.

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26 CFR 1.163-5: Denial of interest deduction on certain obligations issued after December 31, 1982, unless issued in registered form.

Interest; temporary global security. A temporary security that remains outstanding beyond a reasonable time after the completion of the initial offering must meet the foreign targeting requirements.

Rev. Rul. 89-9

ISSUES

(1) Does the term "temporary global security" include an obligation that is not retired within a reasonable period of time after the completion of the initial offering?

(2) Does such a temporary security meet the foreign targeting requirements of section 1.163-5(c)(2)(i)(B), if the certificate described in section 1.163-5(c)(2)(i)(B)(iv) is not presented to the issuer or underwriter?

FACTS

X, a domestic corporation, planned a public offering of bearer bonds in foreign markets through *Y*, an underwriter. The bonds were exempt from registration under section 3 of the Securities Act of 1933. Under the arrangements between *X* and *Y*, the bonds satisfied all the predelivery requirements of section 1.163-5(c)(2)(B) of the Income Tax Regulations.

As part of the offering, *X* issued *Y* a seven-year obligation designated a "temporary global security." A temporary global security is typically issued to the underwriter at the outset of an offering, and interests in the security are given to bond purchasers pending delivery of the bonds. At the close of the offering, the underwriter obtains statements that no United States person owns an interest in the security, the bonds are delivered, and the security is promptly retired.

X, however, never issued the definitive bearer bonds. The temporary global security remained outstanding for its full term, after which *X* paid its indebtedness in full and the security was cancelled.

LAW AND ANALYSIS

Section 163(f) of the Code denies a deduction for interest on any "registration required obligation" unless the obligation is in registered form. Section 163(f)(2) describes certain foreign-targeted obligations that are not registration required obligations.

Section 1.163-5(c)(2)(i)(B) of the regulations lists five requirements that obligations exempt from registration by section 3 of the Securities Act of 1933 must meet to qualify for the section 163(f)(2) exception. Section 1.163-5(c)(2)(i)(B)(iv) provides that one of those requirements is that a bearer obligation cannot be delivered to the person entitled to receive it unless that person presents a signed certificate to the issuer or underwriter which states that the obligation is not being acquired by or on behalf of a United States person, or for offer to sell or for resale to a United States person or any person inside the United States. The certification requirement ensures that bearer obligations will not be available to United States persons or to any persons within the United States.

Section 1.163-5(c)(2)(i) of the regulations provides that a temporary global security need not satisfy the requirements of section 1.163-5(c)(2)(i)(B). The reason for this exception is that a temporary global security is retired promptly at the close of the offering after the underwriter obtains the statement described in section 1.163-5(c)(2)(i)(B)(iv) and delivers the bearer obligations in definitive form.

The exception provided by section 1.163-5(c)(2)(i) does not apply to the seven-year obligation issued by *X*. The temporary security issued by *X* was not promptly retired, but remained outstanding for its full term. It is therefore not a "temporary global security" within the meaning of section 1.163-5(c)(2)(i) of the regulation. Because it is not a temporary global security, it must satisfy all of the requirements of section 1.163-5(c)(2)(i)(B), including the certification requirements of section 1.163-5(c)(2)(i)(B)(iv). That requirement was not satisfied, and therefore the obligation does not qualify under section 1.163-5(c)(2)(i)(B).

HOLDING

(1) The term "temporary global security" does not include an obligation that is not retired within a reasonable period of time after the completion of the initial offering.

(2) A temporary security that remains outstanding beyond a reasonable time after the completion of the initial offering must meet the foreign targeting requirements of section 1.163-5(c)(2). Such an obligation does not qualify under section 1.163-5(c)(2)(i)(B) unless each of the five requirements thereunder is satisfied.

Section 164.—Taxes

26 CFR 1.164-1: Deduction for taxes.

State income taxes; mandatory wage assessments. Amounts withheld from the wages of employees for contribution to the West Virginia Unemployment Compensation Trust Fund qualify as state "income taxes" and, therefore, are deductible by the employees under section 164(a)(3) of the Code.

Rev. Rul. 89-16

ISSUE

Are contributions made by employees and employers pursuant to the West Virginia Unemployment Compensation Law taxes which are allowed as a deduction under section 164(a) of the Internal Revenue Code for the taxable year in which paid or accrued?

FACTS

The State of West Virginia pays unemployment compensation benefits, based upon average weekly wages, from the state's Unemployment Compensation Trust Fund (the Fund). Because the state's Fund was depleted, the West Virginia Department of Employment Security (the Department), a state agency, was advanced funds by the federal government under the provisions of section 1201 of the Social Security Act, 42 U.S.C.A. section 1321, as amended in 1981, to help pay the unemployment compensation benefits.

In order for West Virginia to repay the debt the state owed to the federal government, the state in 1987 amended its Unemployment Compensation Law (Law), Chap. 21A of the West Virginia Code, to authorize the Department to borrow money by the issuance of revenue bonds or notes. To repay the notes and bonds, the Law requires all employers as defined therein to withhold a percentage of the gross wages paid to each employee and remit the withheld amounts to the Department. W. Va. Code ch. 21A-8A-8(a) (Michie 1985 & Supp. 1987). All employers for which employee withholding is required are also subject to, and must remit to the Department, a compulsory contribution based on a percentage of each employee's gross wages. W. Va. Code ch. 21A-8A-8(b).

The Law further empowers the state to impose an additional "stabilization" assessment on employees and employers for any calendar quarter for which the Department determines that benefits paid out of the Fund will exceed the contributions received. W. Va. Code ch. 21A-5-10a(a). This optional stabilization assessment is computed similarly to the mandatory one described above. W. Va. Code ch. 21A-5-10a(b).

LAW AND ANALYSIS

Section 164(a)(3) of the Code provides, in part, that state income taxes shall be allowed as a deduction for the taxable year in which they are paid or accrued. Section 164(a) also allows as a deduction state taxes not otherwise specifically described therein that are paid or accrued within the taxable year in carrying on a trade or business.

In Rev. Rul. 81-191, 1981-2 C.B. 49, employees were required to contribute to the Rhode Island temporary disability insurance benefit fund pursuant to the Rhode Island Temporary Disability Insurance Act (Act). The employer was required to withhold the amount of such contributions from the employees' wages at the time the wages were paid. If the employer failed to withhold the contributions of any employee within the time provided by the Act, the employer became solely liable for such contributions under the Act.

Rev. Rul. 81-191 holds (1) that the contributions withheld from the wages of an employee are state "income taxes" that are deductible by the employee under section 164(a)(3) of the Code, provided that the employee itemizes deductions in computing taxable income, and (2) that amounts paid or accrued by an employer are "excise taxes" that are deductible by the employer under section 164(a). Rev. Rul. 81-191 reasons that the employee and employer contributions to the fund are "taxes" because they are exacted pursuant to legislative authority in the exercise of the taxing power of the state, and they are imposed and collected by the state for the purpose of raising revenue to be used for a governmental function that serves public purposes. The ruling further reasons that the employee contributions to the fund are "income taxes" because they are measured by wages paid during the calendar year, and that the employer contributions to the fund are state taxes paid or accrued in carrying on a trade or business. For similar results and rationale, see Rev. Rul. 81-192, 1981-2 C.B. 50 (New York) ; Rev. Rul. 81-193, 1981-2 C.B. 52 (New Jersey); and Rev. Rul. 81-194, 1981-2 C.B. 54 (California).

In West Virginia, the contributions under its Unemployment Compensation Law by both employees and employers are taxes. The law requires employers to withhold a portion of each employee's wages at the time the wages are paid, and subjects employers to compulsory contributions based on a percentage of each employee's gross wages. In addition, the Law provides for a similarly computed stabilization assessment on employees and employers if needed. These withheld and contributed amounts are exacted pursuant to legislative authority in the exercise of the taxing power of the State of West Virginia, and are imposed and collected by the State for the purpose of raising revenue to be used for a governmental function that serves public purposes, namely, to repay a State public debt that was incurred to provide unemployment compensation benefits to qualified recipients.

Moreover, the amounts withheld from the employees' wages are "income taxes" because they are measured by wages paid during the calendar year, and the amounts contributed by employers are paid or accrued "in carrying on a trade or business." *See* Rev. Rul. 81-191, and *Trujillo v. Commissioner*, 68 T.C. 670 (1977).

HOLDING

Amounts withheld from the wages of an employee for contribution under the West Virginia Unemployment Compensation Law are state income taxes and, therefore, shall be deductible by the employee under section 164(a)(3) of the Code for the taxable year in which paid or accrued. However, such amounts are deductible by an employee only if the employee's deductions are itemized in computing taxable income under section 63 of the Code.

Amounts contributed by an employer under the Law are state taxes paid or accrued by the employer in carrying on a trade or business and, therefore, shall be deductible by the employer under section 164(a) of the Code for the taxable year in which paid or accrued.

Section 165.—Losses

26 CFR 1.165-2: Obsolescence of nondepreciable property.

A procedure is provided for certain taxpayers to obtain expeditious consent from the Commissioner to change their method of accounting for package design costs to a capitalization method in accordance with Rev. Rul. 89-23. See Rev. Proc. 89-16, page 822.

26 CFR 1.165-2: Obsolescence of nondepreciable property.

If a syndication effort fails and is abandoned, is the deduction under section 165 precluded by the prohibition on deductions for syndication expenses under section 709 of the Code. See Rev. Rul. 89-11, page 179.

26 CFR 1.165-2: Obsolescence of nondepreciable property.

If expenditures are incurred after December 31, 1986, in connection with the development and design of product packages, are those expenditures deductible as ordinary and necessary business expenses under section 162(a) of the Code in the tax year in which the expenditures are incurred, or must they be capitalized under section 263A of the Code. If expenditures are incurred prior to January 1, 1987, must they be capitalized under section 263. If such expenditures must be capitalized under section 263 or section 263A of the Code, are they amortizable under section 1.167(a)-3 of the Regulations. See Rev. Rul. 89-23, page 85.

26 CFR 1.165-11: Election in respect of losses attributable to a disaster.

Losses; casualty; disaster areas; year of deduction. Disaster areas in which losses during 1988 qualify for special tax treatment under section 165(i) of the Code are listed.

Rev. Rul. 89-21

LAW AND ANALYSIS-HOLDING

Under section 165(i) of the Internal Revenue Code, if a taxpayer suffers a loss attributable to a disaster occurring in an area subsequently determined by the President of the United States to warrant assistance by the Federal Government under the Disaster Relief Act of 1974, sections 101 and 102, 42 U.S.C. sections 5121 and 5122 (1982), 1974-2 C.B. 414, then the taxpayer may elect to take a deduction for that loss on the taxpayer's federal income tax return for the taxable year immediately preceding the taxable year in which the disaster occurred.

The election to deduct for the preceding year must be made on or before the later of (1) the original due date of the taxpayer's income tax return for the year in which the disaster occurred, or (2) the due date of the preceding year's return (taking into account extensions of time for filing granted to the taxpayer). Section 1.165-11 of the Income Tax Regulations. This section of the regulations sets forth the procedures for making an election with respect to such losses.

The provisions of section 165(i) of the Code apply only to losses that are otherwise deductible under section 165(a). An individual taxpayer may deduct losses if they are incurred in a trade or business, if they are incurred in a transaction entered into for profit, or if they are casualty losses under section 165(c)(3).

As of December 12, 1988, the President had determined that the areas listed below have been adversely affected by disasters of sufficient severity occurring during 1988 to warrant disaster assistance by the Federal Government under the Disaster Relief Act of 1974.

There may be areas in which a disaster occurred during 1988 and which the President, after December 12, 1988, declares eligible for disaster assistance under the Disaster Relief Act of 1974. Information concerning these areas will be published in future issues of the Internal Revenue Bulletin, and these areas will be included in this revenue ruling when it is published in the Cumulative Bulletin.

Disaster Areas in 1988	Type of Disaster	Date Disaster Occurred or Began
Alaska Borough of North Slope	Fire	February 10, 1988
Arkansas Counties of Chicot, Clark, Columbia, Craighead, Faulkner, Garland, Greene, Hot Spring, Independence, Izard, Johnson, Logan, Lonoke, Nevada, Ouachita, Phillips, Poinsett, Prairie, Pulaski, Saline, Stone, Van Buren, White, and Woodruff	Tornadoes and severe storms	November 15-20, 1988
California Counties of Los Angeles, Orange, San Diego, and Santa Barbara; and the City of San Buenaventura	Severe winds, rainstorms, high tides, and flooding	January 17, 1988
Counties of Nevada, Shasta, Solano, and Yuba	Wildfires	September 11-24, 1988
Guam	Typhoon Roy	January 11-12, 1988
Iowa County of Pottawattamie	Tornadoes, rains, and high winds	July 15-16, 1988
Marshall Islands Kwajalein Atoll	Severe winds, high waves, and flooding caused by Tropical Storm Roy	January 9, 1988
North Carolina Counties of Currituck, Dare, Franklin, Halifax, Hyde, Nash, Northampton, Pamlico, and Wake	Tornadoes and severe storms	November 28, 1988
Northern Mariana Islands Island of Rota	Typhoon Roy	January 11-12, 1988
Texas Counties of Bexar, Cameron, and Hidalgo	Hurricane Gilbert and resulting tornadoes	September 15-17, 1988

Section 167.—Depreciation

26 CFR 1.167(a)-1: Depreciation in general.
(Also Section 168.)

Depreciation; videocassettes. Videocassettes are depreciable under section 167 of the Code in accordance with the straight line method or the income forecast method.

Rev. Rul. 89-62

ISSUE

What is the proper method of depreciating videocassettes under the Internal Revenue Code?

FACTS

In 1988 the taxpayer established a videocassette rental business. A videocassette consists of a cartridge mechanism containing a designated length of magnetic video tape. Videocassettes are used in videocassette recorders or players. The taxpayer purchases mass-produced copies of master versions of movies in the videocassette format and rents them to the public.

LAW AND ANALYSIS

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

Section 168(a) of the Code provides that, except as otherwise provided in this section, the depreciation deduction provided by section 167(a) for any tangible property shall be determined by using the applicable depreciation method, recovery period, and convention.

Section 168(f)(3) of the Code provides that section 168 does not apply to "any motion picture film or video tape". If videocassettes are encompassed within the phrase "any motion picture film or video tape", they are not subject to section 168(a). The language of section 168(f)(3) is broadly inclusive. Similarly inclusive language was used in section 168(e)(5) of the Internal Revenue Code of 1954, the predecessor of section 168(f)(3). There is nothing in the legislative history of these sections to suggest that they were to be narrowly applied. H.R. Conf. Rep. No. 861, 98th Cong., 2d Sess. 1009 (1984), 1984-3 (Vol. 2) C.B. 263.

A videocassette is a video tape adapted for use in a videocassette recorder or player. Accordingly, videocassettes are among the motion picture films and video tapes excluded from the scope of section 168.

If property is excluded from section 168 of the Code, the provisions of section 167 apply in determining the allowable depreciation deduction with respect to such property.

Section 167(b) of the Code provides that a reasonable allowance for depreciation shall include an allowance computed under the straight line method and certain accelerated methods.

Section 167(c) of the Code provides that the accelerated methods of depreciation described in section 167(b) do not apply to any motion picture film, video tape, or sound recording. This broadly inclusive language encompasses videocassettes. Accordingly, the taxpayer may depreciate the videocassettes utilizing the straight line method over their useful life in the taxpayer's business, but may not utilize the methods of depreciation described in paragraphs (2), (3), and (4) of section 167(b).

A taxpayer's videocassettes may be depreciated in a group account consistent with the rules set forth in section 1.167(a)(7) of the Income Tax Regulations. In addition, taxpayers may be able to demonstrate that some of their videocassettes will not have a useful life in excess of 1 year. The cost of such videocassettes may be deducted under section 162 of the Code.

The legislative history of section 167(c) states that the income forecast method of depreciation is available with respect to motion picture films, video tapes, and sound recordings. H.R. Rep. No. 426, 99th Cong., 2d Sess. 914-15 (1985), 1986-3 (Vol. 2) C.B. 914-15. For a description of the income forecast method, see Rev. Rul. 60-358, 1960-2 C.B. 68 (income forecast method applied to films). The income forecast method recognizes that certain assets generate uneven flows of income and have unique income producing potential. To properly apply the income forecast method, taxpayers must make income projections for each asset subject to the method. Taxpayers may group their videocassettes by videocassette title for purposes of making the required income projections. Broader groupings of videocassettes for projection purposes are not permissible under the income forecast method.

HOLDING

Videocassettes are subject to section 167 of the Code and may be depreciated in accordance with the straight line method over the useful life of the videocassettes in the particular taxpayer's business. Alternatively, the income forecast method may be used.

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26 CFR 1.167(a)-2: Tangible property.

Depreciation; home-builder; houses used as models and or sales offices. Houses that a home-builder used for models and/or sales offices were not subject to an allowance for depreciation under section 167 of the Code.

Rev. Rul. 89-25

ISSUE

If a home-builder temporarily used new houses for models and/or sales offices, were the houses subject to an allowance for depreciation?

FACTS

The taxpayer is in the business of building and selling residential houses. To assist in its sales activity, the taxpayer used certain houses as models and/or sales offices temporarily (*i.e.*, for a small fraction of their expected useful life). Such use generated no rental income to the taxpayer. During the period of that use, the taxpayer made no effort to sell those houses; however, the taxpayer expected to sell all houses in development D within a few years (including the houses temporarily used as models and/or sales offices).

LAW AND ANALYSIS

Section 167 of the Internal Revenue Code 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 the trade or business or held for the production of income.

Section 1.167(a)-2 of the Income Tax Regulations provides that the depreciation allowance in the case of tangible property applies only to that part of the property that is subject to wear and tear, to decay or decline from natural causes, to exhaustion, and to obsolescence, and the allowance does not apply to inventories or stock in trade.

Rev. Rul. 75-538, 1975-2 C.B. 35, concerns the treatment for federal income tax purposes of motor vehicles held by a taxpayer engaged in the business of selling motor vehicles. A taxpayer engaged in the trade or business of selling motor vehicles is presumed to hold all such vehicles primarily for sale to customers in the ordinary course of the taxpayer's trade or business. To overcome this presumption, the taxpayer must show clearly that the motor vehicle was actually devoted to use in the business of the dealer and that the dealer looks to consumption through use of the vehicle in the ordinary course of business operation to recover the dealer's cost. Rev. Rul. 75-538 provides that a vehicle is not property used in the business if it is used merely for demonstration purposes, or temporarily withdrawn from stock-in-trade or inventory for business use.

Duval Motor Co. v. Commissioner, 264 F.2d 548 (5th Cir. 1959), *aff'g* 28 T.C. 42 (1957), concerned automobiles used as demonstrators and provided by a car dealer to company officials and salesmen for other business uses. The court found that these automobiles were held primarily for sale to customers. As a result, the dealer was not entitled to a depreciation deduction with respect to such automobiles. *See also Luhring Motor Co. v. Commissioner*, 42 T.C. 732 (1964); *R.E. Moorhead & Son, Inc. v. Commissioner*, 40 T.C. 704 (1963).

In the present situation the houses were used as models and/or sales offices for a small fraction of their expected useful lives and never generated any rental income. After this period of use, the taxpayer expected to sell the houses in the same manner as it had been selling its other houses. Moreover, the essential purpose for which the houses were built — sale to customers — was never altered. Thus, although the houses were used temporarily as models and/or sales offices, and although the taxpayer may have been reluctant or unwilling to sell the houses while they were being used in this way, they remained property held by the taxpayer primarily for sale to customers in the ordinary course of the taxpayer's business rather than property used in the trade or business. Thus, they may not be depreciated. See section 167(a) of the Code; *Duval Motor Co., Supra*.

HOLDING

Houses that a home-builder temporarily used for models and/or sales offices were not subject to an allowance for depreciation.

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26 CFR 1.167(a)-3: Intangibles.

A procedure is provided for certain taxpayers to obtain expeditious consent from the Commissioner to change their method of accounting for package design costs to a capitalization method in accordance with Rev. Rul. 89-23. See Rev. Proc. 89-16, page 822.

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26 CFR 1.167(a)-3: Intangibles.

Taxpayers that incur package design costs are allowed to deem the useful lives of certain package designs to be 60 months. See Rev. Proc. 89-17, page 827.

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26 CFR 1.167(a)-3: Intangibles.

If expenditures are incurred after December 31, 1986, in connection with the development and design of product packages, are those expenditures deductible as ordinary and necessary business expenses under section 162(a) of the Code in the tax year in which the expenditures are incurred, or must they be capitalized under section 263A of the Code. If expenditures are incurred prior to January 1, 1987, must they be capitalized under section 263. If such expenditures must be capitalized under section 263 or section 263A of the Code, are they amortizable under section 1.167(a)-3 of the Regulations. See Rev. Rul. 89-23, page 85.

Section 168.—Accelerated Cost Recovery System

What is the proper method of depreciating videocassettes under the Internal Revenue Code? See Rev. Rul. 89-62, page 78.

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

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

If a taxpayer purchases property at a charitable auction, paying fair market value for it, is any part of the payment deductible as a charitable contribution. See Rev. Rul. 89-51, page 89.

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

Whether churches such as those described in Rev. Rul. 78-232, 1978-1 C.B. 69, and Rev. Rul. 81-94, 1981-1 C.B. 330, are "tax shelters" for purposes of the substantial understatement penalty. See Rev. Rul. 89-74, page 311.

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26 CFR 1.170A-6: Charitable contributions in trust.

The Service ordinarily will not issue rulings as to whether a transfer to an inter vivos charitable remainder trust described in section 664 of the Code that provides for annuity or unitrust payments for one measuring life qualifies for a charitable deduction under section 170(f)(2)(A). See Rev. Proc. 89-19, page 841.

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26 CFR 1.170A-6: Charitable contributions in trust.

Contributions to a qualifying inter vivos charitable remainder unitrust providing for unitrust payments during one life are deductible for income tax purposes, assuming that all other applicable requirements for a charitable contribution are met. See Rev. Proc. 89-20, page 841.

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26 CFR 1.170A-6: Charitable contributions in trust.

Contributions to a qualifying inter vivos charitable remainder annuity trust providing for annuity payments during one life are deductible for income tax purposes, assuming that all other applicable requirements for a charitable contribution are met. See Rev. Proc. 89-21, page 842.

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26 CFR 1.170A-7: Contributions not in trust of partial interests in property.

If a taxpayer purchases property at a charitable auction, paying fair market value for it, is any part of the payment deductible as a charitable contribution. See Rev. Rul. 89-51, page 89.

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26 CFR 1.170A-9: Definition of section 170(b)(1)(A) organization.

Guidelines for the circumstances where grantmaking private foundations will not be considered to be responsible for substantial and material changes in the sources of financial support of recipient organizations for purposes of sections 1.170A-9(e)(4)(v)(b) and 1.170A- 9(e)(5)(iii)(c) of the regulations. See Rev. Proc. 89-23, page 844.

Section 172.—Net Operating Loss Deduction

26 CFR 1.172-4: Net operating loss carrybacks and net operating loss carryovers.
(Also Section 593; 1.593-1.)

Net operating loss deduction; carrybacks and carryovers. For purposes of section 172(b)(1)(L) of the Code, (1) a taxpayer must be an organization to which section 593 applied in the year that the net operating loss was incurred, and (2) the relevant version of section 593 is former section 593, as in effect during the loss year.

Rev. Rul. 89-78

ISSUES

For purposes of section 172(b)(1)(L) of the Internal Revenue Code, (1) when must a taxpayer be an organization to which section 593 applies; and (2) which version of section 593 (former section 593 or section 593 as amended by the Tax Reform Act of 1986) applies?

FACTS

Situation 1. Corporation *X* files its federal income tax return on a calendar year basis. *X* came into existence on January 1, 1982, as a financial institution described in section 582(c)(5) of the Code but, during that year, was not an organization to which former section 593 applied. *X* incurred a net operating loss (NOL) in 1982, a portion of which it had not yet deducted by the end of 1987. *X* had taxable income in 1988 and, throughout the year, was an organization to which section 593 as amended applied.

Situation 2. The facts concerning corporation *Y* are the same as those concerning *X* in *Situation 1* except that in 1982, *Y* was an organization to which former section 593 of the Code applied. Throughout that year, however, *Y* was not an organization to which section 593, as amended, would have applied if the amendment had been effective for that year.

LAW AND ANALYSIS

Section 593 of the Code, effective for taxable years beginning after December 31, 1986, applies to any cooperative bank without capital stock organized and operated for mutual purposes and without profit, any domestic building and loan association, and any mutual savings bank (hereinafter referred to collectively as thrift institutions), provided that the thrift institution meets the 60-percent asset test of section 7701(a)(19)(C). Former section 593, effective for taxable years beginning before January 1, 1987, applies to the same thrift institutions, but without the section 7701(a)(19)(C) limiting proviso.

Section 582(c)(5) of the Code refers to certain financial institutions, which include (but are not limited to) thrift institutions described in section 593.

Section 172(a) of the Code provides that there shall be allowed as a deduction for the taxable year an amount equal to the aggregate of (1) the NOL carryovers to such year, plus (2) the NOL carrybacks to such year. Section 172(b)(1)(A) provides the general rule that an NOL for any taxable year shall be an NOL carryback to each of the 3 taxable years preceding the taxable year of such loss. Section 172(b)(1)(B) provides the general rule that an NOL for any taxable year ending after December 31, 1975, shall be an NOL carryover to each of the 15 taxable years following the taxable year of such loss.

Section 172(b)(1)(F) of the Code provides that an NOL incurred in any of the taxable years beginning after December 31, 1975, and before January 1, 1987, in the case of a financial institution to which section 582(c)(5) applies (a "financial institution"), shall be an NOL carryback to each of the 10 taxable years preceding the taxable year of such loss and shall be an NOL carryover to each of the 5 taxable years following the taxable year of such loss.

By amending section 172(b)(1)(F) of the Code to read as described above, section 903 of the Tax Reform Act of 1986 (the Act), 1986-3 (Vol. 1) C.B. 300, removed, for loss years beginning after December 31, 1986, the special rule granting financial institutions an NOL carryback to the preceding 10 taxable years and an NOL carryover to the succeeding 5 taxable years.

Thus, for losses incurred in taxable years beginning after December 31, 1986, financial institutions generally are subject to the rule in section 172(b)(1)(A) and (B) of the Code, which permits taxpayers to carry NOLs back to the preceding 3 taxable years and forward to the succeeding 15 taxable years. However, section 172(b)(1)(L), as added by section 903(b)(1) of the Act, and as redesignated by section 1009(c)(1) of the Technical and Miscellaneous Revenue Act of 1988, provides a transition rule for thrift institutions.

Section 172(b)(1)(L) of the Code provides that, in the case of an organization to which section 593 applies, an NOL for any taxable year beginning after December 31, 1981, and before January 1, 1986, shall be an NOL carryback to each of the 10 taxable years preceding the taxable year of such loss and shall be an NOL carryover to each of the 8 taxable years following the taxable year of such loss. Thus, section 172(b)(1)(L) extends the NOL carryforward period with respect to certain NOLs from 5 taxable years to 8 taxable years.

The statute is silent both as to when the taxpayer must be an organization to which section 593 of the Code applies and as to which version of section 593 (before or after the 1986 amendment) is relevant. The legislative history accompanying the Act indicates congressional concern with NOLs incurred by thrift institutions, partly as a result of deregulation, during the early 1980s. The Senate Finance Committee believed that the limited transition period was appropriate as thrift institutions recovered from the change in the regulatory rules that caused the NOLs. Thus, the Finance Committee report supports the conclusion that to be entitled to the 3-year extension of the NOL carryforward period, the taxpayer must have been an organization to which section 593 applied in the loss year. The same legislative intent also supports the conclusion that former section 593, as effective during the loss year, is the relevant version of section 593. *See* S. Rep. No. 313, 99th Cong., 2d Sess. 289 (1986), 1986-3 (Vol. 3) C.B. 289; 2 H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. II-335 (1986), 1986-3 (Vol. 4) C.B. 335.

Section 172(b)(1)(L) of the Code therefore extends for 3 years the NOL carryforward periods of those taxpayers that incurred NOLs in taxable years beginning after December 31, 1981, and before January 1, 1986, provided that those taxpayers were organizations to which former section 593 applied in the loss year.

Situation 1. Section 172(b)(1)(L) of the Code does not apply to *X*, because in 1982, the loss year, *X* was not an organization to which former section 593 applied. Section 172(b)(1)(F) determines the carryforward period for *X*'s 1982 NOL. Thus, *X*'s 1982 NOL is subject to a 5-year carryforward under section 172(b)(1)(F) rather than an 8-year carryforward under section 172(b)(1)(L). The unused portion of *X*'s 1982 NOL expires at the end of *X*'s 1987 taxable year.

Situation 2. Section 172(b)(1)(L) of the Code applies to *Y* and allows *Y* to carry forward to 1988 its entire 1982 NOL. Because *Y* was an organization to which former section 593 applied in 1982, the loss year, *Y* qualifies for the 3-year extension of the NOL carryforward period under section 172(b)(1)(L). *Y*'s 1982 NOL does not expire at the end of its 1987 taxable year.

HOLDING

For purposes of section 172(b)(1)(L) of the Code, (1) a taxpayer must be an organization to which section 593 applied in the taxable year that the NOL was incurred; and (2) the relevant version of section 593 is former section 593, as in effect during the loss year.

Section 177.—Trademark and Trade Name Expenditures [Repealed]

26 CFR 1.177-1: Election to amortize trademark and trade name expenditures.

If expenditures are incurred after December 31, 1986, in connection with the development and design of product packages, are those expenditures deductible as ordinary and necessary business expenses under section 162(a) of the Code in the tax year in which the expenditures are incurred, or must they be capitalized under section 263A of the Code. If expenditures are incurred prior to January 1, 1987, must they be capitalized under section 263. If such expenditures must be capitalized under section 263 or section 263A of the Code, are they amortizable under section 1.167(a)-3 of the Regulations. See Rev. Rul. 89-23, page 85.

Section 179.—Election to Expense Certain Depreciable Business Assets

26 CFR 1.179-1: Election to expense certain depreciable assets.

If a partner's distributive share of the partnership's expenses under section 179 of the Code is not fully deductible by the partner because, when combined with the partner's section 179 expenses from other sources, the partner's section 179 expenses from all sources exceed the maximum amount allowable to the partner under section 179(b)(1), is the partner's basis in the partnership interest reduced by the partner's full distributive share of the partnership's section 179 expenses, including the partnership's section 179 expenses that the partner cannot deduct? See Rev. Rul. 89-7, page 178.

Part VII.—Additional Itemized Deductions for Individuals

Section 212.—Expenses for Production of Income

26 CFR 1.212-1: Nontrade or nonbusiness expenses.
(Also Section 67.)

Deduction of expenses for the preparation of a ruling request and the user fee. A fee paid to a tax practitioner to prepare and submit a request for a ruling concerning a nonbusiness transaction, as well as the related user fee paid to the Service, are deductible under section 212 of the Code. These amounts are miscellaneous itemized deductions subject to the 2-percent floor provided by section 67.

Rev. Rul. 89-68

ISSUES

(1) Is a fee paid to a tax practitioner, including an amount for the preparation and submission of a ruling request to the Internal Revenue Service, deductible under section 212(3) of the Internal Revenue Code?

(2) Is a user fee paid to the Internal Revenue Service in connection with the ruling request deductible under section 212(3) of the Code?

(3) If these fees are deductible under section 212(3) of the Code, are they subject to the 2-percent floor under section 67(a)?

FACTS

A, an individual, contacted *C*, a tax practitioner, and inquired whether a certain expense paid by *A* was deductible under section 213 of the Code as an amount paid for medical care. *C* researched the issue and advised *A* that in *C*'s opinion it was not clear that the expense was a deductible medical care expense. *C* recommended that a ruling be requested from the Internal Revenue Service if *A* desired a definitive answer.

A asked *C* to prepare and submit the ruling request, and *C* did so in February 1989. *A* paid *C* $1000 for professional services rendered, including preparation and submission of the ruling request, and also paid a user fee of $300 to the Internal Revenue Service.

LAW AND ANALYSIS

Section 212(3) of the Code allows a deduction to an individual for all the ordinary and necessary expenses paid or incurred during the taxable year in connection with the determination, collection, or refund of any tax. Section 1.212-1(l) of the Income Tax Regulations states that expenses are deductible if paid or incurred by an individual (1) for tax counsel, (2) in connection with the preparation of tax returns or with any proceeding involved in determining the extent of tax liability, or (3) in contesting tax liability.

Section 67(a) of Code provides that an individual's miscellaneous itemized deductions are allowed only to the extent that they exceed 2 percent of adjusted gross income. Section 67(b) defines miscellaneous itemized deductions as all itemized deductions other than the ones specified in section 67(b)(1) through (13).

Section 63(d) of the Code defines itemized deductions as the deductions allowable under chapter 1 of the Code (sections 1 to 1399) other than (1) the deductions allowable in arriving at adjusted gross income under section 62, and (2) the deduction for personal exemptions provided by section 151.

Section 10511 of the Revenue Act of 1987, Pub. L. 100-203, requires the payment of a user fee to the Internal Revenue Service in connection with a request for a ruling. A schedule in Rev. Proc. 89-4, page 767, this Bulletin, sets forth the amount of the user fee payable with respect to each category or subcategory of a request. Pursuant to that schedule, *A* was charged the $300 user fee.

C's fee for profession services, including the portion attributable to the preparation and submission of the ruling request, was paid by *A* in the process of determining whether the expense paid by *A* was a deductible medical expense, and the $300 user fee was paid for a similar purpose. Accordingly, both *C*'s fee and the user fee were paid in connection with determining the extent of *A*'s tax liability, and thus the fees are deductible under section 212(3) of the Code.

However, a deduction allowed by section 212 of the Code is an itemized deduction under section 63(d) that is not excepted by section 67(b)(1) through (13) of the Code from the definition of a miscellaneous itemized deduction. Thus, *A*'s section 212(3) deductions and *A*'s other miscellaneous itemized deductions are subject to the 2-percent floor under section 67(a).

HOLDINGS

(1) and (2) The fees paid by *A* to a tax practitioner, including the portion for the preparation and submission of the ruling request, and to the Internal Revenue Service as a user fee in connection with the ruling request, are deductible under section 212(3) of the Code.

(3) These fees, along with A's other miscellaneous itemized deductions, are subject to the 2-percent floor under section 67(a) of the Code.

Part IX.—Items Not Deductible

Section 262.—Personal, Living and Family Expenses

26 CFR 1.262-1: Personal, living and family expenses.

Whether churches such as those described in Rev. Rul. 78-232, 1978-1, C.B. 69, and Rev. Rul. 81-94, 1981-1 C.B. 330, are "tax shelters" for purposes of the substantial understatement penalty. See Rev. Rul. 89-74, page 311.

Section 263.—Capital Expenditures

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

A procedure is provided for certain taxpayers to obtain expeditious consent from the Commissioner to change their method of accounting for package design costs to a capitalization method in accordance with Rev. Rul. 89-23. See Rev. Proc. 89-16, page 822.

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

Taxpayers that incur package design costs are allowed to deem the useful lives of certain package designs to be 60 months. See Rev. Proc. 89-17, page 827.

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

If expenditures are incurred after December 31, 1986, in connection with the development and design of product packages, are those expenditures deductible as ordinary and necessary business expenses under section 162(a) of the Code in the tax year in which the expenditures are incurred, or must they be capitalized under section 263A of the Code. If expenditures are incurred prior to January 1, 1987, must they be capitalized under section 263. If such expenditures must be capitalized under section 263 or section 263A of the Code, are they amortizable under section 1.167(a)-3 of the Regulations. See Rev. Rul. 89-23, page 85.

26 CFR 1.263(c)-1: Intangible drilling and development costs in the case of oil and gas wells. (Also Section 612; 1.612-4.)

Capital expenditures; intangible drilling and development costs; offshore platforms. Guidance is provided regarding which costs incurred in the course of fabricating, transporting and installing an offshore oil and gas drilling and production platform and the related facilities and equipment are within the option to expense intangible drilling and development costs provided by section 263(c) of the Code. Rev. Rul. 70-596 modified and superseded.

Rev. Rul. 89-56

ISSUE

Which costs incurred in the course of fabricating, transporting, and installing an offshore oil and gas drilling and production platform and the related facilities and equipment are within the option to expense intangible drilling and development costs provided by section 263(c) of the Internal Revenue Code?

FACTS

The taxpayer, an oil and gas company, determined through exploratory drilling and other methods that there was a substantial likelihood of commercial quantities of oil and gas in a domestic offshore property in which the taxpayer held an operating interest. The taxpayer decided to install an offshore platform in a particular location as a base from which to drill wells, prepare for production, and produce oil and gas. The taxpayer contracted for the fabrication of the three major components of the platform.

The three major components of the particular type of platform constructed for the taxpayer (a "jacket-type" platform) are (1) the deck, which holds the equipment required to drill the well and produce the oil and gas; (2) the support system, which supports the deck and the operating equipment, and which consists of a "jacket" (a framework of cross-braced tubular steel legs); and (3) the anchoring system, which stabilizes and anchors the platform to a fixed site, and which consists of pilings (large tubular members fabricated from steel) that are inserted through the hollow jacket legs and driven into the sea floor.

The platform and its three major components were designed as an integrated unit for a particular well site, taking into consideration the condition of the ocean bed, storm ratings, water depths, tides, wave forces, well spacing, and other factors that affect the number and depth of wells desired and the size and configuration of the components. To the extent the major components were constructed by combining subcomponents also fabricated by the contractor, those subcomponents (such as the tubular jacket members, which were rolled and welded from sheet metal) were also designed and built for use in this specific platform. Once fabricated, neither the platform as a unit, nor the major components or subcomponents of this type of platform, were ordinarily reusable at a different well site without substantial and costly modifications.

The deck, jacket, and pilings were constructed at the contractor's onshore shipyard. The taxpayer provided engineering and design specifications in addition to technical consultations during the construction process. After construction, the platform (in component form) was removed from the shipyard and transported to the well site by barge. These transportation operations were contracted for separately. At the well site the platform was positioned, erected, and anchored to the ocean bed. On the deck of the platform, the taxpayer installed the necessary drilling and production equipment and facilities, some of which were purchased by the taxpayer and some of which were fabricated for the taxpayer by a contractor. Although some of the drilling equipment was designed and intended for use at this specific platform, all of the equipment was capable of being installed or reinstalled at other drill sites without substantial and expensive modifications.

LAW AND ANALYSIS

Section 263(a) of the Code generally provides that no deduction shall be allowed for capital expenditures. Section 263(c) provides that, notwithstanding section 263(a), regulations shall be prescribed that grant the option to deduct as expenses intangible drilling and development costs (IDC) in the case of domestic oil and gas wells.

Section 1.612-4(a) of the Income Tax Regulations describes the expenditures that are included in this IDC option as:

> all expenditures made by an operator for wages, fuel, repairs, hauling, supplies, etc., incident to and necessary for the drilling of wells and the preparation of wells for the production of oil or gas. ... They include the cost to operators of any drilling or development work (excluding ... amounts properly allocable to cost of depreciable property) done for them by contractors under any form of contract, including turnkey contracts. Examples of items to which this option applies are, all amounts paid for labor, fuel, repairs, hauling, and supplies, or any of them, which are used —
>
> (1) In the drilling, shooting, and cleaning of wells,
>
> (2) In such clearing of ground, draining, road making, surveying, and geological works as are necessary in preparation for the drilling of wells, and
>
> (3) In the construction of such derricks, tanks, pipelines, and other physical structures as are necessary for the drilling of wells and the preparation of wells for the production of oil or gas.
>
> In general, this option applies only to expenditures for those drilling and developing items which in themselves do not have a salvage value. For the purpose of this option, labor, fuel, repairs, hauling, supplies, etc., are not considered as having a salvage value, even though used in connection with the installation of physical property which has a salvage value.

Section 1.612-4(c)(1) of the regulations describes the nonoptional items that must be capitalized as:

> expenditures by which the taxpayer acquires tangible property ordinarily considered as having a salvage value. Examples of such items are the costs of the actual materials in those structures which are constructed in the wells and on the property, and the cost of drilling tools, pipe, casing, tubing, tanks, engines, boilers, machines, etc. The option does not apply to any expenditure for wages, fuel, repairs, hauling, supplies, etc., in connection with equipment, facilities, or structures, not incident to or necessary for the drilling of wells, such as structures for storing or treating oil or gas. These are capital items and are returnable through depreciation.

Rev. Rul. 70-596, 1970-2 C.B. 68, considering a situation substantially similar to the situation considered here, concludes that the offshore platform in question was incident to and necessary for the drilling of wells, even though it was useful in connection with subsequent production activities. Rev. Rul. 70-596 holds that the costs of transporting components to the well site and installing the platform are therefore within the scope of the IDC option. Under Rev. Rul. 70-596, however, the costs of fabricating the components onshore (including design costs) must be capitalized. The rationale for this treatment of the fabrication costs is that such a platform is "tangible property ordinarily considered as having a salvage value" within the meaning of section 1.612-4(c)(1) of the regulations. Expenditures relating to its fabrication are thus costs of acquiring depreciable property. Rev. Rul. 70-596 also notes that the IDC option granted by the regulations does not apply to expenditures incurred in connection with equipment, facilities, or structures not incident to or necessary for the drilling of wells, such as the costs of fabricating, transporting, and installing production facilities or equipment. The conclusions in Rev. Rul. 70-596 regarding the costs of transporting and installing offshore drilling platforms, and the costs of fabricating, transporting, and installing offshore production facilities or equipment have not been the subject of litigation. Several courts, however, have considered the proper treatment of the costs of fabricating offshore platforms.

In *Exxon Corp. v. United States,* 547 F.2d 548 (Ct. Cl. 1976), the court considered costs incurred in the fabrication of "templet-type" platforms, which differ from the jacket-type platforms described above in that their supporting structures are made up from standardized templet units. The templets were designed to be salvaged as a unit and reused, with some modification and reconditioning, when the platforms were dismantled. The court held that the costs for labor, fuel, repairs, supplies, and hauling incurred in fabricating the platform, including the costs of fabricating the standardized components, were eligible for the IDC option. Adopting the decision of the trial judge, the court interpreted the regulations as excluding from optional treatment only expenditures for "actual materials"—which, in the court's view, meant only steel beams, pipes, etc.—used to fabricate the platforms.

In *Standard Oil Co. (Indiana) v. Commissioner,* 77 T.C. 349 (1981), the Tax Court considered costs incurred in fabricating jacket-type platforms. Consistent with Rev. Rul. 70-596, the Commissioner took the position that the deck, jacket, and pilings—as units—were salvageable "actual materials," the costs of which must be capitalized under section 1.612-4(c)(1) of the regulations. See 77 T.C. at 391. Citing *Exxon,* the taxpayer argued that the term "actual materials" means only those items purchased by the platform fabricator. See *id.* at 349.

The court held for the taxpayer under a different rationale, formulating a "risk analysis" based on the premise that Congress intended to include within the IDC option expenditures that are "at risk", that is, that ordinarily are economically unrecoverable should the well be dry, whether those expenditures are represented by physical property or not. Conversely, expenditures for items that ordinarily are recoverable are excluded from the option. See 77 T.C. at 396-97. Under this approach, platform design and fabrication costs must be analyzed in terms of the salvageability of the components at each stage of fabrication. Even if the ultimate tangible property, the platform, is not ordinarily considered as having a salvage value, intangible-type costs expended to create a component that is ordinarily considered as having a salvage value are not IDC and must be capitalized. Intangible-type costs expended to integrate salvageable materials or components into a component that is, after integration, not ordinarily considered as having a salvage value are deductible IDC, as are any further intangible-type costs expended to integrate this "first unsalvageable component" into the ultimate tangible property. See *id.* at 399-400.

Applying this approach to the facts in *Standard,* the Tax Court determined that neither the jacket-type platform itself, nor its major components, nor any of the subcomponents above the level of such basic "materials" as angle iron, sheet metal, etc., were property ordinarily considered as having salvage value. See 77 T.C. at 401-404. There was no evidence that any platforms had been salvaged or reused in their entirety at the end of their normal useful lives, and there was evidence of only occasional salvage of platform components or subcomponents. Thus, all the fabrication costs claimed by the taxpayer were deductible as IDC. The court noted, however, that given a factual finding that a platform component, such as the templet in the *Exxon* case, was designed to be and was in fact salvageable, the costs of fabricating that component would not be within the option. See *id.* at 399.

In *Texaco, Inc. v. United States,* 598 F. Supp. 1165 (S.D. Texas 1984), and *Gulf Oil Corp. v. Commissioner,* 87 T.C. 324 (1986), the courts considered several different types of offshore platforms. In each case the courts allowed as IDC the intangible fabrication costs. The district court in *Texaco* adopted the Tax Court's risk analysis (also agreeing with the Tax Court that the costs of standardized components such as the *Exxon* templets would not be eligible for the option). See 598 F. Supp. at 1172. In reaching their decisions, both courts emphasized that each type of platform in question was designed and constructed for use at a specific site and that its components were designed for use in a specific platform. Evidence that a platform or component could hypothetically be reused after substantial modifications, or that particular platforms or components were occasionally salvaged, did not establish that the item was "ordinarily" considered salvageable. See *Texaco,* 598 F. Supp. at 1176-77; *Gulf,* 87 T.C. at 347-348.

In view of these decisions, the Service will no longer follow the holding in Rev. Rul. 70-596 that all expenditures incurred in the onshore fabrication of offshore drilling and production platforms are necessarily ineligible for IDC expense treatment. Instead, each platform will be analyzed separately. Design and fabrication expenditures may be treated as IDC if the evidence shows that the platform in question is incident to and necessary for the drilling of wells (even though subsequently used for production), that the platform is designed and constructed for use at a specific site, and that platforms of that type are not ordinarily reused or otherwise salvaged as a unit. To be considered site-specific, a platform must not ordinarily be usable at another site without extensive modifications. Design and fabrication expenditures are not disqualified by evidence that a type of platform could hypothetically be reused (with substantial modification and expense), or by evidence that platforms of that type have occasionally been salvaged in extraordinary circumstances.

If, following this approach, a given platform is determined to be unsalvageable, the same analysis will be applied to its structural components and subcomponents. In other words, the intangible-type costs of fabricating such items qualify for the IDC option if the type of component or subcomponent in question is designed for permanent use at a specific site in a specific platform structure and is not ordinarily used or useable at another site without extensive modifications. The Service will not follow the *Exxon* case to the extent that case holds that costs incurred in the fabrication of a standardized, reusable structural component such as a templet are eligible for IDC treatment. The costs of fabricating such an item must be capitalized, although additional costs incurred to integrate that item into a specific structure may qualify as IDC.

Several restrictions on the scope of the IDC option as it relates to offshore operations should be noted. First, without regard to salvageability, the option to expense IDC is not available for the costs of items acquired by purchase. The regulations authorize optional treatment only for those intangible costs that are incurred directly by an operator or indirectly by an operator who hires a contractor; they do "not permit an operator to look behind a mere purchase ... of materials and claim IDC treatment for intangible costs that his supplier may have incurred in manufacturing those materials ...." *Texaco*, 598 F. Supp. at 1171, n.10.

Second, costs of fabricating drilling equipment, machinery, and similar items installed on offshore platforms are not eligible for the IDC option, whether they are acquired through purchase, contract, or self-construction. Section 1.612-4(c)-(1) of the regulations denies optional treatment not only to "actual materials" used in construction, but also to the cost of acquiring such items as drilling tools, casing, engines, boilers, machines, etc. Although in a given case such items may be intended for permanent use at a specific site and may in fact have no salvage value at the end of their useful lives, as a class they are not site-specific and can ordinarily be used or reused at another site without significant and expensive modification. *Cf. Harper Oil Co. v. United States*, 425 F.2d 1335 (10th Cir. 1970) (costs of surface casing are not within the option even though the casing could not be removed under Oklahoma law and had no salvage value). Thus, costs related to the manufacture of such items, even though necessary for drilling, are not subject to the IDC option, although costs incurred in transporting them to the well site and installing them on the platform remain eligible.

Third, the IDC option applies only to costs that are both incident to and necessary for drilling or development. Expenditures excluded from optional treatment on this basis would include costs relating to a platform that is not incident to and necessary for drilling, as well as costs relating to production structures, facilities, and equipment, such as service facilities for production personnel, pumping equipment, flow lines, separators, storage tanks, treating equipment, salt water disposal equipment, etc. *See* Rev. Rul. 70-414, 1970-2 C.B. 132.

Fourth, the option to expense IDC does not apply to IDC paid or incurred after December 31, 1986, in tax years ending after that date, with respect to wells (other than nonproductive wells) located outside the United States. Section 263(i) of the Code. *See also* Rev. Rul. 87-134, 1987-2 C.B. 69.

HOLDING

The taxpayer's platform is incident to and necessary for drilling. This type of platform, and the structural components and subcomponents integrated into the platform, are designed for permanent installation at a specific site and are not ordinarily reused or otherwise salvaged. Accordingly, they are not tangible property ordinarily considered as having a salvage value, and all the expenditures incurred in design and fabrication, as well as the transportation and installation costs, are within the option to expense intangible drilling and development costs under section 263(c) of the Code.

The drilling equipment and machinery installed on the platform is all property of a type that is ordinarily considered as having a salvage value. Therefore, the costs of fabrication (including related design costs) must be capitalized regardless of whether the items were acquired through purchase, under contract, or by self-construction. Costs of transporting and installing the machinery and equipment, however, remain within the option.

The costs incurred in fabricating, transporting and installing production facilities and equipment are not within the option and must be capitalized.

EFFECT ON OTHER DOCUMENTS

Rev. Rul. 70-596 is modified and superseded.

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

26 CFR 1.263A-1T: Capitalization and inclusion in inventory costs of certain expenses.
(Also Sections 162, 165, 167, 177, 263, 446; 1.162-1(a), 1.165-2(a), 1.167(a)-3, 1.177-1(b), 1.263(a)-2, 1.446-1.)

Inventories; package design costs. Expenditures incurred after December 31, 1986, in connection with the development and design of product packages must be capitalized under section 263A of the Code. Expenditures incurred prior to January 1, 1987, in connection with the development and design of product packages must be capitalized under section 263. In general, the cost of package designs may not be amortized under section 1.167(a)-3 of the regulations because their useful lives cannot be ascertained.

Rev. Rul. 89-23

ISSUES

(1) If expenditures are incurred after December 31, 1986, in connection with the development and design of product packages, are those expenditures deductible as ordinary and necessary business expenses under section 162(a) of the Internal Revenue Code in the tax year in which the expenditures are incurred, or must they be capitalized under section 263A of the Code? If expenses are incurred prior to January 1, 1987, must they be capitalized under section 263?

(2) If such expenditures must be capitalized under section 263 or section 263A of the Code, are they amortizable under section 1.167(a)-3 of the Income Tax Regulations?

FACTS

Corporation *X* is a domestic corporation that manufactures and markets consumer goods at retail. *X* files its federal income tax returns on a calendar year basis using an accrual method of accounting.

During 1986 and 1987, *X* introduced three new products. *X* incurred package design costs for each new product. Although the useful life of each package design could not be ascertained at the time it was placed in service, the useful life of each package design was more than one year.

The term "package design", as used in this revenue ruling, means an asset that is created by a specific graphic arrangement or design of shapes, colors, words, pictures, lettering, and so forth on a given product package, or the design of a container with respect to its shape or function.

The term "package design cost", as used in this revenue ruling, means the cost of package designs. 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, 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, 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. (*See also* section 1.263A-1T(a)(5)(ii) of the regulations that treats a taxpayer purchasing a package design as also producing such design to the extent the taxpayer incurs costs with respect to the design). The term, however, does not include costs associated with coupon inserts, refund offers, and other promotion-related changes, nor does it include costs that are unrelated to the package design itself, such as a change to the list of ingredients. Moreover, the term does not include costs that would have qualified as "trademark or trade name expenditures" under section 177 of the Internal Revenue Code of 1954 (the 1954 Code); such costs must be capitalized and recovered on a disposition of the asset.

In 1988, all three products were still currently marketed by *X* using the 1986 and 1987 package designs.

LAW AND ANALYSIS

Section 162 of the Code provides that there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the tax year in carrying on a trade or business. Section 1.162-1(a) of the regulations provides that among the items included in business expenses are advertising and other selling expenses.

Section 263A of the Code and the regulations thereunder provide for the capitalization of certain direct and indirect costs with respect to real or tangible personal property produced by the taxpayer and certain property acquired for resale. Section 263A was enacted by the 1986 Act, section 803(a), 1986-3 (Vol. 1) C.B. 267. In general, section 263A is effective for costs incurred after December 31, 1986; in the case of property that is inventory in the hands of the taxpayer, the section is generally effective for tax years beginning after that date.

Section 1.263A-1T of the temporary Income Tax Regulations provides that all costs that directly benefit or are incurred by reason of the production of real or tangible personal property, or property that is acquired for resale, are to be capitalized with respect to that property. *See* section 1.263A-1T(b)(2)(iii), which provides examples of indirect costs that must be capitalized with respect to production or resale activities. *See also* section 1.263A-1T(b)(2)(iv), which provides generally that interest on debt incurred or continued to finance the production of real or tangible personal property to which such section otherwise applies must be capitalized.

Section 1.263A-1T(a)(5)(ii) states that the term "produce" includes construct, build, install, manufacture, develop, improve, create, raise or grow. Although section 263A of the Code does not require the costs of producing intangible personal property to be capitalized, section 263A(b) defines tangible personal property to include a film, sound recording, video tape, book, or similar property. For this purpose, tangible personal property includes property embodying words, ideas, concepts, images, or sounds. See section 1.263A-1T(a)(5)(iii) of the temporary regulations; see also 2 H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. II-308 (1986), 1986-3 (Vol. 4) C.B. 308. Moreover, section 1.263A-1T(a)(5)(iii) applies to the production of "tangible personal property" within the meaning of that provision without regard to whether that property is treated as tangible or intangible under other provisions of the Code. Thus, the requirements of section 1.263A-1T(a)(5)(iii) apply to the costs of the properties enumerated therein, although those costs may consist of copyrights, licenses, manuscripts, and other items that may be treated as intangible for other purposes of the Code.

Section 1.263A-1T(b)(4)(x) of the temporary regulations, in illustrating required allocations of administrative, service, and support costs to various activities, provides that the costs of engineering and design services are to be so allocated. *See also* section 1.263A-1T(b)(2)(iii)(S), which provides that engineering and design expenses (to the extent that such amounts are not research and experimental expenses as described in section 174 and the regulations thereunder) are indirect costs that must be capitalized with respect to production and resale activities.

If a taxpayer purchases a package design from another person after December 31, 1986, section 1.263A-1T(a)(5)-(ii) of the temporary regulations treats the taxpayer as producing the package design to the extent that the taxpayer incurs costs (*e.g.*, general and administrative costs, interest, etc.) with respect to the package design. The taxpayer must capitalize these costs, in addition to capitalizing the purchase price of the package design, as part of the total package design expenditures.

The above provisions of the Code and the temporary regulations require that expenses incurred after December 31, 1986, in connection with the development and design, or purchase, of product packages must be capitalized under section 263A of the Code for tax years ending after such date. On the other hand, for tax years not covered by section 263A and section 1.263A-1T of the temporary regulations, a similar result is required by section 263 and the regulations thereunder.

Section 263(a) of the Code provides that no deduction shall be allowed for any amount paid for permanent improvements made to increase the value of any property or estate. Section 1.263(a)-2 of the regulations provides examples of capital expenditures and includes the costs of acquiring property having a useful life substantially beyond the taxable year.

Section 167 of the Code 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 the trade or business. Section 1.167(a)-3 of the regulations provides that if an intangible asset is known from experience or other factors to be of use in the business or in the production of income for only a limited period, the length of which can be estimated with reasonable accuracy, such an intangible asset may be the subject of a depreciation allowance. If the useful life is not limited, no depreciation is allowed. No allowance is permitted based upon the unsupported opinion of the taxpayer that the asset has a limited useful life.

Section 165(a) of the Code provides that there shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise. Section 1.165-2(a) of the regulations provides that a loss incurred in a business or a transaction entered into for profit and arising from the sudden termination of the usefulness in such business or transaction of any nondepreciable property, in a case in which such business or transaction is discontinued or when such property is permanently discarded from use therein, shall be allowed as a deduction under section 165(a) for the taxable year in which the loss is actually sustained. For this purpose, the tax year in which the loss is sustained is not necessarily the tax year in which the overt act of abandonment, or the loss of title to the property, occurs.

An expenditure generally must be capitalized under section 263 of the Code if the expenditure creates, enhances, or is part of the cost of acquiring a tangible or intangible asset with a useful life greater than one year. *See Commissioner v. Lincoln Savings and Loan Association*, 403 U.S. 345 (1971), 1971-2 C.B. 116; *Cen-*

tral 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). Because package designs generally have useful lives greater than one year, package design costs generally must be capitalized under section 263. For these purposes, it is irrelevant whether a package design was created in-house, was created by an independent contractor, or was purchased from a third party that produced it.

Advertising expenditures, which are distinguishable from package design costs, are currently deductible either because they are of a recurring nature or because their benefit does not extend beyond the tax year. *See Davee v. United States*, 444 F.2d 551 (Ct. Cl. 1971). In contrast, package design costs more closely resemble nonrecurring promotional or advertising expenditures that result in benefits to the taxpayer which extend beyond the year in which the expenditures are incurred; such expenditures are a capital investment and are not currently deductible. *See Alabama Coca-Cola Bottling Company*, T.C.M. 1969-123. *See also*, *Cleveland Electric Illuminating Company v. United States*, 7 Cl. Ct. 220 (1985), which held that advertising to lessen the public's fear of nuclear plants had to be capitalized.

X incurred certain costs in its 1986 and 1987 tax years to develop the package designs for three new products. Because these same three package designs will be used by *X* to generate income in its business for an indeterminate number of future years, no amortization or depreciation is allowable under section 167 of the Code and section 1.167(a)-3 of the regulations. Only when a particular package design is abandoned by *X* may the accumulated costs be deducted. *See* section 165 of the Code and section 1.165-2(a) of the regulations.

HOLDINGS

(1) Expenditures incurred by *X* after December 31, 1986, in connection with the development and design of its product packages must be capitalized under section 263A of the Code. *X*'s package design expenditures incurred prior to January 1, 1987, must be capitalized pursuant to section 263 of the Code and the regulations thereunder.

(2) *X*'s package design costs are not amortizable under section 1.167(a)-3 of the Income Tax Regulations. See, however, Rev. Proc. 89-17, page 827, this Bulletin, which allows a taxpayer to elect a deemed 60-month useful life for certain package designs.

APPLICATION

Any change in a taxpayer's method of accounting from the current expensing of package design costs to the method of capitalizing such costs described in the holding of this revenue ruling is a change in method of accounting to which sections 446 and 481 of the Code and regulations thereunder apply. See Rev. Proc. 89-16, page 822, this Bulletin, which provides additional guidance to taxpayers regarding the change in method of accounting with respect to package design costs.

This ruling is identified as a designated ruling pursuant to section 5.12(2) of Rev. Proc. 84-74, 1984-2 C.B. 736, 745.

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26 CFR 1.263A-1T: Capitalization and inclusion in inventory costs of certain expenses.

Inventories; gross receipts exception. Retailers and wholesalers with annual gross receipts of less than $10 million are exempt from the capitalization rules of section 263A of the Code. Gross receipts from all businesses of the taxpayer are included in the computation for purposes of the $10 million test.

Rev. Rul. 89-26

ISSUE

If a taxpayer's average annual gross receipts from all of its businesses exceed $10,000,000 but its average annual gross receipts from the sale of personal property acquired for resale do not, is the taxpayer subject to the uniform capitalization rules under section 263A of the Internal Revenue Code?

FACTS

X corporation is primarily engaged in the performance of credit reporting services, collection services, and data processing services. As a convenience to its customers, *X* sells and repairs data-terminal equipment that is used to gain access to *X*'s credit history data base. *X* does not manufacture the data terminals but purchases them from an unrelated entity and resells them to *X*'s customers.

For the three tax years preceding the current tax year, *X* had average annual gross receipts of $42,000,000. Of these gross receipts, the average annual gross receipts from the sale of data-terminal equipment was $4,000,000.

LAW AND ANALYSIS

Section 263A(a) of the Code provides that in the case of property to which section 263A applies and which is inventory in the hands of the taxpayer, certain specified direct and allocable indirect costs must be included in inventory costs.

Section 263A(b)(2)(A) of the Code provides that, in general, section 263A applies to real or personal property described in section 1221(1) that is acquired by the taxpayer for resale. Section 1221(1) property is stock in trade or other property of a kind properly includable in inventory or property held primarily for sale to customers in the ordinary course of a trade or business.

Section 263A(b)(2)(B) of the Code provides, however, that section 263A(b)-(2)(A) does not apply to any personal property acquired during any tax year by the taxpayer for resale if the average annual gross receipts of the taxpayer (or any predecessor) for the 3-tax year period ending with the tax year preceding the year of acquisition do not exceed $10,000,000.

Section 1.263A-1T(d)(2)(iv)(A) of the temporary Income Tax Regulations provides that the term "gross receipts" means the total amount, as determined under the taxpayer's method of accounting, received from all trades or businesses carried on by the taxpayer (e.g., revenue derived from the sale of inventory before reduction for cost of goods sold).

In determining whether the exception contained in section 263A(b)(2)(B) of the Code applies, section 1.263A-1T(d)-(2)(iv)(A) of the temporary regulations requires that receipts from all of a taxpayer's trades or businesses be included in gross receipts. The parenthetical reference to "revenue derived from the sale of inventory" in this section is an example intended to demonstrate that, for purposes of applying the exception, gross receipts are not reduced by such basis items as cost of goods sold; it does not restrict "gross receipts" to receipts from sales of inventory, or sales of property in general.

X's average annual gross receipts from all of its trades or businesses for the three tax years preceding the current tax year exceed $10,000,000. Accordingly, the gross receipts exception, set forth in section 263A(b)(2)(B) of the Code and the temporary regulations under that provision, does not apply, and *X* is subject to the provisions of section 263A with respect to its data terminal inventory acquired for resale. This result is not changed by either the fact that *X* is principally engaged in providing services or the fact that the average annual gross receipts from the sale of data-terminal inventory, alone, do not exceed $10,000,000.

HOLDING

A taxpayer is required to include certain costs in its inventory costs under section 263A of the Code if its average annual gross receipts from all of its businesses exceed $10,000,000 even though its average annual gross receipts from the sale of personal property acquired for resale do not exceed $10,000,000.

An optional simplified method of accounting for resale costs is provided in section 1.263A-1T(d)(3) of the temporary regulations.

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26 CFR 1.263A-1T: Capitalization and inclusion in inventory costs of certain expenses.

A procedure is provided for certain taxpayers to obtain expeditious consent from the Commissioner to change their method of accounting for package design costs to a capitalization method in accordance with Rev. Rul. 89-23. See Rev. Proc. 89-16, page 822.

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26 CFR 1.263A-1T: Capitalization and inclusion in inventory costs of certain expenses.

Taxpayers that incur package design costs are allowed to deem the useful lives of certain packages designs to be 60 months. See Rev. Proc. 89-17, page 827.

Section 265.—Expenses and Interest Relating to Tax-Exempt Income

Qualified tax-exempt obligations; draw-down note. A draw-down note is considered issued, for purposes of section 265(b) of the Code, on the date that more than a *de minimis* amount is first advanced under the note. The amount of the draw-down note is its stated principal amount.

Rev. Rul. 89-70

ISSUES

(1) For purposes of section 265(b) of the Internal Revenue Code, what is the date of issue of a draw-down note?

(2) For purposes of section 265(b), what is the amount of a draw-down note?

FACTS

X is a financial institution described in section 265(b)(5) of the Code. In November 1987, *X* entered into a construction loan agreement with city *CI* pursuant to which *X* agreed to provide the financing for construction of a new facility. At the closing of the loan agreement, *CI* executed and delivered to *X* its note, the interest on which is exempt from federal income tax under section 103 of the Code. *CI* intends to designate the note as a "qualified tax-exempt obligation" within the meaning of section 265(b)(3) of the Code.

Under the terms of the note, *X* agrees to honor requests by *CI* for draw-down advances on an as-needed basis. The note provides for a rate of interest that applies to all advances under the note. Interest accrues from the time amounts are advanced.

The total amount of the advances to *CI* cannot exceed the stated principal amount of the note. All advances under the note are secured by the same collateral and are repayable from substantially the same source of funds.

In January 1988, *CI* received the first significant advance under the note.

LAW AND ANALYSIS

Section 265(b)(1) of the Code provides the general rule that, in the case of a financial institution, no deduction shall be allowed for that portion of a taxpayer's interest expense that is allocable to tax-exempt interest income.

Section 265(b)(2) provides that the portion of interest expense that is allocable to tax-exempt interest income is that amount that bears the same ratio to such interest expense as the taxpayer's average adjusted bases of tax-exempt obligations acquired after August 7, 1986, bears to the average adjusted bases of all assets of the taxpayer.

Section 265(b)(3) of the Code provides that qualified tax-exempt obligations will be treated as if they were acquired on August 7, 1986. A qualified tax-exempt obligation is a tax-exempt obligation that (1) is issued after August 7, 1986, by a qualified small issuer, (2) is not a private activity bond (as defined in section 141), and (3) is designated by the issuer for purposes of section 265(b)(3).

Sections 265(b)(3)(C) and (D) of the Code impose volume limitations on the issuers of qualified tax-exempt obligations. Under section 265(b)(3)(C), a "qualified small issuer" means any issuer that reasonably anticipates that the amount of tax-exempt obligations (other than certain obligations described in section 265(b)(3)(C)(ii)) that it will issue during the calendar year will not exceed $10,000,000. In addition, section 265(b)(3)(D) provides that not more than $10,000,000 of the obligations issued by an issuer during any calendar year may be designated by the issuer for purposes of section 265(b)(3).

Section 265(b)(4)(B) of the Code provides that the term "tax-exempt obligation" means any obligation the interest on which is wholly exempt from federal income tax.

Section 103(a) of the Code provides that, except as provided in section 103(b), gross income does not include interest on any state or local bond.

The exception in section 265(b)(3) of the Code for qualified tax-exempt obligations is intended to reduce the extent to which section 265(b) increases the borrowing costs of smaller localities that depend on local financial institutions for financing bona fide governmental projects. H.R. Rep. No. 426, 99th Cong., 1st Sess. 589 (1985), 1986-3 (Vol. 2) C.B. 589. The volume limitations of sections 265(b)(3)(C) and (D) are intended to limit the benefit of the exception to small governmental units.

Although the regulations under section 265 of the Code do not address the volume limitations of sections 265(b)(3)(C) and (D), these limitations may be construed in light of regulations under related sections of the Code that affect the issuance of tax-exempt obligations. Generally, for purposes of determining whether a debt is a tax-exempt obligation, these other regulations provide that a loan agreement providing for periodic advances is treated as a single issue the date of issue of which is the first date on which more than a *de minimis* amount of loan proceeds is advanced. Sections 1.103-13(b)(6) and 1.103-13(b)(10) of the Income Tax Regulations; section 1.103-7(a) of the regulations; section 1.103-15AT(b)(8) of the temporary Income Tax Regulations.

In the present situation, *CI* obtained a commitment from *X* for funding in an amount equal to the stated principal amount of the note. Each advance received by *CI* pursuant to the note is part of a single, integrated financing arrangement under which all advances are subject to the same interest rate. The total amount borrowed is secured by the same collateral and repayable from substantially the same source of funds.

Accordingly, for purposes of section 265(b) of the Code, the advances under the draw-down note are advances made under a single obligation that is issued on the date on which more than a *de minimis* amount of funds is first advanced. The amount of the obligation is the maximum amount that can be advanced under the note.

Therefore, for purposes of section 265(b)(3)(C) of the Code, *CI* includes the stated principal amount of the note in determining the amount of obligations it reasonably anticipates issuing during 1988. Furthermore, in designating tax-exempt obligations as qualified tax-exempt obligations under section 265-(b)(3), *CI* treats the note as issued in 1988 in an amount equal to its stated principal amount.

The determination of the amount of a draw-down note in the manner described above applies only with respect to the issuers of the tax-exempt obligations. Thus, it does not affect the computation of a financial institution's adjusted basis in such a note for purposes of section 265(b)(2) of the Code.

HOLDINGS

(1) For purposes of section 265(b) of the Code, the date of issue of the draw-down note is the date on which more than a *de minimis* amount of funds is first advanced under the note.

(2) For purposes of section 265(b)(3), the amount of the draw-down note is the stated principal amount of the note.

Section 280A.—Disallowance of Certain Expenses in Connection with Business Use of Home, Rental of Vacation Homes, Etc.

(Also Section 170; 26 CFR 1.170A-1, 1.170A-7.)

Business expenses; rental of vacation home. The right to use a vacation home for one week, donated by the owner to a charitable fund-raising auction and sold for fair rental value, is counted as one week of personal use by the owner in determining the owner's right to deduct expenses.

Rev. Rul. 89-51

ISSUE

If the owner of a vacation home donates a week's use of the home to a charity auction, is the use of the home by the successful bidder deemed personal use by the owner under section 280A(d) of the Internal Revenue Code?

FACTS

A, an individual, owns a vacation home that is a dwelling unit under section 280A(f)(1). *A* rented the home to individuals unrelated to *A* for 80 days during 1988 at fair rental value. *A* occupied the home for 14 days during the year for personal purposes.

In 1988 *A* donated to charity *X* a 1-week right of occupancy in the property, for disposition at *X*'s fund-raising auction. At the auction, *B* was the highest bidder and paid *X* an amount that represented fair rental. *B* occupied the property for one week during that year.

LAW AND ANALYSIS

Section 280A(a) of the Code generally disallows business deductions for an individual with respect to the use of a dwelling unit which is used by the individual during the taxable year as a residence.

Section 280(c)(3) of the Code provides that section 280A(a) shall not apply to an item attributable to the rental of the dwelling unit. This exemption is subject to the gross income limitation of section 280A(c)(5).

Section 280A(d) of the Code provides that a taxpayer uses a dwelling unit during a tax year as a residence if the taxpayer uses the unit for personal purposes for a number of days that exceeds the greater of 14 days or 10 percent of the number of days during the year for which the unit is rented at fair rental. Section 280A(d)(2)(C) provides that a taxpayer is deemed to have used a dwelling unit for personal purposes for a day if, for any part of such day, the unit is used by any individual, unless for such day the dwelling unit is rented for a rental which, under the facts and circumstances, is fair rental.

Congress enacted section 280A of the Code to provide objective standards for the allocation of expenses attributable to a residence between personal and business use. *See* H.R. Rep. No. 658, 94th Cong., 1st Sess. 164 (1975), 1976-3 (Vol. 2) C.B. 695, 856. Under section 280A(d)(2)(C), the use of a dwelling unit by any individual is generally attributed to the owner and treated as personal use by the owner. *B*'s use of *A*'s vacation home is use by an individual under section 280A(d)(2)(C) of the Code and is deemed personal use by *A*.

Section 280A(d)(2)(C) excepts from its application use by any individual on a day on which the unit is rented for fair rental value. The purpose of that rental exception is to prevent a taxpayer's business use of a dwelling unit from being counted as personal use. The donation of the use of a dwelling unit for charitable purposes is not business use by a taxpayer. Thus even though the amount *B* paid to *X* equalled fair rental for the home, *B*'s use did not fall within the fair rental exception to the attribution rule of section 280A(d)(2)(C). Similarly, *B*'s payment to *X* could not be fair rental under the rule for attributing expenses to rental under section 280A(e)(1).

A used the dwelling unit as a residence during 1988 because the sum of the days *A* personally occupied the dwelling unit (14 days) and the days for which *A* is deemed to have used the property (7 days) is 21 days, which exceeds the greater of 14 days or 10 per cent of the number of days (80 days) during the year for which the unit was rented at fair rental (8 days).

Neither A nor B is entitled to a charitable contribution deduction. The gift of the right to use property is not a deductible contribution. Income Tax Regulations section 1.170A-7(a)(1). A payment to a charity is not a contribution to the extent that valuable consideration is received in return. Revenue Ruling 67-246, 1967-2 C.B. 104.

HOLDING

For purposes of section 280A(d) of the Code, the one week occupancy of the dwelling unit by *B* constitutes personal use of the unit by *A*, the owner, who had donated the right of occupancy to charity *X*. Because *A* used the unit as a residence during the taxable year, *A*'s deductions with respect to the dwelling unit are subject to the gross income limitation of section 280A(c)(5).

Section 280G.—Golden Parachute Payments

Federal short-term, mid-term, and long-term rates are set forth for the month of January 1989. See Rev. Rul. 89-1, page 260.

Federal short-term, mid-term, and long-term rates are set forth for the month of February 1989. See Rev. Rul. 89-15, page 262.

Federal short-term, mid-term, and long-term rates are set forth for the month of March 1989. See Rev. Rul. 89-34, page 263.

Section 280G

Federal short-term, mid-term, and long-term rates are set forth for the month of April 1989. See Rev. Rul. 89-39, page 264.

Federal short-term, mid-term, and long-term rates are set forth for the month of May 1989. See Rev. Rul. 89-65, page 265.

Federal short-term, mid-term, and long-term rates are set forth for the month of June 1989. See Rev. Rul. 89-77, page 266.

Subchapter C.—Corporate Distributions and Adjustments
Part I.—Distributions by Corporations
Subpart A.—Effects on Recipients

Section 302.—Distributions in Redemption of Stock

26 CFR 1.302-1: General.

When a redeemed shareholder receives an option to repurchase the redeemed stock, the receipt of the option prevents the redemption from meeting the requirements of section 302(b)(2) of the Code because the optioned stock is attributable to the redeemed shareholder under section 318(a)(4), even though the option is only exercisable after a period of time has elapsed. See Rev. Rul. 89-64, page 91.

Section 304.—Redemption Through Use of Related Corporations

26 CFR 1.304-2: Acquisition by related corporation (other than subsidiary).

Redemption; related corporation; control, value test in the aggregate. In determining whether the control requirement of section 304(a)(1)(A) of the Code is met the value test of section 304(c)(1) is not applied class-by-class but, instead, is applied to the aggregate of all classes of a corporation's stock.

Rev. Rul. 89-57

ISSUE

If a person owns 50 percent or more of the aggregate value of all the stock of a corporation but owns less than 50 percent of one of the classes of the corporation's stock, is the person in control of the corporation for purposes of section 304(c)(1) of the Internal Revenue Code?

FACTS

I owned all of the outstanding stock of corporation *Y*.

I and *C*, a person not related to *I*, together owned all the outstanding stock of corporation *X*. *I* owned the *X* Class B stock (44 shares) and *C* owned the *X* Class A stock (45 shares). The fair market value of the 44 shares of *X* Class B stock held by *I* was 30*x* dollars, and the fair market value of the 45 shares of *X* Class A stock held by *C* was 20*x* dollars. Thus, *I* owned 60 percent (30/50) of the aggregate fair market value of the *X* stock outstanding. The Class A stock and the Class B stock each had one vote per share. Thus, *I* held less than 50 percent of the vote in *X* (44/89). The difference in value between the Class A stock and the Class B stock was due to differences in dividend and liquidation rights.

Y purchased *I*'s *X* stock for 30*x* dollars cash, the stock's fair market value.

LAW AND ANALYSIS

Section 304(a)(1) of the Code deals with acquisitions of stock between commonly controlled corporations other than those in a parent-subsidiary relationship. Section 304(a)(1) provides that, for purposes of section 302, if a person is in control of each of two corporations and, in return for property, one of the corporations (the acquiring corporation) acquires stock in the other corporation (the issuing corporation) from that person, then the property is treated as a distribution in redemption of the stock of the acquiring corporation.

Section 304(c)(1) of the Code provides that control, for purposes of section 304, means the ownership of stock possessing either at least 50 percent of the total combined voting power of all classes of stock entitled to vote (the voting power test), or at least 50 percent of the total value of shares of all classes of stock (the value test).

Under section 317(a) of the Code, money is property for purposes of section 304(a)(1). Because *I* received money from *Y* in exchange for stock in *X*, *I*'s receipt of the money is subject to the provisions of section 304(a)(1) if *I* was in control of both *X* and *Y* within the meaning of section 304(c)(1).

I was in control of *Y* because *I* owned all of the outstanding *Y* stock immediately before the transaction.

Because *I* owned stock in *X* possessing only 44 votes out of a total of 89 votes, *I* did not satisfy the voting power test of section 304(c)(1) of the Code. If the value test of section 304(c)(1) is determined in an aggregate manner, then *I* was in control of *X* because *I* owned 60 percent of the total value of the *X* stock outstanding. If, however, the value test is determined in a class-by-class manner, then *I* was not in control of *X* because *I* did not own any of the *X* Class A stock.

The fact that the statute bases the value test of section 304(c)(1) of the Code on the total value of shares implies that the test is applied in an aggregate manner rather than in a class-by-class manner. *See* Rev. Rul. 87-88, 1987-2 C.B. 81 (concluding that if a corporation has more than one class of common stock outstanding, the provisions of section 302(b)(2)(C) are applied in an aggregate manner and not in a class-by-class manner). Moreover, construing the value test as involving a class-by-class approach would render that test meaningless. Under such a construction, the value test could be satisfied only when the voting power test is also satisfied. Thus, control would exist if, and only if, the voting power test is met. Therefore, for purposes of section 304(c)(1), the determination of the total value of the *X* stock must be made by aggregating all of the outstanding classes of *X* stock.

HOLDING

Because *I* owned *X* Class B stock having a value of at least 50 percent of the total value of all of the outstanding *X* stock, *I* is in control of *X* for purposes of section 304(c)(1) of the Code, even though *I* owned none of the *X* Class A stock.

Under section 304(a) and (b) of the Code, the 30*x* dollars *I* received from *Y* is treated as a distribution in redemption of stock in *Y*, and this redemption is tested under section 302(b) by reference to the stock of *X*. Under sections 304(b)(1) and 318(a)(2)(C), *I*'s equity interest in *X* is not decreased and, therefore, paragraphs (1), (2), and (3) of section 302(b) do not apply. Accordingly, this deemed redemption is described in section 302(d), and not section 302(a).

Section 306.—Dispositions of Certain Stock

26 CFR 1.306-2: Exceptions.

Section 306 stock; transactions not in avoidance. The fact that section 306 stock is widely held is in itself not sufficient grounds for relief under section 306(b)(4). Rev. Ruls. 56-116, 57-103 and 57-212 revoked.

Rev. Rul. 89-63

The Internal Revenue Service has reconsidered Rev. Rul. 56-116, 1956-1 C.B. 164, Rev. Rul. 57-103, 1957-1 C.B. 113, and Rev. Rul. 57-212, 1957-1 C.B. 114. In each of these rulings, certain preferred stock that qualified as section 306 stock within the meaning of section 306(c)(1)(B) of the Internal Revenue Code was held to fall within the exception provided by section 306(b)(4), which renders the provisions of section 306(a) inapplicable. Those revenue rulings are hereby revoked.

LAW AND ANALYSIS

Section 306(a) of the Code concerns the treatment of the amount realized on the disposition or redemption of section 306 stock (as defined in section 306(c)). Section 306(b)(4) provides in part that section 306(a) shall not apply if it is established to the satisfaction of the Secretary that the distribution and the disposition or redemption of the section 306 stock was not in pursuance of a plan having as one of its principal purposes the avoidance of federal income tax.

In Rev. Rul. 56-116, two widely held corporations, *X* and *Y*, were merged in a reorganization qualifying under section 368(a)(1)(A) of the Code. In the merger, both preferred and common stock of *X* were issued in exchange for the common stock of *Y*. There was a business reason for issuing both preferred and common stock of *X* in exchange for the *Y* common stock. The management of *X* had no intention of redeeming any of the preferred stock issued in connection with the merger, except as required under the provisions of purchase fund and sinking fund agreements.

That ruling holds that the *X* preferred stock issued in connection with the merger is section 306 stock, but it concludes without full explanation that section 306(a)(1) of the Code does not apply to the proceeds of the disposition of such stock, unless the disposition is in anticipation of redemption.

In Rev. Rul. 57-103, 1957-1 C.B. 113, a publicly held corporation acquired all the assets of a closely held corporation with only common stock outstanding in return for voting preferred stock and common stock, constituting 5 percent of the acquiring corporation's outstanding stock, in a reorganization described in section 368(a)(1)(C) of the Code.

Although the preferred stock issued in the reorganization constituted section 306 stock, as defined in section 306(c)(1)(B) of the Code, that ruling holds, citing Rev. Rul. 56-116, that the issuance of such stock was not in pursuance of a plan having as one of its principal purposes the avoidance of federal income tax within the meaning of section 306(b)(4).

In Rev. Rul. 57-212, 1957-1 C.B. 114, publicly held corporation *B* was merged into publicly held corporation *C* in a reorganization described in section 368(a)(1)(A) of the Code. Each share of *B* common stock (the only class of *B* stock outstanding) was converted into one share of first preferred stock, one-half share of second preferred stock, and three shares of common stock of *C*. All three classes of *C* stock were widely held and traded on the New York Stock Exchange. Pursuant to the provisions of a sinking fund, so long as any of the shares of first preferred stock were outstanding, *C* was required to redeem 3 percent of the outstanding first preferred shares annually.

Rev. Rul. 57-212 reasons that Rev. Rul. 56-116 stands for the proposition that section 306(b)(4) of the Code provides relief from section 306(a)(1) on the disposition of section 306 stock issued by a widely held corporation unless the disposition was in anticipation of redemption. The ruling then considers whether the sinking fund provisions precluded relief under section 306(b)(4) from the operation of section 306(a)(2). It holds that the distribution of the first preferred stock and the subsequent redemption of portions thereof under the sinking fund provisions were not in pursuance of a plan having as one of its principal purposes the avoidance of federal income tax within the meaning of section 306(b)(4). The ruling also states in summary that the provisions of section 306(a)(1) are not applicable to the proceeds of a sale of such shares (whether or not in anticipation of a redemption through the operation of the sinking fund), and the provisions of section 306(a)(2) are not applicable to amounts distributed by *C* in redemption of such first preferred shares to meet the requirements of its sinking fund provisions.

Upon reconsideration, the Service has concluded that the fact that the section 306 stock is issued by a corporation whose stock is widely held is not sufficient grounds for the application of section 306(b)(4) of the Code. Thus, in such circumstances, relief from the provisions of section 306(a) should not be automatic. Although Rev. Rul. 56-116 does not support its application of section 306(b)(4) by specifically relying on the fact that the section 306 stock was issued by a widely held corporation, Rev. Rul. 56-116 was cited in both Rev. Ruls. 57-103 and 57-212 for that proposition. Both Rev. Ruls. 57-103 and 57-212 use that proposition to support their holdings. Because these rulings conflict with the conclusion that the widely held nature of the issuing corporation's stock is not sufficient grounds for the application of section 306(b)(4), they are revoked.

EFFECT ON OTHER RULINGS

Rev. Ruls. 56-116, 57-103, and 57-212 are revoked.

PROSPECTIVE APPLICATION

Pursuant to the authority contained in section 7805(b) of the Code, the conclusion of this revenue ruling will not be applied adversely to taxpayers who treat transactions in accordance with the position set forth in Rev. Ruls. 56-116, 57-103, 57-212 in the case of stock either issued before May 1, 1989, date of publication of this revenue ruling in the Internal Revenue Bulletin, or issued after that date pursuant to the terms of a plan of reorganization which was adopted before that date and the terms of which remained in effect at all times until that date.

Subpart C.—Definitions: Constructive Ownership of Stock

Section 318.—Constructive Ownership of Stock

26 CFR 1.318-3: Estates, trusts, and options.
(Also Section 302; 1.302-1.)

Constructive ownership of stock; option not currently exercisable. An option constitutes an option for purposes of section 318(a)(4) of the Code, even though it is only exercisable after a period of time has elapsed. Rev. Rul. 68-601 clarified.

Rev. Rul. 89-64

ISSUE

If an option is exercisable only after the lapse of a fixed period of time, is it an option within the meaning of section 318(a)(4) of the Internal Revenue Code and, therefore, must it be taken into consideration in determining whether a redemption qualifies as substantially disproportionate within the meaning of section 302(b)(2)?

FACTS

X, a domestic manufacturing corporation, had outstanding solely 100 shares of voting common stock. *A*, an officer of *X*, held 30 shares of this stock. *A* resigned from *X* in order to devote time and money to an unrelated endeavor, and *X* redeemed 15 shares of A's *X* stock. *A* received in the redemption cash plus an option to purchase 15 shares of *X* stock. This option was exercisable only after the lapse of a fixed period of time following the redemption. Except for the provision that the option could not be exercised until the fixed period of time had elapsed, there were no limitations on the exercise of the option. The fair market value of the *X* stock surrendered by *A* was equal to the fair market value of the cash and option that *A* received from *X* in exchange therefor.

The redemption constituted a substantially disproportionate redemption of stock within the meaning of section 302(b)(2) of the Code, provided that the option received by *A* did not constitute an option within the meaning of section 318(a)(4).

LAW AND ANALYSIS

The treatment of distributions in redemption of stock is governed by the provisions of section 302 of the Code. Pursuant to section 302(c)(1), the constructive ownership rules of section 318(a) are applicable in determining the ownership of stock for purposes of section 302.

Section 318(a)(4) of the Code provides that, if a person has an option to acquire stock, this stock is considered as owned by this person. Neither section 318 of the Code nor the regulations thereunder define the term "option." Moreover, neither section 302 of the Code nor the regulations thereunder specifically address the question of how section 318(a)(4) is to be interpreted for section 302 purposes.

Rev. Rul. 68-601, 1968-2 C.B. 124, dealing with the effect of warrants and convertible debentures on the substantially disproportion computation of section 302(b)(2) of the Code states:

> In order for a warrant to acquire stock to qualify as an option, the holder must have the right to obtain the stock at his election. When this right to acquire stock exists, warrants or convertible debentures are not realistically different from options as referred to in section 318(a)(4) of the Code. In each instance, stock may be acquired at the election of the shareholder and there exist no contingencies with respect to such election.

The phrase "at the election of the shareholder" in Rev. Rul. 68-601 is intended to distinguish situations where the holder of a warrant, convertible debenture, or option has a unilateral right to acquire stock, from situations where there is a bilateral contract. This phrase does not address the question here at issue of whether a delay in the right to exercise prevents an otherwise valid option from constituting an option for purposes of section 318(a)(4).

In the present situation, the delay does not prevent *A* from being viewed as having a right to receive 15 shares of *X* stock at *A*'s election. In enacting section 302(b)(2) of the Code, Congress intended not only that certain specific limitations be met at the time of the transaction, but also that the circumstances of the redemption offer some assurance that the redeemed shareholder will sustain the required contraction of equity with a degree of permanence. Here, the option not only meets the literal wording of section 318(a)(4) but also prevents the transaction from meeting this intent underlying section 302(b)(2). The option distributed by *X* to *A* in redemption of *A*'s *X* stock constitutes an option within the meaning of section 318(a)(4); accordingly, *A* owned, directly and constructively, the same number of shares of *X* stock after the redemption that *A* owned before the redemption.

HOLDING

The option distributed by *X* to *A* in redemption of *A*'s *X* stock, though exercisable only after the lapse of a fixed period of time following the redemption, is an option within the meaning of section 318(a)(4) of the Code and must be taken into consideration in determining whether the redemption qualified under section 302(b)(2). As a result of owning the option, *A* is considered as owning the stock covered by the option and, thus, fails to meet the requirement of section 302(b)(2).

EFFECT ON OTHER REVENUE RULINGS

Rev. Rul. 68-601 is clarified.

Part II.—Corporate Liquidations
Subpart A.—Effects on Recipients

Section 332.—Complete Liquidations of Subsidiaries

26 CFR 1.332-2: Requirements for nonrecognition of gain or loss.

Does section 332 of the Code apply to a distributee corporation's receipt of property in complete liquidation of a distributor corporation, if the distributee owns no stock in the distributor. See Rev. Rul. 89-46, page 272.

Section 334.—Basis of Property Received in Liquidation

26 CFR 1.334-1: Basis of property received in liquidation.

Whether the Service will issue rulings treating the life insurance reserves received by the distributee corporation in a liquidation as unsecured liabilities assumed. See Rev. Proc. 89-36, page 919.

Subpart B.—Effects on Corporations

Section 336.—Gain or Loss Recognized on Property Distributed in Complete Liquidation

26 CFR 1.336-1: General rule on liquidation of corporation.

Whether the Service will rule as to whether the liquidation of a life insurance subsidiary is a termination pursuant to section 815(d)(2) of the Code as in effect before the enactment of the Tax Reform Act of 1984. See Rev. Proc. 89-36, page 919.

Section 338.—Certain Stock Purchases Treated As Asset Acquisitions

Whether the Service will rule as to the tax consequences, under subchapter L, from the stock purchase and the deemed purchase of assets of a life insurance subsidiary. See Rev. Proc. 89-36, page 919.

Part III.—Corporate Organizations and Reorganizations
Subpart A.—Corporate Organizations

Section 351.—Transfer to Corporation Controlled by Transferor

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

If a member of an affiliated group filing consolidated income tax returns transfers property to another corporation in exchange for a security and has no actual stock ownership in the transferee, can section 351(a) of the Code apply to prevent recognition of gain or loss on the transfer. See Rev. Rul. 89-46, page 272.

Subpart B.—Effects of Shareholders and Security Holders

Section 354.—Exchanges of Stock and Securities in Certain Reorganizations

26 CFR 1.354-1: Exchanges of stock and securities in certain reorganizations.

If a recapitalization that qualifies under section 368(a)(1)(E) increases the value of the stock held by a trust and reduces the value of the stock held by the controlling shareholder, who is the original grantor of the trust, has a gift been made to the trust beneficiaries for federal gift tax purposes, and has an addition to corpus been made for purposes of the generation-skipping transfer tax? See Rev. Rul. 89-3, page 278.

Section 355.—Distributions Of Stock And Securities Of A Controlled Corporation

When, pursuant to a single integrated transaction, a corporation transfers section 38 property to a newly formed subsidiary in year one and distributes its stock in the subsidiary to its shareholders in year two, the disposition of the section 38 property triggering investment credit recapture under section 47(a) of the Code occurs in year one. See Rev. Rul. 89-18, page 14.

26 CFR 1.355-1: Distribution of stock and securities of a controlled corporation.

T.D. 8238

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1

Corporate Separations

AGENCY: Internal Revenue Service, Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to corporate separations. A corporate separation, typically, is a transaction in which a distributing corporation distributes to its shareholders or security holders stock, or stock and securities, of a controlled corporation and after which the distributing and the controlled corporations conduct businesses previously conducted directly or indirectly by the distributing corporation. These regulations revise existing regulations to reflect administrative and judicial experience under those existing regulations. These regulations apply to the shareholders and security holders of corporations under-taking corporate separations and provide guidance needed to comply with the law. The final regulations do not reflect amendments to section 355 of the Internal Revenue Code of 1986 made by the Revenue Act of 1987 and the Technical and Miscellaneous Revenue Act of 1988.

EFFECTIVE DATE: These regulations apply to transactions occurring after February 6, 1989.

SUPPLEMENTARY INFORMATION:

Background

On January 21, 1977, the FEDERAL REGISTER published proposed amendments to the Income Tax Regulations (26 CFR Part 1) under sections 355 and 346 (as in effect prior to its amendment by the Tax Equity and Fiscal Responsibility Act of 1982) of the Internal Revenue Code of 1954 (42 FR 38866). The amendments were proposed to revise the existing regulations to reflect administrative and judicial experience under those existing regulations. Since a public hearing was not requested, none was held. After consideration of all of the comments regarding the proposed amendments, those amendments are adopted as revised by this Treasury decision.

Section 355 provides that, under certain conditions, a corporation may distribute stock, or stock and securities, of a subsidiary without recognition of gain or loss to its shareholders or security holders. The proposed regulations made two major changes to the existing regulations under section 355. First, the regulations under section 355(a)(1)(B) (requiring that the transaction not be used principally as a device for the distribution of earnings and profits) were revised to specify factors to be taken into account in determining whether a transaction was used principally as such a device. Second, the regulations under section 355(b) (relating to active businesses) were revised to permit the separation of a single business, thereby conforming them to the holdings of *Commissioner v. Coady*, 289 F.2d 490 (6th Cir. 1961), *aff'g* 33 T.C. 771 (1960), and *United States v. Marett*, 325 F.2d 28 (5th Cir. 1963). The proposed regulations also proposed to clarify the business purpose requirement under section 355. A discussion of the more important comments received on, and a description of the changes made to, the proposed regulations follow.

Comments On, And Changes To, Proposed Regulations

Business Purpose

(1) *Independent requirement.* Section 1.355-2(b)(1) of the proposed regulations expressed the business purpose requirement as an independent requirement under section 355. Commenters objected to the treatment of the business purpose requirement as a separate requirement and suggested that the existence of a corporate business purpose should be considered only in determining whether a transaction was used principally as a device for the distribution of earnings and profits within the meaning of section 355(a)(1)(B).

Treasury and the Internal Revenue Service acknowledge that there is a very close relationship between the business purpose requirement and the requirement that the transaction not be used principally as a device for the distribution of earnings and profits. Accordingly, the final regulations clarify that the corporate business purpose is evidence that the transaction was not used principally as such a device. See §1.355-2(d)(3)(ii) in this document. This new provision is discussed below under the heading "Evidence of Nondevice."

However, Treasury and the Internal Revenue Service believe that, as held in *Commissioner v. Wilson*, 353 F.2d 184 (9th Cir. 1965), a transaction that is not carried out for a corporate business purpose should not qualify under section 355, even if it was not used principally as a device for the distribution of earnings and profits. Accordingly, the final regulations retain the independent business purpose requirement. See §1.355-2(b)(1) in this document.

(2) *Corporate business purpose.* Section 1.355-2(b)(1) of the proposed regulations provided that a distribution qualifies under section 355 only if it is carried out for one or more corporate business purposes. Corporate business purposes were identified as "real and substantial nontax reasons germane to the business of the corporations."

Commenters objected to the "real and substantial" standard on the grounds that it is not useful and is confusing. However, Treasury and the Internal Revenue Service continue to believe that the "real and substantial" standard provides a useful description of the type of corporate business purpose required under section 355. Accordingly, the final regulations retain that standard. See §1.355-2(b)(2) in this document.

Commenters requested reconsideration of the "nontax" standard. The Internal Revenue Service has ruled that reduction of state and local capital taxes is a corporate business purpose. Rev. Rul. 76-187, 1976-1 C.B. 97. That rule will remain in effect. However, Treasury and the Internal Revenue Service continue to believe that reduction of Federal taxes should not be regarded as a corporate business purpose. Accordingly, the final regulations replace the "nontax" standard with a "non Federal tax" standard.

Commenters wondered whether the potential reduction of Federal taxes will offset or negate the existence of a non-Federal tax business purpose. In response, the final regulations clarify that only a transaction motivated in whole or in substantial part by a corporate business purpose will satisfy the corporate business purpose requirement. Further, the final regulations clarify that the potential reduction of Federal taxes by the distributing or controlled corporations (or a corporation controlled by either) is relevant in determining whether a corporate business purpose motivated the distribution. The final regulations also provide that a purpose of reducing non Federal taxes is not a corporate business purpose if (i) the transaction will effect a reduction in both Federal and non Federal taxes because of similarities between Federal tax law and the tax law of the other jurisdiction and (ii) the reduction of Federal taxes is greater than or substantially coextensive with the reduction of non Federal taxes. See §1.355-2(b)(1) and (2) in this document. Three examples are also added in §1.355-2(b)(5). The first illustrates that a distribution which is made to enable the distributing and/or controlled corporation to make an election to be an S corporation does not meet the corporate business purpose requirement. The second example illustrates that the result is the same if the distribution is made to enable the distributing and/or controlled corporation to elect to become an S corporation both for Federal tax purposes and for purposes of a state that has tax law provisions similar to Subchapter S of the Internal Revenue Code of 1986. The third example illustrates that the magnitude of the potential reduction of Federal taxes is relevant to the determination of whether the distribution is motivated by a corporate business purpose.

(3) *Shareholder purpose.* Section 1.355-2(b)(1) of the proposed regulations provided that a distribution qualifies under section 355 only if it is carried out for purposes "germane to the business of the corporations." It further provided that "a shareholder purpose for a transaction may be so nearly coextensive with a corporate business purpose as to preclude any distinction between them. In such a case, the transaction is carried out for purposes germane to the business of the corporations." Some commenters complained that the proposed regulations did not adequately acknowledge that, in a closely held corporation, the purposes of the shareholders cannot be distinguished from those of the corporation. Other commenters complained that the proposed regulations addressed cases in which the shareholder purposes are totally coextensive with the corporate business purposes, but failed to address the more common cases in which there is only partial overlap.

In response, the final regulations revise example (2) of §1.355-2(b)(2) of the proposed regulations to present a disproportionate distribution that satisfies the business purpose requirement without a shareholder disagreement. See example (2) of §1.355-2(b)(5) in this document. The final regulations also provide that a purpose germane to the business of the affiliated group to which a corporation belongs is a corporate business purpose. See §1.355-2(b)(2) in this document.

As explained above, the final regulations clarify that a transaction that is motivated in substantial part by a corporate business purpose does not fail to satisfy the business purpose requirement merely because it is motivated in part by non-Federal tax shareholder purposes. See §1.355-2 (b) (1) in this document.

(4) *Business purposes for distribution.* The final regulations provide that the distribution of the stock, or stock and securities, of the controlled corporation to the shareholders must be carried out for one or more corporate business purposes. In example (3) of §1.355-2(b)(2) of the proposed regulations, the distribution is not carried out for a corporate business purpose. The alleged corporate business purpose for the transaction is protection of a business from the risks of another business. Because that purpose is satisfied as soon as the risky business is dropped down to a subsidiary, the distribution of the stock of the subsidiary is not carried out for that purpose. Commenters argued that separate incorporation might not satisfy the alleged corporate business purpose because a court might disregard the separate corporate identity of the subsidiary. Upon reconsideration, Treasury and the Internal Revenue Service continue to believe that example (3) is an appropriate illustration of the requirement that the distribution be carried out for a corporate business purpose. The facts of that example have been clarified, however, to assume that, under applicable law, risk is alleviated by the transfer of assets to the subsidiary. See example (3) of §1.355-2(b)(5) in this document.

(5) *Availability of alternative arrangement.* Example (4) of §1.355-2(b)(2) of the proposed regulations involves a transfer by the distributing corporation of one of its two businesses to a new controlled corporation and a distribution of the stock of the controlled corporation where the transfer and the distribution are required by a lender as a condition on additional loans. The example concludes that the distribution was carried out for one or more corporate business purposes. Commenters asked whether the distribution in example (4) would be carried out for one or more corporate business purposes if the lender would have been satisfied to have the distributing corporation transfer its two businesses to two new controlled corporations and continue as a holding company.

Commenters referred to Rev. Rul. 77-22, 1977-1 C.B. 91, in which a distribution by the distributing corporation of the stock of a preexisting controlled corporation is carried out for one or more corporate business purposes, where the distribution is made in response to the concerns of a lender that the proceeds of loans to the controlled corporation not be applied to the business of the distributing corporation. They hypothesized the existence of lenders who would have been satisfied to have the distributing corporation transfer its other business to a new controlled corporation and continue as a holding company. They noted that Rev. Rul. 77-22 could be read to hold that, under these hypothetical facts, a distribution by the distributing corporation of the stock of the preexisting controlled corporation would be carried out for one or more corporate business purposes.

Treasury and the Internal Revenue Service believe that a distribution satisfies the business purpose requirement only if the distributing corporation cannot achieve its corporate business purpose through a nontaxable transaction that does not involve a distribution of the stock of a subsidiary and that is neither impractical nor unduly expensive. Thus, if such an alternative transaction is available, the distribution is not carried out for a corporate business purpose. Accordingly, example (4) is replaced by new examples illustrating this aspect of the business purpose requirement. See examples (4) and (5) of §1.355-2(b)(5) in this document.

Continuity of Interest

Section 1.355-2(b)(1) of the proposed regulations provided that section 355 contemplates a continuity of interest in all or part of the business enterprise on the part of those persons who, directly or indirectly, were the owners of the enterprise prior to the distribution or exchange. There was concern it could be argued that the phrase "all or part" meant a transaction could qualify even if none of the owners of the enterprise before the separation had, after the distribution, an interest in the business enterprise of one of the separated corporations. The final regulations make clear that the separation must effect only a readjustment of continuing interests in the property of the distributing and controlled corporations. In this regard, section 355 requires that one or more persons who, directly or indirectly, were the owners of the enterprise prior to the distribution or exchange own, in the aggregate, an amount of stock establishing a continuity of interest in each of the modified corporate forms in which the enterprise is conducted after the separation. These rules have been relocated in a new §1.355-2(c). Four examples illustrating the continuity of interest requirement are added, the principles of which are based on previously published revenue rulings. See Rev. Rul. 69-293, 1969-1 C.B. 102 and Rev. Rul. 79-293, 1979-2 C.B. 125.

Device For Distribution Of Earnings and Profits

In General

Section 1.355-2(c) of the proposed regulations interpreted the requirement of section 355(a)(1)(B) that the transaction not be used principally as a device for the distribution of earnings and profits of the distributing corporation, the controlled corporation, or both (a ''device''). That interpretation consisted of a description of the tax avoidance that could be achieved through the use of a device, a specification of factors (''device factors'') whose presence is evidence that the transaction was used principally as a device (''evidence of device''), and a specification of certain transactions that ordinarily would not be considered to be a device for the distribution of earning and profits. The final regulations generally retain these provisions. At the request of commenters, they also specify factors (''nondevice factors'') whose presence is evidence that the transaction was not used principally as a device (''evidence of nondevice''). See §1.355-2(d) in this document.

Section 1.355-2(c)(1) of the proposed regulations explained that a corporate separation can present potential for the avoidance of the dividend provisions of the Code. The final regulations make clear that avoidance potential is presented by the substitution of stock interests in two or more corporations for a stock interest in a single corporation. In particular, avoidance potential can be presented by distributions in which the distributing corporation liquidates as well as by distributions in which the distributing corporation does not liquidate. The final regulations also replace the reference to sales or liquidations with a reference to sales, exchanges, or transactions that are treated as exchanges under the Code, thus making clear that redemptions as well as liquidations are covered by the rules. They also limit the rules to transactions involving stock on the grounds that sections 355(a)(3) and 356(d)(2)(C) generally render transactions involving securities incapable of use to avoid the dividend provisions of the Code. At the request of commenters, the final regulations clarify that the determination whether a transaction was used principally as a device depends on all of the facts and circumstances, and that the presence of the device factors specified in §1.355-2(d)(2) is not alone controlling. See §1.355-2(d)(1) in this document. The final regulations also make clear that a device can include a transaction that effects a recovery of basis.

The provision in §1.355-2(c)(1) of the proposed regulations regarding pro rata distributions is clarified and made a separate provision in the final regulations. See §1.355-2(d)(2)(ii) in this document. Certain transactions that are ordinarily considered not to have been used principally as a device are specified in a separate provision in the final regulations. As suggested by commenters, that provision clarifies that these transactions are ordinarily considered not to have been used principally as a device, notwithstanding the presence of any of the device factors specified in §1.355-2(d)(2). See §1.355-2(d)(5) in this document.

Subsequent Sale Or Exchange Of Stock

(1) *Per se rule*. Section 1.355-2(c)(2) of the proposed regulations provided that a subsequent sale or exchange of 20 percent or more of the stock of either the distributing or the controlled corporation, negotiated or agreed upon before the distribution, is conclusive evidence of device. Commenters objected to this rule on the grounds that it is arbitrary, that it has no case law support, and that it is inconsistent with the facts and circumstances standard mandated by the Code and expressed in §1.355-1(c)(1) of the proposed regulations.

Upon reconsideration, Treasury and the Internal Revenue Service continue to believe that a subsequent sale or exchange of stock of either the distributing or the controlled corporation, negotiated or agreed upon before the distribution, is substantial evidence of device. However, they agree with the commenters that section 355(a)(1)(B) does not require that this evidence be treated as conclusive, and that taxpayers should not be denied the opportunity to prove that, despite the sale or exchange, the transaction was not used principally as a device. Accordingly, the *per se* rule is eliminated in the final regulations.

The final regulations provide that a subsequent sale or exchange of stock of either the distributing or the controlled corporation, negotiated or agreed upon before the distribution, is substantial evidence of device. Generally, the greater the percentage of stock sold or exchanged, the stronger the evidence of device. See §1.355-2(d)(2)(iii)(A) in this document. In addition, the shorter the period of time between the distribution and the sale or exchange, the stronger the evidence of device.

(2) *Negotiated or agreed upon before the distribution*. The final regulations retain the rules of the proposed regulations concerning whether a sale or exchange is considered to be negotiated or agreed upon before the distribution. See §1.355-2(d)(2)(iii)(D) in this document.

(3) *Subsequent reorganizations*. The final regulations retain the provision in §1.355-2(c)(2) of the proposed regulations that an exchange of stock pursuant to a plan of reorganization in which either no gain or loss or only an insubstantial amount of gain is recognized is not evidence of device. The final regulations provide that for this purpose, gain treated as a dividend pursuant to sections 356(a)(2) and 316 shall be disregarded. They also add a provision that any stock received in a reorganization exchange excepted from the subsequent sale rules will be treated, for purposes of those subsequent sale rules, as the stock surrendered. Thus, any sale or exchange of the stock received will be subject to the subsequent sale rules. See §1.355-2(d)-(2)(iii)(E) in this document.

Nature And Use Of Assets

(1) *Assets not used in a qualifying trade or business*.

Section 1.355-2(c)(3)(iii) of the proposed regulations provided that the transfer or retention of cash or liquid assets in excess of the reasonable needs of the post-distribution business of the transferee or the retaining corporation (''excess liquid assets'') is evidence of device. Some commenters agreed that the transfer of excess liquid assets should be evidence of device, but asserted that the retention of excess liquid assets should be a neutral factor. Other commenters noted that, because liquid assets must either be transferred or retained, the proposed regulations appeared to find evidence of device whenever excess liquid assets are present.

Section 1.355-2(c)(3)(ii) of the proposed regulations provided that, if a substantial portion of the post-distribution assets of the distributing or the controlled corporation consists of a trade or business acquired during the five-year period preceding the distribution in a transaction in which the basis of the assets was not determined in whole or in part by reference to the transferor's basis, this fact is evidence of device (the ''new trade or business device factor''). Some commenters objected to this device factor on the grounds that the acquisition of a trade or business should be treated under the active business requirements of section 355(b) instead of the device clause of section 355(a)(1)(B). They pointed out that section 355(b)(2)(C) denies qualification under section 355 to a distribution after which the only trade or business of the distributing or the controlled corporation is a trade or business that was acquired during the five-year period preceding the distribution in a transaction in which the basis of the assets was not determined in whole or in part by reference to the transferor's basis. Other commenters objected to this device factor on the grounds that the presence of operating assets, even if newly acquired, should not be evidence of device. They argued that operating assets are not suitable for use in a device.

Treasury and the Internal Revenue Service believe that the presence of excess liquid assets permits avoidance of the dividend provisions of the Code, regardless of the corporation that holds them. Treasury and the Internal Revenue Service also believe that the active business requirements of section 355(b) do not render unnecessary the principle of the new trade or business device factor of §1.355-2(c)(3)(ii) of the proposed regulations. Those requirements can be satisfied by a distribution after which the distributing corporation holds a business that it has conducted for five years, while the controlled corporation holds such a business and a business that was acquired during the five-year period preceding the distribution in a transaction in which the basis of the assets was not determined in whole or part by reference to the transferor's basis. Rev. Rul. 73-44, 1973-1 C.B. 182, as clarified in Rev. Rul. 76-54, 1976-1 C.B. 96.

The new trade or business device factor of the proposed regulations was limited to trades or businesses. Thus, it was generally consistent with §1.355-2(b)(3) of the existing regulations, which provides that, if substantially all of the assets of the distributing and the controlled corporations are and have been used in the active conduct of trades or businesses that meet the requirements of section 355(b), this fact will be evidence of nondevice. On the other hand, the new trade or business device factor of the proposed regulations failed to find evidence of device in the presence of business assets that were not acquired as part of a trade or business and that are not or have not been used in the active conduct of a trade or business that satisfies the requirements of section 355(b). Such assets include excess inventory. The final regulations correct this oversight.

Accordingly, the final regulations provide that the existence of assets that are not used in a trade or business that satisfies the requirements of section 355(b) is evidence of device. For this purpose, assets that are not used in a trade or business that satisfies the requirements of section 355(b) include, but are not limited to, cash and other liquid assets that are not related to the reasonable needs of a business satisfying such section. The strength of the evidence depends on all the facts and circumstances, including, but not limited to, the ratio for each corporation of the value of assets not used in a trade or business that satisfies the requirements of section 355(b) to the value of its business that is so described. A difference in the ratio described in the preceding sentence for the distributing and controlled corporation is ordinarily not evidence of device if the distribution is not pro rata among the shareholders of the distributing corporation and such difference is attributable to a need to equalize the value of the stock distributed and the value of stock or securities exchanged by the distributees. See §1.355-2(d)(2)(iv)-(B).

(2) *Related function.* Section 1.355-2(c)(3)(iv) of the proposed regulations provided that the continued integration of a function with the business from which it has been separated is evidence of device. Commenters objected to this device factor on the grounds that the specified conditions present no compelling evidence of device.

Treasury and the Internal Revenue Service believe that the continued integration of a function with the business from which it has been separated should be evidence of device. This belief is based on the interpretation of section 355(a)(1)(B) expressed in §1.355-2(c)(1) of the proposed regulations. Under certain circumstances, continued integration indicates a likelihood of avoidance of the dividend provisions of the Code.

Most commenters agreed that the continued integration of a function consisting of real estate with the business from which it has been separated should be evidence of device. However, they questioned whether other cases of continued integration should be evidence of device. The function might be truly integral to the business from which it has been separated, in which case it could not be sold without adversely affecting that business.

Accordingly, the final regulations revise the related function device factor of §1.355-2(c)(3)(iv) of the proposed regulations. The device factor is restricted to apply to the continued integration of a function with the business from which it has been separated only if the function can be sold without adversely affecting the business from which it has been separated. For example, the function may be capable of sale without an adverse effect on the business from which it has been separated because adequate substitutes are available. See §1.355-2(d)(2)(iv)(C) in this document.

Evidence Of Nondevice

Section 1.355-2(c)(1), (2), and (3) of the proposed regulations specified device factors whose presence is evidence of device. At the request of commenters, the final regulations specify several nondevice factors whose presence is evidence of nondevice. See §1.355-2(d)(3) in this document.

Commenters suggested that the business purposes for a transaction may indicate that it was not used for tax avoidance purposes and, therefore, was not used principally as a device. Upon reconsidering the device rules, Treasury and the Internal Revenue Service agree that the corporate business purposes for a transaction may be sufficiently compelling to outweigh the evidence of device that the transaction presents. Accordingly, the final regulations reflect this conclusion. See §1.355-2(d)(3)(ii) in this document.

The final regulations provide that the corporate business purposes for a transaction present evidence of nondevice. In accordance with the facts and circumstances standard of §1.355-2(c)(1) of the proposed regulations, the strength of this evidence depends on all of the facts and circumstances. The final regulations adopt a sliding scale approach. Thus, the greater the evidence of device, the stronger the corporate business purpose necessary to outweigh that evidence. Evidence of device presented by a disproportionate allocation of assets not used in a trade or business that satisfies the requirements of section 355 (b) can be outweighed by the presence of a strong corporate business purpose for that allocation. The final regulations also specify nonexclusive factors to be taken into account in assessing the strength of a corporate business purpose. See §1.355-2(d)(3)(ii) in this document.

The final regulations specify other nondevice factors. One of these nondevice factors is that the distributing corporation is publicly traded and has no shareholders who hold large blocks of stock. See §1.355-2(d)(3)(iii) in this document. Another nondevice factor is that all of the distributees are domestic corporations that would be entitled to the deduction under section 243(a)(1) available to corporations meeting the stock ownership requirements of section 243(c), 243(a)(2), 243(a)(3), or 245(b) if the distribution were taxable as a dividend. See §1.355-2(d)(3)(iv) in this document.

Examples

In light of the changes made to the device rules in the final regulations, the examples in §1.355-2(c)(4) of the proposed regulations are replaced by new examples. The examples illustrate the application of the facts and circumstances device standard of §1.355-2(d)(1) and the balancing of the evidence of device presented by the device factors specified in §1.355(d)(2) against the evidence of nondevice presented by the corporate business purpose nondevice factor specified in §1.355-2(d)(3)(ii). See §1.355-2(d)(4) in this document.

Example (1) illustrates that the transaction will be considered to have been used principally as a device if there is a subsequent sale of stock by a shareholder to a key employee that is negotiated or agreed upon before the distribution, even though the employee could have acquired an equivalent amount of stock directly from the corporation.

Example (2) involves the retention of liquid assets in excess of the reasonable needs of the business of the retaining corporation. That example concludes that the transaction was not used principally as a device because of the corporate business purpose for the transaction and the other facts and circumstances, including the facts that the excess liquid assets are not a substantial portion of the postdistribution assets of the retaining corporation and that the assets not used in the trade or business are divided between the two businesses in proportion to their values. In contrast, example (3) presents a case in which there is a strong corporate business purpose for the distribution, but there is also a transfer of cash substantially in excess of the reasonable needs of the business of the transferor and transferee corporations. That example concludes that, based on all of the facts and circumstances, the transaction was used principally as a device. Example (4) illustrates that the result will be the same as in example (3) if, instead of cash being transferred, operating assets unrelated to the business of the transferee corporation are purchased and transferred to it in anticipation of the distribution.

Transactions Ordinarily Not A Device

Section 1.355-2(c)(1) of the proposed regulations specified two transactions that are ordinarily not considered to be a device for the distribution of earnings and profits. The final regulations specify those transactions in a separate provision. As suggested by commenters, that provision clarifies that such a transaction is ordinarily considered not to have been used principally as a device, notwithstanding the presence of any of the device factors specified in §1.355-2(d)(2). See §1.355-2(d)(5)(i) in this document.

Section 1.355-2(c)(1) of the proposed regulations accorded a presumption against device to a distribution if, in the absence of section 355, no part of a distribution of money by the distributing corporation, the controlled corporation, or any corporation controlled, directly or indirectly, by either of those corporations would be taxable as a dividend because of the absence of earnings and profits.

Commenters questioned the relevance of the earnings and profits of the corporations other than the distributing corporation. They argued that the dividend avoidance interpretation of section 355(a)(1)(B) expressed in §1.355-2(c)(1) of the proposed regulations made only the earnings and profits of the distributing corporation relevant. Treasury and the Internal Revenue Service, however, believe that the earnings and profits of both the distributing and controlled corporations must be taken into account, and the final regulations so provide. See §1.355-2(d)(5)(ii) in this document. Also, the application of the presumption must take into account the possibility that a distribution by the distributing corporation would create earnings and profits if section 355 did not apply.

Section 1.355-2(d)(5)(iii) provides that distributions that would be entitled to sale or exchange treatment under section 303(a) if section 355 did not apply are ordinarily considered not to have been used principally as a device. Section 1.355-2(d)(5)(iv) contains the presumption against device specified in §1.355-2(c)(1) of the proposed regulations for distributions that would be entitled to sale or exchange treatment under section 302 (a) if section 355 did not apply.

The final regulations also clarify that a transaction to which section 302(a) or 303(a) would apply if section 355 did not is not accorded the presumption against device if it involves the distribution of the stock of more than one controlled corporation and facilitates the avoidance of the dividend provisions of the Code through the subsequent sale or exchange of the stock of one corporation and the retention of the stock of another. The final regulations also add an example of a transaction that is not accorded the presumption because it presents such tax avoidance potential. See example (2) of §1.355-2(d)(5)(v) in this document.

Active Conduct Of A Trade Or Business

(1) *In general.* Section 1.355-3 of the proposed regulations interpreted the active business requirements of section 355(b). The final regulations retain those provisions and make clarifying revisions to §1.355-3(b)(2)(iii) (the "active conduct" requirement of section 355(b)(2)(A)) and §1.355-3(b)(3) (the "five-year active conduct" requirement of section 355(b)(2)(B)).

Section 1.355-3(b)(2)(iii) of the proposed regulations provided that the active conduct of a trade or business requires the performance of active and substantial management and operational functions. Commenters inquired whether a corporation may satisfy that requirement if some or all of its activities are performed by independent contractors. In response, the final regulations clarify that, in determining whether a corporation is actively conducting a trade or business, the activities performed by persons outside the corporation, including independent contractors, generally will not be taken into account. However, a corporation may satisfy that requirement through the activities that it performs directly, even though other activities are performed by independent contractors. See §1.355-3(b)(2)(iii) in this document.

The final regulations slightly revise examples (1), (2), and (3) of §1.355-3(c) of the proposed regulations to explain why the described activities do not satisfy the active business requirements. Example (1) illustrates that the holding of investment securities is not the active conduct of a trade or business. See §1.355-3(b)(2)(iv)(A) in this document. This example is consistent with Rev. Rul. 66-204, 1966 C.B. 113, which holds that activity generated by trading in stock and securities held for one's own account is an investment function and is not the active conduct of a trade or business within the meaning of section 355. Examples (2) and (3) illustrate that the activities relied upon to satisfy the active business requirements must have been actively conducted throughout the five-year period preceding the distribution. See §1.355-3(b)(3) in this document.

(2) *Separation of a single business.* The proposed regulations provided for the separation of a single business in §1.355-1(a). They interpreted the five-year active conduct requirement accordingly in §1.355-3(b)(3). The final regulations retain these provisions. They redesignate example (10) of §1.355-3(c) of the proposed regulations, which was based on *Commissioner v. Coady,* 289 F.2d 490 (6th Cir. 1961), *aff'g* 33 T.C. 771 (1960), as example (4). They redesignate example (11) of §1.355-3(c) of the proposed regulations, which was based on *United States v. Marett*, 325 F.2d 28 (5th Cir. 1963), as example (5) and revise it to conform more closely to the facts of that case. See examples (4) and (5) of §1.355-3(c) in this document.

(3) *Single or multiple businesses.* In reexamining the active business requirements, Treasury and the Internal Revenue Service recognized that it is often difficult to determine whether a corporation is conducting a single business, which may be separated under section 355 if it has been actively conducted for five years, or multiple businesses, which may be separated from each other under section 355 only if each has been actively conducted for five years. Correlatively, they recognized that it is difficult to determine whether a corporate expenditure for a new activity constitutes the acquisition or creation of a new business or the expansion of an existing business. Accordingly, it is considered to be appropriate to simplify these determinations.

As in *Estate of Lockwood v. Commissioner*, 350 F.2d 712 (8th Cir. 1965), the final regulations provide that, for purposes of the five-year active conduct requirement, a new activity in the same line of business as an activity that has been actively conducted by the distributing corporation for the five-year period preceding the distribution ordinarily will not be considered a separate business. As a result, the distribution of a new activity will more easily satisfy the five-year active conduct requirement. See §1.355-3(b)(3)(ii) in this document.

In example (12) of §1.355-3(c) of the proposed regulations, a department store that was constructed within the preceding five years is separated from a department store business that has been actively conducted for nine years. The separation satisfies the five-year active conduct requirement because the newly constructed department store became part of the existing business. The final regulations revise example (12) and redesignate it as example (7). Example (7) illustrates that the five-year active conduct requirement is met, whether or not the new and old stores are operated as a single unit prior to the separation. The final regulations also add a new example (8) to illustrate that the same result obtains, whether the new activity results from internal corporate expansion or is purchased as a going concern. See examples (7) and (8) of §1.355-3(c) in this document.

(4) *Functional separations.* The proposed regulations provided for the separation of a single business in §1.355-1(a). They interpreted the five-year active conduct requirement accordingly in §1.355-3(b)(3). Examples (8), (9), and (14) of §1.355-3(c) of the proposed regulations presented separations of businesses along functional lines satisfying the active business requirements. These examples are grouped together as examples (9), (10), and (11) in the final regulations. Example (14) of the proposed regulations presented the separation of a research department from a business engaged in the manufacture and sale of household products. The final regulations redesignate example (14) as example (9) and revise it to illustrate that the separation satisfies the active business requirements, whether the research department subsequently provides services only to the business from which it was separated or also to others. See examples (9), (10), and (11) of §1.355-3(c) in this document. It should be noted that functional separations may present evidence of device under §1.355-2(d)(2)-(iv)(C).

(5) *Owner-occupied real estate.* The proposed regulations interpreted the active business requirements to permit functional separations. Commenters noted that, in appropriate cases, the separation of real estate occupied by its owner prior to the distribution ("owner-occupied real estate") should satisfy those requirements. Treasury and the Internal Revenue Service recognize that the separation of owner-occupied real estate may satisfy the active business requirements, but they also recognize that such a separation presents significant tax avoidance opportunities. Accordingly, the final regulations revise §1.355-3(b)(2)(iv)(B) of the proposed regulations to provide that the separation of owner-occupied real estate will be subject to careful scrutiny under the active business requirements. Also, such a separation may be subject to close examination under the related function device factor of §1.355-2(d)(2)(iv)(C).

Examples (4), (5), (6), and (13) of §1.355-3(c) of the proposed regulations presented separations of owner-occupied real estate. The final regulations delete examples (6) and (13). Example (13) is deleted because it is redundant. Example (6) is deleted because it is misleading. Thus, in determining whether the separation of owner-occupied real estate satisfies the active business requirements, it is immaterial whether, prior to the distribution, the real estate is owned by the distributing corporation or by a wholly owned subsidiary. Examples (4) and (5) presented separations of owner-occupied real estate that do and do not satisfy the active business requirements. The final regulations redesignate them as examples (12) and (13). Whether separations of owner-occupied real estate that differ from those presented in these examples satisfy the active business requirements will be decided on a case-by-case basis.

Use Of Section 355 (b) Definition Of Active Conduct Of A Trade Or Business For Purposes Of Section 346(b)

In 26 CFR 1.346-1(c) (revised as of April 1, 1987), the term "active conduct of a trade or business" is given the same meaning for purposes of section 346(b) (as in effect before its amendment by the Tax Equity and Fiscal Responsibility Act of 1982) as the term is given in §1.355-1(c) of the existing regulations. In what was intended merely as a conforming change, the proposed amendments substituted in §1.346-1(c) a reference to the definition of "active conduct of a trade or business" in §1.355-3(b)(2) of the proposed regulations. Treasury and the Internal Revenue Service have decided not to adopt the conforming change at this time.

General Utilities Repeal

The Internal Revenue Service is developing regulations under section 337(d) of the Code that will relate to the distribution of stock, or stock and securities, of a controlled corporation.

New §1.355-6 is reserved for this purpose.

Special Analyses

The Commissioner of Internal Revenue has determined that this final rule is not a major rule as defined in Executive Order 12291 and that a Regulatory Impact Analysis is therefore not required. Because the notice of proposed rulemaking for these regulations was filed with the Federal Register on January 19, 1977, no regulatory flexibility analysis is required.

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Adoption of amendment to the regulations

Accordingly, 26 CFR Part 1 is amended as follows:

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

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

Par. 2. A new section 1.355-0 is added to read as follows:

§1.355-0 In order to facilitate the use of §§1.355-1 through 1.355-6, this section lists the paragraphs, subparagraphs, and subdivisions in those sections.

§1.355-1 Distribution of stock and securities of a controlled corporation

(a) *Effective date of certain sections.*

(b) *Application of section.*

§1.355-2 Limitations

(a) *Property distributed.*

(b) *Independent business purpose.*

(1) *Independent business purpose requirement.*

(2) *Corporate business purpose.*

(3) *Business purpose for distribution.*

(4) *Business purpose as evidence of nondevice.*

(5) *Examples.*

(c) *Continuity of interest requirement.*

(1) *Requirement.*

(2) *Examples.*

(d) *Device for distribution of earnings and profits.*

(1) *In general.*

(2) *Device factors.*

(i) *In general.*

(ii) *Pro rata distribution.*

(iii) *Subsequent sale or exchange of stock.*

(A) *In general.*

(B) *Sale or exchange negotiated or agreed upon before the distribution.*

(C) *Sale or exchange not negotiated or agreed upon before the distribution.*

(D) *Negotiated or agreed upon before the distribution.*

(E) *Exchange in pursuance of a plan of reorganization.*

(iv) *Nature and use of assets.*

(A) *In general.*

(B) *Assets not used in a trade or business meeting the requirement of section 355 (b).*

(C) *Related function.*

(3) *Nondevice factors.*

(i) *In general.*

(ii) *Corporate business purpose.*

(iii) *Distributing corporation publicly traded and widely held.*

(iv) *Distribution to domestic corporate shareholders.*

(4) *Examples.*

(5) *Transactions ordinarily not considered as a device.*

(i) *In general.*

(ii) *Absence of earnings and profits.*

(iii) *Section 303(a) transactions.*

(iv) *Section 302(a) transactions.*

(v) *Examples.*

(e) *Stock and securities distributed.*

(1) *In general.*

(2) *Additional rules.*

(f) *Principal amount of securities.*

(1) *Securities received.*

(2) *Only stock received.*

(g) *Period of ownership.*

(1) *Other property.*

(2) *Example.*

(h) *Active conduct of a trade or business.*

§1.355-3 Active conduct of a trade or business

(a) *General requirements.*

(1) *Application of section 355.*

(2) *Examples.*

(b) *Active conduct of a trade or business defined.*

(1) *In general.*

(2) *Active conduct or a trade or business immediately after distribution.*

(i) *In general.*

(ii) *Trade or business.*

(iii) *Active conduct.*

(iv) *Limitations.*

(3) *Active conduct for five year period preceding distribution.*

(4) *Special rules for acquisition of a trade or business (Prior to the Revenue Act of 1987 and Technical and Miscellaneous Revenue Act of 1988).*

(i) *In general.*

(ii) *Example.*

(iii) *Gain or loss recognized in certain transactions.*

(iv) *Affiliated group.*

(5) *Special rules for acquisition of a trade or business (After the Revenue Act of 1987 and Technical and Miscellaneous Revenue Act of 1988).*

(c) *Examples.*

§1.355-4 Non pro rata distributions, etc.

§1.355-5 Records to be kept and information to be filed.

§1.355-6 [Reserved.]

Par. 3. Sections 1.355-1 through 1.355-4 are revised to read as follows:

§1.355-1 Distribution of stock and securities of a controlled corporation.

(a) *Effective date of certain sections.* Sections 1.355-1 through 1.355-4 apply to transactions occurring after February 6, 1989. For transactions occurring on or before that date, see 26 CFR 1.355-1 through 1.355-4 (revised as of April 1, 1987). Sections 1.355-1 through 1.355-4 do not reflect the amendments to section 355 made by the Revenue Act of 1987 and the Technical and Miscellaneous Revenue Act of 1988.

(b) *Application of section.* Section 355 provides for the separation, without recognition of gain or loss to (or the inclusion in income of) the shareholders and security holders, of one or more existing businesses formerly operated, directly or indirectly, by a single corporation (the "distributing corporation"). It applies only to the separation of existing businesses that have been in active operation for at least five years (or a business that has been in active operation for at least five years into separate businesses), and which, in general, have been owned, directly or indirectly, for at least five years by the distributing corporation. A separation is achieved through the distribution by the distributing corporation of stock, or stock and securities, of one or more subsidiaries (the "controlled corporations") to its shareholders with respect to its stock or to its security holders in exchange for its securities. The controlled corporations may be preexisting or newly created subsidiaries.

Throughout the regulations under section 355, the term "distribution" refers to a distribution by the distributing corporation of stock, or stock and securities, of one or more controlled corporations, unless the context indicates otherwise. Section 355 contemplates the continued operation of the business or businesses existing prior to the separation. See §1.355-4 for types of distributions that may qualify under section 355, including pro rata distributions and non pro rata distributions. For purposes of section 355, stock rights and stock warrants are not included in the term "stock and securities."

§1.355-2 Limitations.

(a) *Property distributed.* Section 355 applies to a distribution only if the property distributed consists solely of stock, or stock and securities, of a controlled corporation. If additional property (including an excess principal amount of securities received over securities surrendered) is received, see section 356.

(b) *Independent business purpose* — (1) *Independent business purpose requirement.* Section 355 applies to a transaction only if it is carried out for one or more corporate business purposes. A transaction is carried out for a corporate business purpose if it is motivated, in whole or substantial part, by one or more corporate business purposes. The potential for the avoidance of Federal taxes by the distributing or controlled corporations (or a corporation controlled by either) is relevant in determining the extent to which an existing corporate business purpose motivated the distribution. The principal reason for this business purpose requirement is to provide nonrecognition treatment only to distributions that are incident to readjustments of corporate structures required by business exigencies and that effect only readjustments of continuing interests in property under modified corporate forms. This business purpose requirement is independent of the other requirements under section 355.

(2) *Corporate business purpose.* A corporate business purpose is a real and substantial non Federal tax purpose germane to the business of the distributing corporation, the controlled corporation, or the affiliated group (as defined in §1.355-3(b)(4)(iv)) to which the distributing corporation belongs. A purpose of reducing non Federal taxes is not a corporate business purpose if (i) the transaction will effect a reduction in both Federal and non Federal taxes because of similarities between Federal tax law and the tax law of the other jurisdiction and (ii) the reduction of Federal taxes is greater than or substantially coextensive with the reduction of non Federal taxes. See examples (7) and (8) of paragraph (b)(5) of this section. A shareholder purpose (for example, the personal planning purposes of a shareholder) is not a corporate business purpose. Depending upon the facts of a particular case, however, a shareholder purpose for a transaction may be so nearly coextensive with a corporate business purpose as to preclude any distinction between them. In such a case, the transaction is carried out for one or more corporate business purposes. See example (2) of paragraph (b)(5) of this section.

(3) *Business purpose for distribution.* The distribution must be carried out for one or more corporate business purposes. See example (3) of paragraph (b)(5) of this section. If a corporate business purpose can be achieved through a nontaxable transaction that does not involve the distribution of stock of a controlled corporation and which is neither impractical nor unduly expensive, then, for purposes of paragraph (b)(1) of this section, the separation is not carried out for that corporate business purpose. See examples (3) and (4) of paragraph (b)(5) of this section. For rules with respect to the requirement of a business purpose for a transfer of assets to a controlled corporation in connection with a reorganization described in section 368(a)(1)(D), see §1.368-1(b).

(4) *Business purpose as evidence of nondevice.* The corporate business purpose or purposes for a transaction are evidence that the transaction was not used principally as a device for the distribution of earnings and profits within the meaning of section 355(a)(1)(B). See paragraph (d)(3)(ii) of this section.

(5) *Examples.* The provisions of this paragraph (b) may be illustrated by the following examples:

Example (1). Corporation X is engaged in the production, transportation, and refining of petroleum products. In 1985, X acquires all of the properties of corporation Z, which is also engaged in the production, transportation, and refining of petroleum products. In 1991, as a result of antitrust litigation, X is ordered to divest itself of all of the properties acquired from Z. X transfers those properties to new corporation Y and distributes the stock of Y pro rata to X's shareholders. In view of the divestiture order, the distribution is carried out for a corporate business purpose. See paragraph (b)(1) of this section.

Example (2). Corporation X is engaged in two businesses: the manufacture and sale of furniture and the sale of jewelry. The businesses are of equal value. The outstanding stock of X is owned equally by unrelated individuals A and B. A is more interested in the furniture business, while B is more interested in the jewelry business. A and B decide to split up the businesses and go their separate ways. A and B anticipate that the operations of each business will be enhanced by the separation because each shareholder will be able to devote his undivided attention to the business in which he is more interested and more proficient. Accordingly, X transfers the jewelry business to new corporation Y and distributes the stock of Y to B in exchange for all of B's stock in X. The distribution is carried out for a corporate business purpose, notwithstanding that it is also carried out in part for shareholder purposes. See paragraph (b)(2) of this section.

Example (3). Corporation X is engaged in the manufacture and sale of toys and the manufacture and sale of candy. The shareholders of X wish to protect the candy business from the risks and vicissitudes of the toy business. Accordingly, X transfers the toy business to new corporation Y and distributes the stock of Y to X's shareholders. Under applicable law, the purpose of protecting the candy business from the risks and vicissitudes of the toy business is achieved as soon as X transfers the toy business to Y. Therefore, the distribution is not carried out for a corporate business purpose. See paragraph (b)(3) of this section.

Example (4). Corporation X is engaged in a regulated business in State T. X owns all of the stock of corporation Y, a profitable corporation that is not engaged in a regulated business. Commission C sets the rates that X may charge its customers, based on its total income. C has recently adopted rules according to which the total income of a corporation includes the income of a business if, and only if, the business is operated, directly or indirectly, by the corporation. Total income, for this purpose, includes the income of a wholly owned subsidiary corporation but does not include the income of a parent or "brother/sister" corporation. Under C's new rule, X's total income includes the income of Y, with the result that X has suffered a reduction of the rates that it may charge its customers. It would not be impractical or unduly expensive to create in a nontaxable transaction (such as a transaction qualifying under section 351) a holding company to hold the stock of X and Y. X distributes the stock of Y to X's shareholders. The distribution is not carried out for the purpose of increasing the rates that X may charge its customers because that purpose could be achieved through a nontaxable transaction, the creation of a holding company, that does not involve the distribution of stock of a controlled corporation and which is neither impractical nor unduly expensive. See paragraph (b)(3) of this section.

Example (5). The facts are the same as in example (4), except that C has recently adopted rules according to which the total income of a corporation includes not only the income included in example (3), but also the income of any member of the affiliated group to which the corporation belongs. In order to avoid a reduction in the rates that it may charge its customers, X distributes the stock of Y to X's shareholders. The distribution is carried out for a corporate business purpose. See paragraph (b)(3) of this section.

Example (6). (i) Corporation X owns all of the one class of stock of corporation Y. X distributes the stock of Y pro rata to its five shareholders, all of whom are individuals, for the sole purpose of enabling X and/or Y to elect to become an S corporation. The distribution does not meet the corporate business purpose requirement. See paragraph (b)(1) and (2) of this section.

(ii) The facts are the same as in Example 6(i), except that the business of Y is operated as a division of X. X transfers this division to new corporation Y and distributes the stock of Y pro rata to its shareholders, all of whom are individuals, for the sole purpose of enabling X and/or Y to elect to become an S corporation. The distribution does not meet the corporate business purpose requirement. See paragraph (b)(1) and (2) of this section.

Example (7). The facts are the same as in example (6)(i), except that the distribution is made to enable X to elect to become an S corporation both for Federal tax purposes and for purposes of the income tax imposed by State M. State M has tax law provisions similar to subchapter S of the Internal Revenue Code of 1986. An election to be an S corporation for Federal tax purposes will effect a substantial reduction in Federal taxes that is greater than the reduction of State M taxes pursuant to an election to be an S corporation for State M purposes. The purpose of reducing State M taxes is not a corporate business purpose. The distribution does not meet the corporate business purpose requirement. See paragraph (b)(1) and (2) of this section.

Example (8). The facts are the same as Example (7), except that the distribution also is made to enable *A*, a key employee of Y, to acquire stock of Y without investing in X. A is considered to be critical to the success of Y and he has indicated that he will seriously consider leaving the company if he is not given the opportunity to purchase a significant amount of stock of Y. As a matter of state law, Y could not issue stock to the employee while it was a subsidiary of X. As in Example (7), the purpose of reducing State M taxes is not a corporate business purpose. In order to determine whether the issuance of stock to the key employee, in fact, motivated the distribution of the Y stock, the potential avoidance of Federal taxes is a relevant factor to take into account. If the facts and circumstances establish that the distribution was substantially motivated by the need to issue stock to the employee, the distribution will meet the corporate business purpose requirement.

(c) *Continuity of interest requirement*—(1) *Requirement.* Section 355 applies to a separation that effects only a readjustment of continuing interests in the property of the distributing and controlled corporations. In this regard section 355 requires that one or more persons who, directly or indirectly, were the owners of the enterprise prioı to the distribution or exchange own, in the aggregate, an amount of stock establishing a continuity of interest in each of the modified corporate forms in which the enterprise is conducted after the separation. This continuity of interest requirement is independent of the other requirements under section 355.

(2) *Examples.*

Example (1). For more than five years, corporation X has been engaged directly in one business, and indirectly in a different business through its wholly owned subsidiary, S. The businesses are equal in value. At all times, the outstanding stock of X has been owned equally by unrelated individuals A and B. For valid business reasons, A and B cause X to distribute all of the stock of S to B in exchange for all of B's stock in X. After the transaction, A owns all the stock of X and B owns all the stock of S. The continuity of interest requirement is met because one or more persons who were the owners of X prior to the distribution (A and B) own, in the aggregate, an amount of stock establishing a continuity of interest in each of X and S after the distribution.

Example (2). Assume the same facts as in Example (1), except that pursuant to a plan to acquire a stock interest in X without acquiring, directly or indirectly, an interest in S, C purchased one-half of the X stock owned by A and immediately thereafter X distributed all of the S stock to B in exchange for all of B's stock in X. After the transactions, A owns 50 percent of X and B owns 100 percent of S. The distribution by X of all of the stock of S to B in exchange for all of B's stock in X will satisfy the continuity of interest requirement for section 355 because one or more persons who were the owners of X prior to the distribution (A and B) own, in the aggregate, an amount of stock establishing a continuity of interest in each of X and S after the distribution.

Example (3). Assume the same facts as in Example (1) and (2), except that C purchased all of the X stock owned by A. After the transactions, neither A nor B own any of the stock of X, and B owns all the stock of S. The continuity of interest requirement is not met because the owners of X prior to the distribution (A and B) do not, in the aggregate, own an amount of stock establishing a continuity of interest in each of X and S after the distribution, *i.e.*, although A and B collectively have retained 50 percent of their equity interest in the former combined enterprise, they have failed to continue to own the minimum stock interest in the distributing corporation, X, that would be required in order to meet the continuity of interest requirement.

Example (4). Assume the same facts as in Examples (1) and (2), except that C purchased 80 percent of the X stock owned by A. After the transactions, A owns 20 percent of the stock of X, B owns no X stock, and B owns 100 percent of the S stock. The continuity of interest requirement is not met because the owners of X prior to the distribution (A and B) do not, in the aggregate, have a continuity of interest in each of X and S after the distribution, *i.e.*, although A and B collectively have retained 60 percent of their equity interest in the former combined enterprise, the 20 percent interest of A in X is less than the minimum equity interest in the distributing corporation, X, that would be required in order to meet the continuity of interest requirement.

(d) *Device for distribution of earnings and profits*—(1) *In general.* Section 355 does not apply to a transaction used principally as a device for the distribution of the earnings and profits of the distributing corporation, the controlled corporation, or both (a "device"). Section 355 recognizes that a tax-free distribution of the stock of a controlled corporation presents a potential for tax avoidance by facilitating the avoidance of the dividend provisions of the Code through the subsequent sale or exchange of stock of one corporation and the retention of the stock of another corporation. A device can include a transaction that effects a recovery of basis. In this paragraph (d), "exchange" includes transactions, such as redemptions, treated as exchanges under the Code. Generally, the determination of whether a transaction was used principally as a device will be made from all of the facts and circumstances, including, but not limited to, the presence of the device factors specified in paragraph (d)(2) of this section ("evidence of device"), and the presence of the nondevice factors specified in paragraph (d)(3) of this section ("evidence of nondevice"). However, if a transaction is specified in paragraph (d)(5) of this section, then it is ordinarily considered not to have been used principally as a device.

(2) *Device factors*—(i) *In general.* The presence of any of the device factors specified in this subparagraph (2) is evidence of device. The strength of this evidence depends on the facts and circumstances.

(ii) *Pro rata distribution.* A distribution that is pro rata or substantially pro rata among the shareholders of the distributing corporation presents the greatest potential for the avoidance of the dividend provisions of the Code and, in contrast to other types of distributions, is more likely to be used principally as a device. Accordingly, the fact that a distribution is pro rata or substantially pro rata is evidence of device.

(iii) *Subsequent sale or exchange of stock*—(A) *In general.* A sale or exchange of stock of the distributing or the controlled corporation after the distribution (a "subsequent sale or exchange") is evidence of device. Generally, the greater the percentage of the stock sold or exchanged after the distribution, the stronger the evidence of device. In addition, the shorter the period of time between the distribution and the sale or exchange, the stronger the evidence of device.

(B) *Sale or exchange negotiated or agreed upon before the distribution.* A subsequent sale or exchange pursuant to an arrangement negotiated or agreed upon before the distribution is substantial evidence of device.

(C) *Sale or exchange not negotiated or agreed upon before the distribution.* A subsequent sale or exchange not pursuant to an arrangement negotiated or agreed upon before the distribution is evidence of device.

(D) *Negotiated or agreed upon before the distribution.* For purposes of this subparagraph (2), a sale or exchange is always pursuant to an arrangement negotiated or agreed upon before the distribution if enforceable rights to buy or sell existed before the distribution. If a sale or exchange was discussed by the buyer and the seller before the distribution and was reasonably to be anticipated by both parties, then the sale or exchange will ordinarily be considered to be pursuant to an arrangement negotiated or agreed upon before the distribution.

(E) *Exchange in pursuance of a plan of reorganization*. For purposes of this subparagraph (2), if stock is exchanged for stock in pursuance of a plan of reorganization, and either no gain or loss or only an insubstantial amount of gain is recognized on the exchange, then the exchange is not treated as a subsequent sale or exchange, but the stock received in the exchange is treated as the stock surrendered in the exchange. For this purpose, gain treated as a dividend pursuant to sections 356(a)(2) and 316 shall be disregarded.

(iv) *Nature and use of assets*—(A) *In general*. The determination of whether a transaction was used principally as a device will take into account the nature, kind, amount, and use of the assets of the distributing and the controlled corporations (and corporations controlled by them) immediately after the transaction.

(B) *Assets not used in a trade or business meeting the requirement of section 355 (b)*. The existence of assets that are not used in a trade or business that satisfies the requirements of section 355(b) is evidence of device. For this purpose, assets that are not used in a trade or business that satisfies the requirements of section 355(b) include, but are not limited to, cash and other liquid assets that are not related to the reasonable needs of a business satisfying such section. The strength of the evidence of device depends on all the facts and circumstances, including, but not limited to, the ratio for each corporation of the value of assets not used in a trade or business that satisfies the requirements of section 355(b) to the value of its business that satisfies such requirements. A difference in the ratio described in the preceding sentence for the distributing and controlled corporation is ordinarily not evidence of device if the distribution is not pro rata among the shareholders of the distributing corporation and such difference is attributable to a need to equalize the value of the stock distributed and the value of the stock or securities exchanged by the distributees.

(C) *Related function*. There is evidence of device if a business of either the distributing or controlled corporation (or a corporation controlled by it) is (*1*) a "secondary business" that continues as a secondary business for a significant period after the separation, and (*2*) can be sold without adversely affecting the business of the other corporation (or a corporation controlled by it). A secondary business is a business of either the distributing or controlled corporation, if its principal function is to serve the business of the other corporation (or a corporation controlled by it). A secondary business can include a business transferred to a newly-created subsidiary or a business which serves a business transferred to a newly-created subsidiary. The activities of the secondary business may consist of providing property or performing services. Thus, in example (11) of §1.355-3(c), evidence of device would be presented if the principal function of the coal mine (satisfying the requirements of the steel business) continued after the separation and the coal mine could be sold without adversely affecting the steel business. Similarly, in example (10) of §1.355-3 (c), evidence of device would be presented if the principal function of the sales operation after the separation is to sell the output from the manufacturing operation and the sales operation could be sold without adversely affecting the manufacturing operation.

(3) *Nondevice factors*—(i) *In general*. The presence of any of the nondevice factors specified in this subparagraph (3) is evidence of nondevice. The strength of this evidence depends on all of the facts and circumstances.

(ii) *Corporate business purpose*. The corporate business purpose for the transaction is evidence of nondevice. The stronger the evidence of device (such as the presence of the device factors specified in paragraph (d)(2) of this section), the stronger the corporate business purpose required to prevent the determination that the transaction was used principally as a device. Evidence of device presented by the transfer or retention of assets not used in a trade or business that satisfies the requirements of section 355(b) can be outweighed by the existence of a corporate business purpose for those transfers or retentions. The assessment of the strength of a corporate business purpose will be based on all of the facts and circumstances, including, but not limited to, the following factors:

(A) The importance of achieving the purpose to the success of the business;

(B) The extent to which the transaction is prompted by a person not having a proprietary interest in either corporation, or by other outside factors beyond the control of the distributing corporation; and

(C) The immediacy of the conditions prompting the transaction.

(iii) *Distributing corporation publicly traded and widely held*. The fact that the distributing corporation is publicly traded and has no shareholder who is directly or indirectly the beneficial owner of more than five percent of any class of stock is evidence of nondevice.

(iv) *Distribution to domestic corporate shareholders*. The fact that the stock of the controlled corporation is distributed to one or more domestic corporations that, if section 355 did not apply, would be entitled to a deduction under section 243(a)(1) available to corporations meeting the stock ownership requirements of section 243(c), or a deduction under section 243(c)(2) or (3) or 245(b) is evidence of nondevice.

(4) *Examples*. The provisions of paragraph (d)(1) through (3) of this section may be illustrated by the following examples:

Example (1). Individual A owns all of the stock of corporation X, which is engaged in the warehousing business. X owns all of the stock of corporation Y, which is engaged in the transportation business. X employs individual B, who is extremely knowledgeable of the warehousing business in general and the operations of X in particular. B has informed A that he will seriously consider leaving the company if he is not given the opportunity to purchase a significant amount of stock of X. Because of his knowledge and experience, the loss of B would seriously damage the business of X. B cannot afford to purchase any significant amount of stock of X as long as X owns Y. Accordingly, X distributes the stock of Y to A and A subsequently sells a portion of his X stock to B. However, X could have issued additional shares to B sufficient to give B an equivalent ownership interest in X. There is no other evidence of device or evidence of nondevice. In light of the fact that X could have issued additional shares to B, the sale of X stock by A is substantial evidence of device. The transaction is considered to have been used principally as a device. See paragraph (d)(1), (2)(ii), (iii)(A)(B) and (D), and (3)(i) and (ii) of this section.

Example (2). Corporation X owns and operates a fast food restaurant in State M and owns all of the stock of corporation Y, which owns and operates a fast food restaurant in State N. X and Y operate their businesses under franchises granted by D and E, respectively. X owns cash and marketable securities that exceed the reasonable needs of its business but whose value is small relative to the value of its business. E has recently changed its franchise policy and will no longer grant or renew franchises to subsidiaries (or other members of the same affiliated group) of corporations operating businesses under franchises granted by its competitors. Thus, Y will lose its franchise if it remains a subsidiary of X. The franchise is about to expire. Accordingly, X distributes the stock of Y pro rata among X's shareholders. X retains its business and transfers cash and marketable securities to Y in an amount proportional to the value of Y's business. There is no other evidence of device or evidence of nondevice. The transfer by X to Y and the retention by X of cash and marketable securities is relatively weak evidence of device because after the transfer X and Y hold cash and marketable securities in amounts proportional to the values of their businesses. The fact that the distribution is pro rata is evidence of device. A strong corporate business purpose is relatively strong evidence of nondevice. Accordingly, the transaction is considered not to have been used principally as a device. See paragraph (d)(1), (2)(ii), (iv)(A), and (B) and (3)(i) and (ii)(A), (B), and (C) of this section.

Example (3). Corporation X is engaged in a regulated business in State M and owns all of the stock of corporation Y, which is not engaged in a regulated business in State M. State M has recently amended its laws to provide that affiliated corporations operating in M may not conduct both regulated and unregulated businesses. X transfers cash not related to the reasonable needs of the business of X or Y to Y and then distributes the stock of Y pro rata among X's shareholders. As a result of the transfer of cash, the ratio of the value of its assets not used in a trade or business that satisfies the requirements of section 355(b) to the value of its business is substantially greater for Y than for X. There is no other evidence of device or evidence of nondevice. The transfer of cash by X to Y is relatively strong evidence of device because after the transfer Y holds disproportionately many assets that are not used in a trade or business that satisfies the requirements of section 355(b). The fact that the distribution is pro rata is evidence of device. The strong business purpose is relatively strong evidence of nondevice, but it does not pertain to the transfer. Accordingly, the transaction is considered to have been used principally as a device. See paragraph (d)(1), (2)(ii), (iv)(A) and (B), and (3)(i) and (ii) of this section.

Example (4). The facts are the same as in example (3), except that, instead of transferring cash to Y, X purchases operating assets unrelated to the business of Y and transfers them to Y prior to the distribution. There is no other evidence of device or evidence of nondevice. The transaction is considered to have been used principally as a device. See paragraph (d)(1), (2)(ii), (iv)(A) and (B), and (3)(i) and (ii) of this section.

(5) *Transactions ordinarily not considered as a device*—(i) *In general.* This subparagraph (5) specifies three distributions that ordinarily do not present the potential for tax avoidance described in paragraph (d)(1) of this section. Accordingly, such distributions are ordinarily considered not to have been used principally as a device, notwithstanding the presence of any of the device factors described in paragraph (d)(2) of this section. A transaction described in paragraph (d)(5)(iii) or (iv) of this section is not protected by this subparagraph (5) from a determination that it was used principally as a device if it involves the distribution of the stock of more than one controlled corporation and facilitates the avoidance of the dividend provisions of the Code through the subsequent sale or exchange of stock of one corporation and the retention of the stock of another corporation.

(ii) *Absence of earnings and profits.* A distribution is ordinarily considered not to have been used principally as a device if—

(A) The distributing and controlled corporations have no accumulated earnings and profits at the beginning of their respective taxable years,

(B) The distributing and controlled corporations have no current earnings and profits as of the date of the distribution, and

(C) No distribution of property by the distributing corporation immediately before the separation would require recognition of gain resulting in current earnings and profits for the taxable year of the distribution.

(iii) *Section 303(a) transactions.* A distribution is ordinarily considered not to have been used principally as a device if, in the absence of section 355, with respect to each shareholder distributee, the distribution would be a redemption to which section 303(a) applied.

(iv) *Section 302(a) transactions.* A distribution is ordinarily considered not to have been used principally as a device if, in the absence of section 355, with respect to each shareholder distributee, the distribution would be a redemption to which section 302(a) applied. For purposes of the preceding sentence, section 302(c)(2)(A)(ii) and (iii) shall not apply.

(v) *Examples.* The provisions of this subparagraph (5) may be illustrated by the following examples:

Example (1). The facts are the same as in example (3) of paragraph (d)(4) of this section, except that X and Y had no accumulated earnings and profits at the beginning of its taxable year, X and Y have no current earnings and profits as of the date of the distribution, and no distribution of property by X immediately before the separation would require recognition of gain that would result in earnings and profits for the taxable year of the distribution. The transaction is considered not to have been used principally as a device. See paragraph (d)(5)(i) and (ii) of this section.

Example (2). Corporation X is engaged in three businesses: a hotel business, a restaurant business, and a rental real estate business. Individuals A, B, and C own all of the stock of X. X transfers the restaurant business to new corporation Y and transfers the rental real estate business to new corporation Z. X then distributes the stock of Y and Z pro rata between B and C in exchange for all of their stock in X. In the absence of section 355, the distribution would be a redemption to which section 302(a) applied. Since this distribution involves the stock of more than one controlled corporation and facilitates the avoidance of the dividend provisions of the Code through the subsequent sale or exchange of stock in one corporation and the retention of the stock of another corporation, it i not protected by paragraph (d)(5)(i) and (iv) of this section from a determination that it was used principally as a device. Thus, the determination of whether the transaction was used principally as a device must be made from all the facts and circumstances, including the presence of the device factors and nondevice factors specified in paragraph (d)(2) and (3) of this section.

(e) *Stock and securities distributed*—(1) *In general.* Section 355 applies to a distribution only if the distributing corporation distributes—

(i) All of the stock and securities of the controlled corporation that it owns, or

(ii) At least an amount of the stock of the controlled corporation that constitutes control as defined in section 368(c). In such a case, all, or any part, of the securities of the controlled corporation may be distributed, and paragraph (e)(2) of this section shall apply.

(2) *Additional rules.* Where a part of either the stock or the securities of the controlled corporation is retained under paragraph (e)(1)(ii) of this section, it must be established to the satisfaction of the Commissioner that the retention by the distributing corporation was not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax. Ordinarily, the corporate business purpose or purposes for the distribution will require the distribution of all of the stock and securities of the controlled corporation. If the distribution of all of the stock and securities of a controlled corporation would be treated to any extent as a distribution of "other property" under section 356, this fact tends to establish that the retention of stock or securities is in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax.

(f) *Principal amount of securities*—(1) *Securities received.* Section 355 does not apply to a distribution if, with respect to any shareholder or security holder, the principal amount of securities received exceeds the principal amount of securities surrendered, or securities are received but no securities are surrendered. In such cases, see section 356.

(2) *Only stock received.* If only stock is received in a distribution to which section 355(a)(1)(A) applies, the principal amount of the securities surrendered, if any, and the par value or stated value of the stock surrendered, if any, are not relevant to the application of that section.

(g) *Period of ownership*—(1) *Other property.* For purposes of section 355(a)(1)(A), stock of a controlled corporation acquired in a transaction in which gain or loss was recognized in whole or in part (other than a transaction described in §1.355-3(b)(4)(iii)) within the five-year period ending on the date of the distribution shall not be treated as stock of the controlled corporation but shall be treated as "other property." See section 356. However, for purposes of section 355(a)(1)(D), the stock so acquired is stock of the controlled corporation.

(2) *Example*. Paragraph (g) (1) of this section may be illustrated by the following example:

Example. Corporation X has held 85 of the 100 outstanding shares of the stock of corporation Y for more than five years on the date of the distribution. Six months before that date, X purchased ten more shares. If X distributes all of its 95 shares of the stock of Y, so much of section 356 as relates to section 355 may apply to the transaction and the ten newly acquired shares are treated as other property. On the other hand, if X retains ten of the shares of the stock of Y then the application of paragraph (e) of this section must take into account all of the stock of Y, including the ten shares newly acquired by X and the five shares owned by others. Similarly, if, by the use of any agency, X acquired any of the stock of Y within the five-year period ending on the date of the distribution in a transaction in which gain or loss was recognized in whole or in part (for example, where another subsidiary of X purchased stock of Y), then that stock is treated as other property. If X had held only 75 of the 100 outstanding shares of the stock of Y for more than five years on the date of the distribution and had purchased the remaining 25 shares six months before that date, then neither section 355 nor section 356 would apply to the distribution.

(h) *Active conduct of a trade or business*. Section 355 applies to a distribution only if the requirements of §1.355-3 (relating to the active conduct of a trade or business) are satisfied.

§1.355-3 Active conduct of a trade or business.

(a) *General requirements*—(1) *Application of section 355*. Under section 355(b)(1), a distribution of stock, or stock and securities, of a controlled corporation qualifies under section 355 only if—

(i) The distributing and the controlled corporations are each engaged in the active conduct of a trade or business immediately after the distribution (section 355(b)(1)(A)), or

(ii) Immediately before the distribution, the distributing corporation had no assets other than stock or securities of the controlled corporations, and each of the controlled corporations is engaged in the active conduct of a trade or business immediately after the distribution (section 355(b)(1)(B)). A *de minimis* amount of assets held by the distributing corporation shall be disregarded for purposes of this paragraph (a)(1)(ii).

(2) *Examples*. Paragraph (a) (1) of this section may be illustrated by the following examples:

Example (1). Prior to the distribution, corporation X is engaged in the active conduct of a trade or business and owns all of the stock of corporation Y, which also is engaged in the active conduct of a trade or business. X distributes all of the stock of Y to X's shareholders, and each corporation continues the active conduct of its trade or business. The active business requirement of section 355(b)(1)(A) is satisfied.

Example (2). The facts are the same as in example (1), except that X transfers all of its assets other than the stock of Y to a new corporation in exchange for all of the stock of the new corporation and then distributes the stock of both controlled corporations to X's shareholders. The active business requirement of section 355(b)(1)(B) is satisfied.

(b) *Active conduct of a trade or business defined*—(1) *In general*. Section 355(b)(2) provides rules for determining whether a corporation is treated as engaged in the active conduct of a trade or business for purposes of section 355(b)(1). Under section 355(b)(2)(A), a corporation is treated as engaged in the active conduct of a trade or business if it is itself engaged in the active conduct of a trade or business or if substantially all of its assets consist of the stock, or stock and securities, of a corporation or corporations controlled by it (immediately after the distribution) each of which is engaged in the active conduct of a trade or business.

(2) *Active conduct of a trade or business immediately after distribution*—(i) *In general*. For purposes of section 355(b), a corporation shall be treated as engaged in the "active conduct of a trade or business" immediately after the distribution if the assets and activities of the corporation satisfy the requirements and limitations described in paragraph (b)(2)(ii), (iii), and (iv) of this section.

(ii) *Trade or business*. A corporation shall be treated as engaged in a trade or business immediately after the distribution if a specific group of activities are being carried on by the corporation for the purpose of earning income or profit, and the activities included in such group include every operation that forms a part of, or a step in, the process of earning income or profit. Such group of activities ordinarily must include the collection of income and the payment of expenses.

(iii) *Active conduct*. For purposes of section 355(b), the determination whether a trade or business is actively conducted will be made from all of the facts and circumstances. Generally, the corporation is required itself to perform active and substantial management and operational functions. Generally, activities performed by the corporation itself do not include activities performed by persons outside the corporation, including independent contractors. A corporation may satisfy the requirements of this subdivision (iii) through the activities that it performs itself, even though some of its activities are performed by others. Separations of real property all or substantially all of which is occupied prior to the distribution by the distributing or the controlled corporation (or by any corporation controlled directly or indirectly by either of those corporations) will be carefully scrutinized with respect to the requirements of section 355(b) and this §1.355-3.

(iv) *Limitations*. The active conduct of a trade or business does not include—

(A) The holding for investment purposes of stock, securities, land, or other property, or

(B) The ownership and operation (including leasing) of real or personal property used in a trade or business, unless the owner performs significant services with respect to the operation and management of the property.

(3) *Active conduct for five-year period preceding distribution*. Under section 355(b)(2)(B), a trade or business that is relied upon to meet the requirements of section 355(b) must have been actively conducted throughout the five-year period ending on the date of the distribution. For purposes of this subparagraph (3)—

(i) activities which constitute a trade or business under the tests described in paragraph (b)(2) of this section shall be treated as meeting the requirement of the preceding sentence if such activities were actively conducted throughout the 5-year period ending on the date of distribution, and

(ii) the fact that a trade or business underwent change during the five-year period preceding the distribution (for example, by the addition of new or the dropping of old products, changes in production capacity, and the like) shall be disregarded, provided that the changes are not of such a character as to constitute the acquisition of a new or different business. In particular, if a corporation engaged in the active conduct of one trade or business during that five-year period purchased, created, or otherwise acquired another trade or business in the same line of business, then the acquisition of that other business is ordinarily treated as an expansion of the original business, all of which is treated as having been actively conducted during that five-year period, unless that purchase, creation, or other acquisition effects a change of such a character as to constitute the acquisition of a new or different business.

(4) *Special rules for acquisition of a trade or business (Prior to the Revenue Act of 1987 and Technical and Miscellaneous Revenue Act of 1988)*—(i) *In general.* Under section 355(b)(2)(C), a trade or business relied upon to meet the requirements of section 355(b) must not have been acquired by the distributing corporation, the controlled corporation, or another member of the affiliated group during the five-year period ending on the date of the distribution unless it was acquired in a transaction in which no gain or loss was recognized. Similarly, under section 355(b)(2)(D), the trade or business must not have been indirectly acquired by any of those corporations (or a predecessor in interest of any of those corporations) during that five-year period in a transaction in which gain or loss was recognized in whole or in part and which consisted of the acquisition of control of the corporation directly engaged in the trade or business, or the indirect acquisition of control of that corporation through the direct or indirect acquisition of control of one or more other corporations. A trade or business acquired, directly or indirectly, within the five-year period ending on the date of the distribution in a transaction in which the basis of the assets acquired was not determined in whole or in part by reference to the transferor's basis does not qualify under section 355(b)(2), even though no gain or loss was recognized by the transferror.

(ii) *Example.* Paragraph (b)(4)(i) of this section may be illustrated by the following example:

Example. In 1985, corporation X, which operates a business and has cash and other liquid assets, purchases all of the stock of corporation Y, which is engaged in the active conduct of a trade or business. Later in the same year, X merges into Y in a "downstream" statutory merger. In 1986, Y transfers the business assets formerly owned by X to a new subsidiary, corporation Z, and then distributes the stock of Z to Y's shareholders. Section 355 does not apply to the distribution of the stock of Z because the trade or business of Y was indirectly acquired by X, a predecessor in interest of Y, during the five-year period preceding the distribution.

(iii) *Gain or loss recognized in certain transactions.* The requirements of section 355(b)(2)(C) and (D) are intended to prevent the direct or indirect acquisition of a trade or business by a corporation in anticipation of a distribution by the corporation of that trade of business in a distribution to which section 355 would otherwise apply. A direct or indirect acquisition of a trade or business by one member of an affiliated group from another member of the group is not the type of transaction to which section 355 (b)(2)(C) and (D) is intended to apply. Therefore, in applying section 355 (b)(2)(C) or (D), such an acquisition, even though taxable, shall be disregarded.

(iv) *Affiliated group.* For purposes of this subparagraph (4), the term "affiliated group" means an affiliated group as defined in section 1504(a) (without regard to section 1504(b)), except that the term "stock" includes nonvoting stock described in section 1504(a)(4).

(5) *Special rules for acquisition of a trade or business (After the Revenue Act of 1987 and Technical and Miscellaneous Revenue Act of 1988).* [Reserved]

(c) *Examples.* The following examples illustrate section 355(b)(2)(A) and (B) and paragraph (b)(1), (2), and (3) of this section. However, a transaction that satisfies these active business requirements will qualify under section 355 only if it satisfies the other requirements of section 355(a) and (b).

Example (1). Corporation X is engaged in the manufacture and sale of soap and detergents and also owns investment securities. X transfers the investment securities to new subsidiary Y and distributes the stock of Y to X's shareholders. Y does not satisfy the requirements of section 355(b) because the holding of investment securities does not constitute the active conduct of a trade or business. See paragraph (b)(2)(iv)(A) of this section.

Example (2). Corporation X owns, manages, and derives rental income from an office building and also owns vacant land. X transfers the land to new subsidiary Y and distributes the stock of Y to X's shareholders. Y will subdivide the land, install streets and utilities, and sell the developed lots to various homebuilders. Y does not satisfy the requirements of section 355(b) because no significant development activities were conducted with respect to the land during the five-year period ending on the date of the distribution. See paragraph (b)(3) of this section.

Example (3). Corporation X owns land on which it conducts a ranching business. Oil has been discovered in the area, and it is apparent that oil may be found under the land on which the ranching business is conducted. X has engaged in no significant activities in connection with its mineral rights. X transfers its mineral rights to new subsidiary Y and distributes the stock of Y to X's shareholders. Y will actively pursue the development of the oil producing potential of the property. Y does not satisfy the requirements of section 355(b) because X engaged in no significant exploitation activities with respect to the mineral rights during the five-year period ending on the date of the distribution. See paragraph (b)(3) of this section.

Example (4). For more than five years, corporation X has conducted a single business of constructing sewage disposal plants and other facilities. X transfers one half of its assets to new subsidiary Y. These assets include a contract for the construction of a sewage disposal plant in State M, construction equipment, cash, and other tangible assets. X retains a contract for the construction of a sewage disposal plant in State N, construction equipment, cash, and other intangible assets. X then distributes the stock of Y to one of X's shareholders in exchange for all of his stock of X. X and Y both satisfy the requirements of section 355(b). See paragraph (b)(3)(i) of this section.

Example (5). For the past six years, corporation X has owned and operated two factories devoted to the production of edible pork skins. The entire output of one factory is sold to one customer, C, while the output of the second factory is sold to C and a number of other customers. To eliminate errors in packaging, X opens a new factory. Thereafter, orders from C are processed and packaged at the two original factories, while the new factory handles only orders from other customers. Eight months after opening the new factory, X transfers it and related business assets to new subsidiary Y and distributes the stock of Y to X's shareholders. X and Y both satisfy the requirements of section 355(b). See paragraph (b)(3)(i) and (ii) of this section.

Example (6). Corporation X has owned and operated a men's retail clothing store in the downtown area of the City of G for nine years and has owned and operated another men's retail clothing store in a suburban area of G for seven years. X transfers the store building, fixtures, inventory, and other assets related to the operations of the suburban store to new subsidiary Y. X also transfers to Y the delivery trucks and delivery personnel that formerly served both stores. Henceforth, X will contract with a local public delivery service to make its deliveries. X retains the warehouses that formerly served both stores. Henceforth, Y will lease warehouse space from an unrelated public warehouse company. X then distributes the stock of Y to X's shareholders. X and Y both satisfy the requirements of section 355(b). See paragraph (b)(3)(i) of this section.

Example (7). For the past nine years, corporation X has owned and operated a department store in the downtown area of the City of G. Three years ago, X acquired a parcel of land in a suburban area of G and constructed a new department store on it. X transfers the suburban store and related business assets to new subsidiary Y and distributes the stock of Y to X's shareholders. After the distribution, each store has its own manager and is operated independently of the other store. X and Y both satisfy the requirements of section 355(b). See paragraph (b)(3)(i) and (ii) of this section.

Example (8). For the past six years, corporation X has owned and operated hardware stores in several states. Two years ago, X purchased all of the assets of a hardware store in State M, where X had not previously conducted business. X transfers the State M store and related business assets to new subsidiary Y and distributes the stock of Y to X's shareholders. After the distribution, the State M store has its own manager and is operated independently of the other stores. X and Y both satisfy the requirements of section 355(b). See paragraph (b)(3)(i) and (ii) of this section.

Example (9). For the past eight years, corporation X has engaged in the manufacture and sale of household products. Throughout this period, X has maintained a research department for use in connection with its manufacturing activities. The research department has 30 employees actively engaged in the development of new products. X transfers the research department to new subsidiary Y and distributes the stock of Y to X's shareholders. After the distribution, Y continues its research operations on a contractual basis with several corporations, including X. X and Y both satisfy the requirements of section 355(b). See paragraph (b)(3)(i) of this section. The result in this example is the same if, after the distribution, Y continues its research operations but furnishes its services only to X. See paragraph (b)(3)(i) of this section. However, see §1.355-2(d)(2)(iv)(C) (related function device factor) for possible evidence of device.

Example (10). For the past six years, corporation X has processed and sold meat products. X derives income from no other source. X separates the sales function from the processing function by transferring the business assets related to the sales function and cash for working capital to new subsidiary Y. X then distributes the stock of Y to X's shareholders. After the distribution, Y purchases for resale the meat products processed by X. X and Y both satisfy the requirements of section 355(b). See paragraph (b)(3)(i) of this section. However, see §1.355-2(d)(2)(iv)(C) (related function device factor) for possible evidence of device.

Example (11). For the past eight years, corporation X has been engaged in the manufacture and sale of steel and steel products. X owns all of the stock of corporation Y, which, for the past six years, has owned and operated a coal mine for the sole purpose of supplying X's coal requirements in the manufacture of steel. X distributes the stock of Y to X's shareholders. X and Y both satisfy the requirements of section 355(b). See paragraph (b)(3)(i) of this section. However, see §1.355-2(d)(2)(iv)(C) (related function device factor) for possible evidence of device.

Example (12). For the past seven years, corporation X, a bank, has owned an eleven-story office building, the ground floor of which X has occupied in the conduct of its banking business. The remaining ten floors are rented to various tenants. Throughout this seven-year period, the building has been managed and maintained by employees of the bank. X transfers the building to new subsidiary Y and distributes the stock of Y to X's shareholders. Henceforth, Y will manage the building, negotiate leases, seek new tenants, and repair and maintain the building. X and Y both satisfy the requirements of section 355(b). See paragraph (b)(3) of this section.

Example (13). For the past nine years, corporation X, a bank, has owned a two-story building, the ground floor and one half of the second floor of which X has occupied in the conduct of its banking business. The other half of the second floor has been rented as storage space to a neighboring retail merchant. X transfers the building to new subsidiary Y and distributes the stock of Y to X's shareholders. After the distribution, X leases from Y the space in the building that it formerly occupied. Under the lease, X will repair and maintain its portion of the building and pay property taxes and insurance. Y does not satisfy the requirements of section 355(b) because it is not engaged in the active conduct of a trade or business immediately after the distribution. See paragraph (b)(2)(iv)(A) of this section. This example does not address the question of whether the activities of X with respect to the building prior to the separation would constitute the active conduct of a trade or business.

§1.355-4 Non pro rata distributions, etc.

Section 355 provides for nonrecognition of gain or loss with respect to a distribution whether or not (a) the distribution is pro rata with respect to all of the shareholders of the distributing corporation, (b) the distribution is pursuant to a plan of reorganization within the meaning to section 368(a)(1)(D), or (c) the shareholder surrenders stock in the distributing corporation. Under section 355, the stock of a controlled corporation may consist of common stock or preferred stock. (See, however, section 306 and the regulations thereunder.) Section 355 does not apply, however, if the substance of a transaction is merely an exchange between shareholders or security holders of stock or securities in one corporation for stock or securities in another corporation. For example, if two individuals, A and B, each own directly 50 percent of the stock of corporation X and 50 percent of the stock of corporation Y, section 355 would not apply to a transaction in which A and B transfer all of their stock of X and Y to a new corporation Z, for all of the stock of Z, and Z then distributes the stock of X to A and the stock of Y to B.

Par. 4. A new section 1.355-6 is added to read as follows:

§1.355-6 Certain distributions qualifying under section 355 made ineligible for nonrecognition of gain to the distributing corporation under 337(d). [RESERVED]

Lawrence B. Gibbs,
Commissioner of Internal Revenue.

Approved December 15, 1988

O. Donaldson Chapoton,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on January 4, 1989, 8:45 a.m. and published in the issue of the Federal Register for January 5, 1989, 54 F.R. 283)

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26 CFR 1.355-3: Active conduct of a trade or business.

Active conduct of a trade or business; oil and gas. A nonoperator owner of working interests in oil and gas properties satisfies the active conduct of a trade or business requirement of section 355(b) of the Code under certain circumstances.

Rev. Rul. 89-27

ISSUE

Can a corporation that is a nonoperator owner of working interests in oil and gas properties satisfy the active conduct of a trade or business requirement of section 355(b) of the Internal Revenue Code?

FACTS

For more than 5 years, *X*, a domestic corporation, has been engaged directly and through its subsidiaries in the exploration, development, production and marketing of petroleum products.

Y is a domestic corporation engaged, as discussed below, in the oil and gas business in state *Z*. All of the stock of *Y* has been owned by *X* for more than 5 years. The activities of *Y* are performed by its employees. *Y* employs, on a full time basis, geologists, petroleum engineers, accountants and other employees necessary to conduct its business.

Y is in constant search for properties that may yield commercial quantities of oil and gas and has, in previous years, acquired nonoperator working interests in such properties.

As an owner of a working interest, *Y* participates in deciding whether to develop the property. This requires extensive gathering and analyzing of technical data by *Y*. Once a decision is made to develop any property, *Y* enters into a standard form operating agreement with other owners of working interests in the property.

Under the agreement, one working interest owner (other than *Y*) is designated as operator and generally supervises the daily activities involved in development and production. *Y* pays its pro rata share of costs of development and expenses of operations involving the property. In addition, *Y* meaningfully participates in management decisions, inspects the drilling site to determine if the drilling operations conform to the agreement, and analyzes data obtained from drillsite activities. *Y* also participates in deciding the location and depth of the wells to be drilled and whether to drill a new well, deepen an old well, and to abandon a well. Although the operating agreement reserves the right to *Y* to take the production in kind, *Y* typically authorizes an agent to market the production. *Y* has derived substantial revenue from its oil and gas operations during the last 5 years.

For valid business reasons, *X* proposes to distribute pro-rata to its shareholders all of the shares of *Y*. Thereafter, *Y* will continue its present operations, including the acquisition of additional working interests in new properties.

Except for the question here at issue concerning the active conduct of a trade or business requirement of section 355(b) of the Code, the distribution by *X* of the *Y* shares meets all of the other requirements of section 355 and the regulations thereunder.

LAW AND ANALYSIS

Section 355 of the Code provides rules for the distribution of stock of a corporation controlled by the distributing corporation without recognition of gain or loss to the shareholders. For such treatment, section 355(b)(1)(A) requires that both the distributing corporation and the controlled corporation must be engaged in the active conduct of a trade or business. Section 355(b)(2)(B) provides that a corporation will be treated as engaged in the active conduct of a trade or business only if such trade or business has been actively conducted throughout the 5-year period ending on the date of distribution.

Section 1.355-3(b)(2)(ii) of the Income Tax Regulations, in defining "trade or business" for section 355 purposes, provides that a trade or business consists of a specific existing group of activities being carried on for the purpose of earning income or profit from such group of activities, and the activities included in such group must include every operation which forms a part of, or a step in, the process of earning income or profit. Such group of activities ordinarily must include the collection of income and the payment of expenses.

In defining "active conduct" of a trade or business the regulations indicate that in order for a trade or business to be actively conducted, substantial management and operational activities generally must be directly carried on by the corporation itself and such activities generally do not include the activities of others outside the corporation, including independent contractors. However, the fact that a portion of a corporation's business activities is performed by others will not preclude the corporation from being engaged in the active conduct of a trade or business if the corporation itself directly performs active and substantial management and operational functions. Section 1.355-3(b)(2)(iii) of the regulations.

In Revenue Ruling 73-237, 1973-1 C.B. 184, a corporation's direct performance of substantial management and operational activities, apart from those activities performed by independent contractors, was held to satisfy the active conduct of a trade or business requirement of section 355(b) of the Code.

A determination whether a trade or business is actively conducted for purposes of section 355(b) is based on all the facts and circumstances. In the instant case, *Y's* business activities include its direct performance of active and substantial management and operational functions, apart from those activities performed by others. Section 1.355-3(b)(2)(iii) of the regulations; Rev. Rul. 73-237; *also see* Rev. Rul. 73-234, 1973-1 C.B. 180; *compare* Rev. Rul. 73-236, 1973-1 C.B. 183.

HOLDING

Under the facts of this case, *Y*, a non-operator owner of working interests in oil and gas properties, is engaged in the active conduct of a trade or business within the meaning of section 355(b) of the Code. Accordingly, the distribution by *X* to its shareholders of the *Y* stock qualifies as a tax-free distribution under section 355(a)(1) of the Code.

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26 CFR 1.355-4: Active conduct of a trade or business.

Controlled corporation; stock distributing; active business. A corporation purchased all of the stock of another corporation in a transaction in which gain or loss was recognized. Two years later, the acquired corporation distributed the stock of its wholly owned subsidiary, whose stock it had acquired more than five years before that time, to the acquiring corporation. The distribution fails to meet the active trade or business requirement of section 355(b)(2)(D) of the Code, as amended by the Revenue Act of 1987 and the Technical and Miscellaneous Revenue Act of 1988. Rev. Rul. 74-5 obsoleted.

Rev. Rul. 89-37

PURPOSE

This revenue ruling obsoletes Rev. Rul. 74-5, 1974-1 C.B. 82, in light of the amendment of section 355(b)(2)(D) of the Internal Revenue Code by section 10223(b) of the Revenue Act of 1987, Pub. L. No. 100-203, 101 Stat. 1330 (1987) ("Act") and section 2004(k)(1) of the Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, 102 Stat. 3342 (1988) ("TMRA").

LAW AND ANALYSIS

Rev. Rul. 74-5 involved a distribution of the stock of a controlled corporation, *Y*, by a distributing corporation, *X*, to *X*'s parent corporation, *P*, 2 years after *P* acquired the stock of *X* for cash in a transaction in which gain or loss was recognized ("first distribution"). At the time of the first distribution, *X* had owned the stock of *Y* for more than 5 years. *P* subsequently distributed the stock of *Y* to its shareholders at a time when it had not owned the stock of *Y* directly or indirectly through *X* for a 5-year period prior to the distribution ("second distribution"). Rev. Rul. 74-5 considered whether the requirements of section 355(b)(2)(D) of the Code were met with regard to each of the distributions, since *P* acquired control of *X* directly and *Y* indirectly in a transaction in which gain or loss was recognized within the 5-year period prior to each of the distributions.

Section 355(b)(2)(D) of the Code, prior to its amendment by the Act and TMRA, provided that control of a corporation that, at the time of acquisition of control, was conducting an active trade or business, must not have been acquired directly (or through one or more corporations) by "another corporation" within the 5-year period described in section 355(b)(2)(B), or if so acquired by "another corporation" within such period, such control must not have been acquired by reason of transactions in which gain or loss was recognized in whole or in part, or acquired by reason of such transactions combined with acquisitions before the beginning of such period. Rev. Rul. 74-5 reasoned that the purpose of section 355(b)(2)(D) was to prevent a distributing corporation from accumulating excess funds to purchase the stock of a corporation having an active business and then immediately distributing such stock to its shareholders. Rev. Rul. 74-5 concluded that the first distribution was not the type of transaction to which section 355(b)(2)(D) of the Code was directed because *P* was merely the shareholder receiving the distribution and not the distributing corporation or the controlled corporation and, therefore, the ruling held that section 355(b)(2)(D) was inapplicable to the first distribution. Rev. Rul. 74-5 further held that the second distribution did not meet the requirements of section 355(b)(2)(D) because the distributing corporation, *P*, indirectly acquired control of the controlled corporation, *Y*, through another corporation, *X*, in a transaction in which gain or loss was recognized within the 5-year period prior to the distribution.

Section 10223(b) of the Act and section 2004(k)(1) of TMRA amended section 355(b)(2)(D) of the Code to provide that a corporation is engaged in the active conduct of a trade or business only if control of a corporation which (at the time of acquisition of control) was conducting such trade or business (i) was not acquired by any distributee corporation directly (or through one or more corporations, whether through the distributing corporation or otherwise) within the 5-year period ending on the date of the distribution, and was not acquired by the distributing corporation directly (or through one or more corporations) within such period, or (ii) was so acquired by any such corporation within such period, but, in each case in which such control was so acquired, it was so acquired only by reason of transactions in which gain or loss was not recognized in whole or in part, or only by reason of such transactions combined with acquisitions before the beginning of such period.

Under section 355(b)(2)(D) of the Code, as amended by section 10223(b) of the Act and section 2004(k)(1) of TMRA, the first distribution described in Rev. Rul. 74-5 is now a transaction described in section 355(b)(2)(D). Therefore, because *Y* was acquired by a distributee corporation within the meaning of section 355(b)(2)(D) in a transaction in which gain or loss was recognized within the 5-year period prior to the distribution, the first distribution fails to meet the active trade or business requirement of section 355(b)(2)(D).

The holding as to the second distribution in Rev. Rul. 74-5 has not been affected by the Act or by TMRA.

EFFECT ON OTHER REVENUE RULINGS

Rev. Rul. 74-5 is obsoleted.

PROSPECTIVE APPLICATION

This revenue ruling is effective for distributions of stock which are subject to the amendments made by section 10223(b) of the Act and section 2004(k)-(1) of TMRA. Under section 10223(d)-(2)(A) of the Act and section 2004(k) of TMRA, the transition rules provide that the amendments do not apply to any distribution after December 15, 1987, and before January 1, 1993, if (1) 80 percent or more of the stock of the distributing corporation was acquired by the distributee before December 15, 1987, or (2) 80 percent or more of the stock of the distributing corporation was acquired by the distributee before January 1, 1989, pursuant to a binding written contract or tender offer in effect on December 15, 1987. For purposes of these transition rules, stock described in section 1504(a)-(4) of the Code is not taken into account.

Subpart D.—Special Rules; Definitions

Section 367.—Foreign Corporations

26 CFR 7.367(b)-2: Definitions.

T.D. 8243

TITLE 26—INTERNAL REVENUE.—CHAPTER 1, SUBCHAPTER A, PART 7—TEMPORARY INCOME TAX REGULATIONS UNDER THE TAX REFORM ACT OF 1976

Requirements Relating to Certain Exchanges Involving a Foreign Corporation

AGENCY: Internal Revenue Service, Treasury.

ACTION: Temporary regulations.

SUMMARY: This document provides temporary Income Tax Regulations concerning requirements relating to certain exchanges involving a foreign corporation as required by section 367(b) of the Internal Revenue Code as enacted by the Tax Reform Act of 1976 [1976-3 C.B. (Vol. 1), 1]. These regulations would provide guidance needed to comply with these requirements. The text of the temporary regulations set forth in this document also serves as the text of proposed regulations that are cross-referenced in * * * [INTL-988-86, page 1024, this Bulletin].

DATES: Section 7.367(b)-2(d) and (f) are effective on January 1, 1978, and applies to exchanges beginning on or after that date. Sections 7.367(b)-7(c)(1) and 7.367(b)-9(b)(4) are effective on March 3, 1989, and apply to transactions beginning on or after that date.

SUPPLEMENTARY INFORMATION:

BACKGROUND

This document contains amendments to §§7.367(b)-2(d) and (f), 7.367(b)-7(c)(1) and 7.367(b)-9(b) of 26 CFR Part 7. Temporary regulations under those sections with cross-reference notice were originally published on December 20, 1977 (42 FR 65152, 65204) [1977-2 C.B. 112].

NEED FOR TEMPORARY REGULATIONS

This Treasury decision with respect to §7.367(b)-2(d) and (f) merely clarifies existing rules in the section 367(b) temporary regulations. With respect to §§7.367(b)-7(c)(1) and 7.367(b)-9(b)(4) this Treasury decision eliminates unintended opportunities available under the existing section 367(b) temporary regulations to avoid liability for income tax. For these reasons, it is found impractical to issue this Treasury decision with notice and public procedure either under section 553(b) of Title 5 of the United States Code or subject to the effective date limitation of subsection (d) of that section. In addition, in order to prevent avoidance by taxpayers of the changes made to §§7.367(b)-7(c)(1) and 7.367-(b)-9(b)(4), it is provided that those changes will be effective on March 3, 1989.

EXPLANATION OF PROVISIONS

Section 7.367(b)-2(d) defines the term "section 1248 amount" to mean the earnings and profits or deficit in earnings and profits which would have been attributed under section 1248 to the stock of the foreign corporation exchanged if the stock had been sold in a transaction to which section 1248(a) applied. Section 7.367(b)-2(f) defines the term "all earnings and profits amount" to mean the earnings and profits or deficit in earnings and profits for all taxable years which are attributable to the stock of the foreign corporation exchanged under the principles of section 1246 or 1248. This section is amended by these regulations to clarify that for purposes of exchanges of stock in a first-tier foreign corporation described by §7.367(b)-7(c)(1)(i) or distributions by a foreign corporation covered by §7.367(b)-10(i) in which an inclusion determined by reference to the "section 1248 amount" is required, the term "section 1248 amount" means only the net positive earnings and profits attributable to stock. For purposes of asset repatriations covered by §§7.367-(b)-5(b), 7.367(b)-6(c), 7.367(b)-7(c)(2) and 7.367(b)-10(j), the term "all earnings and profits amount" means only the net positive earnings and profits. This amendment applies to exchanges beginning on or after January 1, 1978. For all other purposes, the terms "section 1248 amount" and "all earnings and profits amount" mean earnings and profits or deficits for all taxable years attributable to stock. Section 7.367(b)-7(c)(1) is amended by these regulations to provide that the addition procedure of paragraph (c)(1)(ii) will not apply if the stock received is of a domestic corporation which is a member of the affiliated group as defined in section 1504(a) (without application of section 1504(b)(3)) that also includes the exchanging foreign corporation. This amendment applies to exchanges beginning on or after March 3, 1989.

Section 7.367(b)-9 is amended by these regulations to provide that a foreign corporation will not succeed to the earnings and profits or deficit in earnings and profits of another foreign corporation except to the extent provided in section 381(a) and the regulations under that section if the stock of such corporation is received in an exchange subject to section 7.367(b)-9, and a U.S. shareholder described in section 7.367(b)-7(b) or section 7.367(b)-8(c)(1) owns (applying the attribution rules of section 958) more than 50 percent of either the total voting power or the total value of the stock of both the corporation whose stock is received in the exchange and the corporation whose stock is exchanged. This amendment is effective on or after March 3, 1989. Under these regulations, the foreign corporation whose stock is received in the exchange will only succeed to the earnings and profits or deficit in earnings and profits of the acquired corporation and lower-tier subsidiaries of the acquired corporation as provided in section 381(a) and the regulations thereunder.

Post-exchange distributions of earnings and profits and sales of stock may in some circumstances result in double counting of section 1248 earnings. Regulations which will finalize the temporary regulations under section 367(b) will be issued to prevent this double counting of earnings and profits. The regulations with regard to this issue, when finalized, will be retroactive to the effective date of the above amendment.

SPECIAL ANALYSES

These rules are not major rules as defined in Executive Order 12291. Therefore, a Regulatory Impact Analysis is not required. A general notice of proposed rulemaking is not required by 5 U.S.C. §553 for temporary regulations. Therefore, these rules do not constitute regulations subject to the Regulatory Flexibility Act (5 U.S.C. Chapter 6) and a Regulatory Flexibility Analysis is not required.

* * * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR Part 7 is amended as follows:

TEMPORARY INCOME TAX REGULATIONS UNDER THE TAX REFORM ACT OF 1976 (26 CFR Part 7)

Paragraph 1. The authority for Part 7 continues to read as follows:

Authority: 26 U.S.C. 7805. * * * Section 7.367(b)-2 (d) and (f) also issued under 26 U.S.C. 367(b)(2). * * * Section 7.367(b)-7(c)(1) also issued under 26 U.S.C. 367(b)(2) * * * Section 7.367(b)-9(b)(4) also issued under 26 U.S.C. 367(b)(2). * * *

Par. 2. Section 7.367(b)-2 is amended by revising paragraphs (d) and (f) to read as set forth below:

§7.367(b)-2 Definitions.

* * * * * *

(d) *Section 1248 amount.* In the case of an exchange of stock in a first-tier foreign corporation described in §7.367(b)-7(c)(1)(i) or a distribution by a foreign corporation described in §7.367(b)-10(i) in which an inclusion in gross income determined by reference to the "section 1248 amount" is required by those provisions, the term "section 1248 amount" means the net positive earnings and profits which would have been attributable under section 1248 and the regulations under that section to the stock of the foreign corporation exchanged if the stock had been sold in a transaction to which section 1248(a) applied. For all other purposes of this section, in the case of an exchange of stock in a first-tier foreign corporation to which section 367(b) applies, the term "section 1248 amount" means the earnings and profits or deficit in earnings and profits which would have been attributable under section 1248 and the regulations under that section to the stock of the foreign corporation exchanged if the stock had been sold in a transaction to which section 1248(a) applied.

* * * * * *

(f) *All earnings and profits amount.* For purposes of asset repatriations covered by §§7.367(b)-5(b), 7.367-(b)-6(c), 7.367(b)-7(c)(2) and 7.367-(b)-10(j), the term "all earnings and profits amount" means the net positive earnings and profits, if any, for all taxable years which are attributable to the stock of the foreign corporation exchanged under the principles of section 1246 or 1248 (whichever is applicable) and the regulations under that section. For all other purposes, the term "all earnings and profits amount" means the earnings and profits or deficit in earnings and profits for all taxable years which are attributable to the stock of the foreign corporation exchanged under the principles of section 1246 or 1248 (whichever is applicable) and the regulations under that section. The determination shall be made by applying section 1246 or 1248 as modified by §§7.367(b)-2 through 7.367(b)-12 as if there were no distinction in those sections between earnings and profits accumulated before or after December 31, 1962.

* * * * * *

Par. 3. Section 7.367(b)-7(c)(1) is amended as follows:

1. Subdivision (ii) is amended by adding after the second sentence the following sentence "Subdivision (iii) of this paragraph, and not this subdivision (ii), applies if the stock received (A) is of a domestic corporation which is a member of an affiliated group (as defined in section 1504(a), without application of section 1504(b)(3)) that also includes the exchanging foreign corporation as a member, and (B) is not received in an exchange pursuant to which the foreign corporation whose stock is exchanged transfers its assets to a domestic corporation."

2. Subdivision (iii) is redesignated as subdivision (iv) and a new subdivision (iii) is added immediately after subdivision (ii) and before subdivision (iv) to read as follows:

§7.367(b)-7 Exchange of stock described in section 354.

* * * * * *

(c) *Receipt of other stock*—(i) *General rule.*

* * * * * *

(iii) For exchanges beginning after March 3, 1989, if the stock received is described in the last sentence of subdivision (ii), then the foreign corporation whose stock is exchanged will be considered to be a foreign corporation for purposes of section 354 or 356. This subdivision (iii) may be illustrated by the following examples:

Example (1). A U.S. parent corporation (USP) owns all of the stock of a foreign corporation (CFC1), which in turn owns all of the stock of a second foreign corporation (CFC2), which in turn owns all of the stock of a third foreign corporation (CFC3). USP also owns all of the stock of U.S. subsidiary (Subsidiary). CFC2 and CFC3 have accumulated earnings and profits or accumulated deficits in earnings and profits. Subsidiary acquires all of the stock of CFC2 from CFC1 in exchange for stock of Subsidiary in a reorganization described in section 368(a)(1)(B). CFC1 will not recognize gain on the exchange. Moreover, CFC2's and CFC3's accumulated earnings and profits or accumulated deficits in earnings and profits will remain in CFC2 and CFC3, respectively, and will not be added to the earnings and profits account of CFC1.

Example (2). USP owns all of the stock of CFC1, which in turn owns all of the stock of CFC2. USP also owns all of the stock of a U.S. subsidiary (Subsidiary), which in turn owns all of the stock of CFC3. CFC3 acquires the assets of CFC2 in exchange for voting stock of Subsidiary in a reorganization described in section 368(a)(1)(C). Pursuant to the reorganization, CFC2 distributes the stock of Subsidiary to CFC1. CFC1 will not recognize gain on the exchange. In addition, CFC2's accumulated earnings and profits or accumulated deficit in earnings and profits will be added to CFC3's earnings and profits account under section 381(c)(2), subject to the limitations contained in section 381 and in the regulations under that section.

Par. 4. Section 7.367(b)-9 is amended by adding a new paragraph (b)(4) immediately after paragraph (b)(3) to read as follows:

§7.367(b)-9 Attribution of earnings and profits on an exchange described in section 351, 354, or 356.

* * * * * *

(b) *General rule.* * * *

(4) For exchanges beginning on or after March 3, 1989, paragraph (b)(2) and (3) of this section will not apply if a U.S. shareholder described in §7.367(b)-7(b) or §7.367(b)-8(c)(1) owns (applying the attribution rules of section 958) more than 50 percent of either the total voting power or the total value of the stock of both the corporation whose stock is received in the exchange and the corporation whose stock is exchanged. If this paragraph (b)(4) applies, the rules of section 381(a) and the regulations under that section will determine the extent to which the corporation whose stock is received in the exchange (or other acquiring corporation) will succeed to the earnings and profits or a deficit in earnings and profits of the corporation whose stock is exchanged and of lower-tier corporations. This paragraph (b)(4) may be illustrated by the following examples:

Example (1). A U.S. parent owns all of the stock of CFC1 and CFC2. CFC1 has accumulated earnings and profits or an accumulated deficit in earnings and profits. CFC2 acquires all of the stock of CFC1 from the U.S. parent in a reorganization described in section 368(a)(1)(B). CFC2 will not succeed to the earnings and profits or the accumulated deficit in earnings and profits of CFC1.

Example (2). A U.S. parent owns all of the stock of CFC1, which in turn owns all of the stock of CFC2. The U.S. parent also owns all of the stock of CFC3. CFC2 has accumulated earnings and profits or an accumulated deficit in earnings and profits. CFC3 acquires all of the assets of CFC1, including the stock of CFC2, in a reorganization described in section 368(a)(1)(D). CFC3 will not succeed to the earnings and profits or the accumulated deficit in earnings and profits of CFC2.

Lawrence B. Gibbs,
Commissioner of Internal Revenue.

Approved January 30, 1989.

O. Donaldson Chapoton,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on March 3, 1989, 11:08 a.m., and published in the issue of the Federal Register for March 6, 1989, 54 F.R. 9200)

Section 368.—Definitions Relating To Corporate Reorganizations

When, pursuant to a single integrated transaction, a corporation transfers section 38 property to a newly formed subsidiary in year one and distributes its stock in the subsidiary to its shareholders in year two, the disposition of the section 38 property triggering investment credit recapture under section 47(a) of the Code occurs in year one. See Rev. Rul. 89-18, page 14.

26 CFR 1.368-2: Definition of terms.

If a recapitalization that qualifies under section 368(a)(1)(E) increases the value of the stock held by a trust and reduces the value of the stock held by the controlling shareholder, who is the original grantor of the trust, has a gift been made to the trust beneficiaries for federal gift tax purposes, and has an addition to corpus been made for purposes of the generation-skipping transfer tax? See Rev. Rul. 89-3, page 278.

Part V.—Carryovers

Section 381.—Carryovers in Certain Corporate Acquisitions

26 CFR 1.381(c)(1)-1: Net operating loss carryovers in certain corporate acquisitions.

After a consolidation of the common parents of two unrelated affiliated groups described in section 368(a)(1)(A) of the Code, to what extent may the transferor corporations carry back consolidated net operating losses that are attributable to the newly formed common parent corporation. See Rev. Rul. 89-80, page 273.

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

The adjusted federal long-term rate is set fo for the month of January 1989. See Rev. Ri 89-1, page 260.

The adjusted federal long-term rate is set fo for the month of February 1989. See Rev. Ri 89-15, page 262.

The adjusted federal long-term rate is set for for the month of March 1989. See Rev. Ru 89-34, page 263.

The adjusted federal long-term rate is set for for the month of April 1989. See Rev. Rul. 89-3 page 264.

The adjusted federal long-term rate is set for for the month of May 1989. See Rev. Rul. 89-6 page 265.

The adjusted federal long-term rate is set for for the month of June 1989. See Rev. Rul. 89-7 page 266.

Subchapter D.—Deferred Compensation, etc.

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

Subpart A.—General Rule

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

Final guidelines for determining whether a fast vesting rate than would otherwise be required appropriate for advance determination purposes d to actual or potential discrimination in favor of high compensated employees. See Rev. Proc. 89-29, pa 893.

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

Qualification; participants right t exercise control of assets. A plan do not qualify under section 401(a) of t Code where plan participants have t right to acquire, hold and dispose of a amount attributable to their account ba ances in the plan.

Rev. Rul. 89-52

ISSUE

Did a written instrument create qualified trust under section 401(a) of t Internal Revenue Code if participar have the right to acquire, hold and d pose of amounts attributable to their account balances in the plan?

FACTS

An employer adopted a written instrument intended to be a trust forming part of a qualified defined contribution plan. The instrument permits a participant to hold an amount equal to his account balance in the plan. Thus, a participant may invest or reinvest the amounts as the participant determines is appropriate. However, the participant must segregate such investments from such funds and periodically account for them to the trustee named in the instrument. Furthermore, the participant must return the investments to the trustee upon separation from service to be used to provide retirement benefits for the participant.

LAW AND ANALYSIS

Section 401(a) of the Code provides that a trust created or organized in the United States and forming part of a stock bonus, pension or profit-sharing plan of an employer will constitute a qualified trust if certain conditions are met.

Section 1.401-1(a)(3) of the Income Tax Regulations provides that a qualified trust under section 401(a) of the Code must be created or organized in the United States and must be maintained at all times as a domestic trust in the United States.

The term "trust" is not a term of art or of fixed content, and its meaning for the purposes of employee trusts under section 401(a) of the Code is not necessarily the same as under state law or as under other sections of the Internal Revenue Code. *Tavannes Watch Co. v. Commissioner,* 176 F.2d 211, 215 (2d Cir. 1949).

Generally, for a trust to be qualified under section 401(a) of the Code, the trust must be a valid trust under the law of the jurisdiction in which the trust is located. See section 1.401-1(a)(3)(i) of the regulations. However, even if the trust is valid under local law, the arrangement may be required to satisfy certain other requirements in order to be considered a trust for purposes of section 401(a). For example, Rul. Rul. 69-231, 1969-1 C.B. 118, holds that a qualified trust under section 401(a) of the Code must be in writing, even though oral trusts are valid in some states.

In Rev. Rul. 71-437, 1971-2 C.B. 185, the Service considered the qualification of a noncontributory money purchase pension plan that permitted the trustee to make two year loans to plan participants secured by the account balance. The revenue ruling concluded that the plan was not qualified because there was "a tacit understanding between the parties that collection is not intended." Therefore, these so-called "loans" were effectively distributions that violated the requirements for qualification under section 401(a) of the Code.

Similarly, the participants may not have rights which effectively eliminate the trust arrangement required for qualification under section 401(a) of the Code. While a qualified trust may permit a participant to elect how amounts attributable to the participant's account balance will be invested (*see* Rev. Rul. 55-354, 1955-1 C.B. 396), it may not allow the participant to have the right to acquire, hold and dispose of amounts attributable to the participant's account balance at will. *See also* Rev. Rul. 60-323, 1960-2 C.B. 148, *modifying* Rev. Rul. 56-693, 1956-2 C.B. 282. To give the participants such rights effectively eliminates the trust arrangement.

HOLDING

The written instrument described in this case did not create a qualified trust under section 401(a) of the Code because participants have the right to acquire, hold and dispose of an amount attributable to their account balances in the plan.

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26 CFR 1.401(a)-13: Assignment or alienation of benefits.

Employee loans at low interest rates. A loan to a qualified plan participant that is secured by the participant's accrued nonforfeitable benefit constitutes an assignment or alienation if the loan is made at an unreasonable interest rate.

Rev. Rul. 89-14

ISSUE

Whether the benefits of a participant in a qualified plan have been assigned or alienated in violation of section 401(a)(13) of the Internal Revenue Code where the accrued nonforfeitable benefits of the participant were used as security for a loan from the plan's trust to the participant at an unreasonably low interest rate.

FACTS

The employer maintains a plan qualified under section 401 of the Code. The plan provides that a loan from the plan's trust to a plan participant may not exceed the participant's accrued nonforfeitable benefit under the plan. The individual's account is the security for the loan. The plan provides that such a loan is available to all participants on an equivalent basis and is not made available to highly compensated employees in an amount greater than the amount available to other employees.

In 1989 *A*, a participant in the plan, borrowed 100x dollars from the trust of the plan at an unreasonably low interest rate. The loan was secured by *A*'s accrued nonforfeitable benefit under the plan, the value of which was greater than 100x dollars.

A was not a disqualified person within the meaning of section 4975(e)(2) of the Code.

LAW AND ANALYSIS

In general, section 401(a)(13) of the Code states that benefits provided under a qualified plan may not be assigned or alienated. However, a loan from the trust of a plan to a participant secured by the accrued nonforfeitable benefit of the participant shall not be treated as an assignment or alienation, provided the loan is exempt from the tax imposed by section 4975 by reason of section 4975(d)(1).

Section 4975 of the Code imposes an excise tax on prohibited transactions between a qualified plan and a disqualified person. Section 4975(d)(1) provides that the term "prohibited transaction" does not apply to any loan by the plan to a disqualified person who is a participant or beneficiary of the plan if such loan satisfies certain requirements, including the requirement that the loan bear a reasonable rate of interest.

Section 1.401(a)-13(d)(2)(iii) of the Income Tax Regulations states that, if the loan is made to a participant or beneficiary who is not a disqualified person, the loan must be one which would be exempt from the tax imposed by section 4975 by reason of section 4975(d)(1) if the loan were made to a disqualified person.

The loan from the plan to *A* must satisfy the requirements of section 4975(d)(1) even though *A* is not a disqualified person. Since the rate of interest on the loan was not reasonable, the use of *A*'s accrued nonforfeitable benefit constitutes an assignment of *A*'s benefits.

HOLDING

The participant's benefits under the plan were assigned or alienated in violation of section 401(a)(13) because the accrued nonforfeitable benefits of the participant were used as security for the loan from the plan's trust to the participant at an unreasonable rate of interest.

This revenue ruling only deals with the issue whether, under the above facts, the participant's benefits under the plan were assigned or alienated in violation of section 401(a)(13) of the Code. It does not deal with other issues, including the question of whether the loan also violated the requirements of section 401(a) of the Code that the plan be for the exclusive benefit of the employer's employees or with whether the loan may be treated as a distribution under section 72(p).

Section 403.—Taxation of Employee Annuities

26 CFR 1.403(b)-1: Taxability of beneficiary under annuity purchased by a section 501(c)(3) organization or public school.

Individual retirement accounts; rollover; annuity contract. The portion of a distribution from a section 403(b) annuity contract that was previously included in an employee's income may not be rolled over into an IRA.

Rev. Rul. 89-50

ISSUE

Is the transfer to an individual retirement account (IRA) of amounts distributed from an annuity contract described in section 403(b) of the Internal Revenue Code a rollover contribution described in section 403(b)(8) if it includes amounts contributed by the employer in excess of the exclusion allowance under section 403(b)(2)?

FACTS

An employee of an employer described in section 501(c)(3) of the Code received a total distribution within the meaning of section 403(b)(8)(B)(ii) from an annuity contract described in section 403(b)(1). The distribution included contributions made by the employer that had not been excluded from the employee's gross income under section 403(b)(1) because they were in excess of the exclusion allowance of section 403(b)(2). The employee transferred the entire amount of the distribution into an IRA described in section 408 within 60 days of receipt. The annuity contract did not provide for deductible employee contributions under section 72(o).

LAW AND ANALYSIS

Section 403(b)(1) of the Code provides that if certain conditions are met, amounts contributed by an employer described in section 501(c)(3) and exempt from tax under section 501(a) to purchase an annuity contract for an employee shall be excluded from the employee's gross income to the extent such amounts do not exceed the applicable exclusion allowance.

Section 403(b)(8)(A) and (B) of the Code provides that a total distribution from an annuity contract described in section 403(b)(1) shall not be includible in an employee's gross income to the extent that it is transferred to an IRA or another annuity contract described in section 403(b)(1).

Section 403(b)(8)(C) of the Code provides that, for purposes of section 403(b)(8)(A), rules similar to those of section 402(a)(5)(B) shall apply. Under section 402(a)(5)(B), the maximum amount of any total distribution that may be transferred as a rollover contribution is the amount distributed reduced by the employee contributions (other than accumulated deductible employee contributions under section 72(o)).

Section 402(a)(5)(E)(ii) of the Code defines employee contributions for purposes of section 402(a)(5) as the amount considered contributed by the employee, determined by applying section 72(f), less amounts previously distributed to the employee which were not includible in gross income. Section 72(f) provides that the amount of employer contributions includible in the gross income of the employee are considered employee contributions.

A total distribution from an annuity contract described in section 403(b)(1) of the Code is eligible for treatment as a rollover contribution described in section 403(b)(8) only to the extent that it does not exceed the amount received less employee contributions. Any amount transferred in excess of the limitation is not treated as a rollover contribution.

In this case, the amount transferred includes employer contributions that were includible in the employee's gross income and, therefore, pursuant to section 72(f) of the Code, considered employee contributions.

Under section 4973 of the Code, a six percent tax is imposed on the amounts transferred that are not eligible for rollover treatment, except to the extent that such amounts are allowable as contributions under section 408(a) or are distributed from the IRA in accordance with section 408(d)(4).

HOLDING

The portion of the distribution transferred to the IRA that was previously included in the employee's gross income is not a rollover contribution described in section 403(b)(8) of the Code. The fact that part of the amount transferred is not a rollover contribution does not affect the rollover treatment of the eligible portion of the transferred amounts.

Subpart B.—Special Rules

Section 411.— Minimum Vesting Standards

Final guidelines for determining whether a faster vesting rate than would otherwise be required is appropriate for advance determination purposes due to actual or potential discrimination in favor of highly compensated employees. See Rev. Proc. 89-29, page 893.

26 CFR 1.411(a)-6: Year of service, hour of service, breaks in service.

Plan year ending on other than last day of month. A plan does not fail to satisfy the computation period requirements of section 410(a)(3)(A), 411(a)(5)(A) and 411(b)(4)(A) of the Code merely because those periods are based on a plan year that ends on a date other than the last day of the month.

Rev. Rul. 89-13

ISSUE

Will a retirement plan satisfy the computation period requirements of sections 410(a)(3)(A), 411(a)(5)(A), and 411(b)-(4)(A) of the Internal Revenue Code if the plan's eligibility, vesting, and benefit accrual computation periods are based on the plan year, which ends on a specified date other than the last day of the month?

FACTS

An employer maintains a plan having a plan year based on a 12 consecutive month period ending on June 19 of each calendar year. The plan designates the plan year as the vesting and benefit accrual computation periods and as the computation period to be used to determine service for eligibility to participate after the initial eligibility computation period. Each employee who is credited with 1,000 or more hours of service during a plan year is credited with a year of service for eligibility to participate and for vesting in accrued benefits and a full year of participation for benefit accrual.

LAW AND ANALYSIS

Section 410(a)(3)(A) of the Code defines a year of service for eligibility to participate as a 12-month period. Years of service, after the initial 12-month period that begins on the employee's employment commencement date, may be determined by reference to the plan year.

Section 411(a)(5)(A) of the Code defines a year of service for minimum vesting purposes as a calendar year, plan year, or other 12-consecutive month period designated by the plan during which the employee has completed 1,000 hours of service.

Section 411(b)(4)(A) of the Code defines a year of participation for benefit accrual as a period of service calculated on a reasonable and consistent basis. Section 411(b)(4)(C) provides that for any employee whose service is less than 1,000 hours during any calendar year, plan year, or other 12-consecutve month period designated by the plan, the calculation of the employee's period of service shall not be treated as not made on a reasonable and consistent basis solely because such service is not taken into account.

Although, with certain exceptions, section 441 of the Code precludes a taxable year from ending in the middle of a month, this prohibition does not apply to a plan year. The computation periods in this case are based on a designated 12-consecutive month period and are calculated on a reasonable and consistent basis.

It should be noted that the taxable year of any trust forming part of a plan must end on the last day of a month or be based on a 52-53 week year, because the trust is a taxpayer that must comply with the requirements of section 441 of the Code. Section 441(f) permits a taxable year to end on a day other than the last day of a month only when the taxpayer has a 52-53 week year, which could not end on the same date each year.

HOLDING

A plan does not fail to satisfy the computation period requirements of sections 410(a)(3)(A), 411(a)(5)(A), and 411(b)(4)(A) of the Code merely because those periods are based on a plan year that ends on a specified date other than the last day of the month.

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26 CFR 1.411(c)-1 Allocation of accrued benefits between employer and employee contributions.

Allocation of accrued benefit between employee and employer contributions. Guidance is provided as to the effect on section 411(c) of the Code of changes made by section 9346 of the Pension Protection Act (part II of title IX of the Omnibus Budget Reconciliation Act of 1987). Rev. Ruls. 76-47 and 78-202 amplified.

Rev. Rul. 89-60

ISSUES

(1) What interest rates are used to determine an employee's "accumulated contributions" under section 411(c)(2) of the Internal Revenue Code, as amended by section 9346 of the Pension Protection Act ("PPA"), part II of title IX of the Omnibus Budget Reconciliation Act of 1987, Pub. L. No. 100-203?

(2) If a plan distributes the employee's accumulated contributions with interest as a single sum at termination of employment before normal retirement age, what is the amount of the remaining vested accrued benefit in the form of a single life annuity commencing at normal retirement age that satisfies section 411(c)?

FACTS

Employer *X* maintains a qualified defined benefit plan that required mandatory employee contributions for 1987 and prior years, but not for years after 1987. The plan year is the calendar year. The plan provides for a normal retirement age of 65, and 100-percent vesting in the employer-derived portion of a participant's accrued benefit after 5 years of service.

The terms of the plan provide that a participant who terminates employment with *X* prior to attaining normal retirement age may elect, among other optional forms of benefit, to receive one of the following distributions as an alternative to an annual single life annuity commencing at normal retirement age:

1) A single-sum distribution of his or her accrued benefit upon termination of employment. The plan provides that the single sum is calculated using the UP-1984 Mortality Table with a 1-year age set-forward and interest at the applicable rates in effect on the first day of the plan year described in section 417(e) of the Code.

2) A single-sum distribution of his or her employee contributions as of the date of termination of employment, credited with interest to the date of distribution ("determination date") at the rate specified in section 411(c) of the Code, and a distribution of the remainder of his or her vested accrued benefit in the form of an annual single life annuity commencing at normal retirement age.

A, an unmarried participant terminated employment with *X* on July 1, 1988, at age 50 with 7 years of service. *A*'s total accrued benefit under the plan in the form of an annual single life annuity commencing at age 65 is $2,949 per year. As of December 31, 1987, *A*'s total accumulated mandatory employee contributions to the plan, including interest compounded annually at 5 percent, equaled $3,021. On January 1, 1988, 120 percent of the federal mid-term rate under section 1274 of the Code was 10.61 percent.

LAW AND ANALYSIS

Section 411(a)(1) of the Code provides that an employee's rights in the employee's accrued benefit derived from the employee's own contributions must be nonforfeitable.

Section 411(a)(2) of the Code provides that an employee's rights in the employee's accrued benefit derived from employer contributions must be nonforfeitable in accordance with one of the vesting schedules described in section 411(a)(2).

Section 411(c)(1) of the Code provides that an employee's accrued benefit derived from employer contributions is the excess, if any, of the employee's accrued benefit over the employee's accrued benefit derived from contributions made by the employee.

Section 411(c)(2)(B)(i) of the Code provides that, in the case of a defined benefit plan providing an annual benefit in the form of a single life annuity (without ancillary benefits) commencing at normal retirement age, the accrued benefit derived from employee contributions is the annual benefit equal to the employee's accumulated contributions multiplied by the appropriate conversion factor. Section 411(c)(2)(B)(ii) of the Code provides that the appropriate conversion factor is the factor necessary to convert an amount equal to the accumulated contributions to a single life annuity (without ancillary benefits) commencing at normal retirement age, and that this factor shall be 10 percent if the normal retirement age is 65.

Prior to the enactment of section 9346 of the PPA, section 411(c)(2)(C) provided that the term "accumulated contributions" was defined as the sum of (1) mandatory contributions made by the employee; (2) interest under the plan (if any) to the end of the last plan year to which section 411(a)(2) does not apply; and (3) with respect to each subsequent plan year, interest on the amounts determined under (1) and (2) at the rate of 5 percent. Section 9346(b) of the PPA amended section 411(c)(2)(C) by replacing 5 percent with 120 percent of the federal mid-term rate as in effect under section 1274 of the Code for the first month of the plan year ("mid-term AFR"). Section 9346(c) of the PPA provides that the amendments made by section 9346 are effective for plan years beginning after December 31, 1987.

Section 411(c)(2)(E) of the Code provides that the accrued benefit derived from employee contributions shall not exceed the greater of the employee's accrued benefit under the plan, or the accrued benefit derived from employee contributions accumulated using an interest rate of zero.

Section 411(c)(3) of the Code provides:

> ACTUARIAL ADJUSTMENT.—For purposes of this section, in the case of any defined benefit plan, if an employee's accrued benefit is to be determined as an amount other than an annual benefit commencing at normal retirement age, or if the accrued benefit derived from contributions made by an employee is to be determined with respect to a benefit other than an annual benefit in the form of a single life annuity (without ancillary benefits) commencing at normal retirement age, the employee's accrued benefit, or the accrued benefits derived from contributions made by an employee, as the case may be, shall be the actuarial equivalent of such benefit or amount determined under paragraph (1) or (2) [of section 411(c)].

Section 1.411(c)-1(e) of the Income Tax Regulations provides that the actuarial equivalent of the employee's accrued benefit under section 411(c)(1) and the actuarial equivalent of the accrued benefit derived from employee contributions under section 411(c)(2)(B) of the Code shall be as determined by the Commissioner.

Rev. Rul. 76-47, 1976-1 C.B. 109, provides that a benefit in a form other than the normal form of benefit shall not be less than an actuarial equivalent of the normal form of benefit, using the actuarial assumptions or actuarial tables prescribed by the plan or by any insurance or annuity contracts used to provide benefits under the plan ("plan assumptions"). Rev. Rul. 76-47 also states that, notwithstanding that the benefit must be the actuarial equivalent of the normal form of benefit using plan assumptions, the amount of benefits under any form of retirement benefit other than the normal form of benefit shall not be less than the benefit that would be derived from employee contributions if such benefit were the normal form of benefit. Rev. Rul. 76-47 provides appropriate conversion factors to determine the minimum accrued benefit derived from employee contributions when the normal retirement age is not 65. It also sets forth the actuarial adjustment required when the normal form of benefit is other than a single life annuity (without ancillary benefits).

Rev. Rul. 78-202, 1978-1 C.B. 124, requires, generally, that if a benefit derived from employee contributions is payable other than at normal retirement age, the benefit must be at least the actuarial equivalent of the employee-derived benefit payable at normal retirement age, based on the same actuarial assumptions required by section 411(c) and Rev. Rul. 76-47 to be used to determine the accrued benefit derived from employee contributions at normal retirement age. Rev. Rul. 78-202 provides methods for determining a single sum that satisfies this requirement.

Thus, a benefit derived from both employee and employer contributions that is to be distributed in a form other than a single life annuity commencing at normal retirement age must satisfy two requirements. First, the amount of the employee's accrued benefit must be the actuarial equivalent of his or her accrued benefit in the form of a single life annuity commencing at normal retirement age. For this first requirement, the actuarial equivalence is determined using plan assumptions, subject to the interest rate limitation described in section 417(e) of the Code. Second, the amount of the benefit must not be less than the actuarial equivalent of the employee-derived accrued benefit payable in the form of a single life annuity commencing at normal retirement age. For this second requirement, the actuarial equivalence is determined using the actuarial assumptions and factors specified in section 411(c)(2) and Rev. Rul. 76-47, taking into account the principle illustrated in Rev. Rul. 78-202.

Generally, section 411 of the Coc provides that an employee's rights in tl portion of his or her accrued benefit that derived from employee contributions mu be nonforfeitable (vested) at all times, an that the employee's rights in the portion (his or her accrued benefit that is derive from employer contributions become ves ted in accordance with one of variou schedules. Section 411(c) sets forth th requirements for allocating an employee' total accrued benefit between employe and employer contributions.

To comply with the requirements o section 411(c), the plan must first deter mine an employee's vested accrued ben efit in the form of an annual single lif annuity commencing at normal retire ment age. Generally, this amount i determined by converting the accumu lated contributions to a benefit anc adding the vested percentage of th remainder, if any, of the employee' total accrued benefit.

Under section 411(c)(2)(C), accumu lated contributions are all mandatory contributions made by the employee anc interest on such contributions until the employee attains normal retirement age. The interest rate for all plan years begin ning on or after the effective date of sec tion 411(a)(2) and before January 1, 1988, is 5 percent. For each plan yea beginning after December 31, 1987, the interest rate is 120 percent of the mid term AFR for the month that includes the first day of that plan year. The interes rate for the plan year that includes the determination date is also used for the entire period from the determination date to the date on which the employee woul attain normal retirement age.

Accordingly, for plan year 1987 anc each prior plan year, *A*'s accumulatec contributions are credited with interest a 5 percent. For plan year 1988 and al subsequent plan years up to and includ ing the plan year in which *A* would attai normal retirement age, *A*'s accumulate contributions are credited with interest compounded annually, at 120 percent o the mid-term AFR on January 1, 1988 *i.e.*, 10.61 percent. (If *A* were to termi nate employment on July 1, 1989, in stead of 1988, *A*'s accumulated contri butions would be credited with interest a 10.61 percent for 1988 and, because 12 percent of the mid-term AFR on Januar 1, 1989, was 11.11 percent, interest a 11.11 percent for the 1989 plan year an all subsequent plan years up to an including the plan year in which *A* woul attain normal retirement age.)

SINGLE LIFE ANNUITY COMMENCING AT NORMAL RETIREMENT AGE

If *A* elects to receive *A*'s accrued benefit in the form of an annual single life annuity commencing at *A*'s normal retirement age, *A*'s benefit would be determined as follows:

(1) Determine *A*'s total accrued benefit in the form of an annual single life annuity commencing at normal retirement age under the plan's formula ($2,949 per year payable at age 65).

(2) Determine *A*'s accumulated contributions with interest to normal retirement age using, for years prior to January 1, 1988, 5-percent interest (which compounds to $3,021 as of December 31, 1987, in this example) and, for the 1988 plan year until normal retirement age, 10.61-percent interest ($14,420).

(3) Determine the accrued benefit derived from *A*'s contributions by multiplying *A*'s accumulated contributions determined in step (2) by the conversion factor specified in section 411(c)(2)(B)(ii) ($14,420 × 10 percent = $1,442 per year) and then limiting the result as required by section 411(c)(2)(E) to the greater of *A*'s accrued benefit under the plan or the employee's accrued benefit derived from the employee's mandatory contributions, without crediting interest.

(4) Determine the accrued benefit derived from employer contributions by subtracting the accrued benefit derived from employee contributions from the employee's accrued benefit under the plan, but in no event is the accrued benefit derived from employer contributions less than zero ($2,949 − $1,442 = $1,507 per year).

(5) Determine the vested percentage of the accrued benefit derived from employer contributions under the plan's vesting schedule (100 percent).

(6) Determine the vested accrued benefit derived from employer contributions by multiplying the accrued benefit derived from employer contributions by the vested percentage ($1,507 × 100 percent = $1,507 per year).

(7) Determine *A*'s vested accrued benefit in the form of an annual single life annuity commencing at normal retirement age by adding the accrued benefit derived from employee contributions and the vested accrued benefit derived from employer contributions ($1,442 + $1,507 = $2,949 per year).

SINGLE SUM DISTRIBUTION UPON TERMINATION OF EMPLOYMENT

If *A* elects to receive *A*'s accrued benefit as a single sum at termination of employment on July 1, 1988, the vested accrued benefit payable as a single sum as of July 1, 1988, is determined as follows:

(1) Determine *A*'s vested accrued benefit in the form of an annual single life annuity commencing at normal retirement age ($2,949 per year; see steps (1) through (7) under "Single Life Annuity Commencing at Normal Retirement Age").

(2) Determine the single sum as of July 1, 1988, that is the actuarial equivalent of the vested accrued benefit using the plan interest rate ($7,108).

(3) Determine the accrued benefit derived from *A*'s mandatory contributions as of July 1, 1988, in the form of an annual single life annuity commencing at normal retirement age ($1,442 per year; see step (3) under "Single Life Annuity Commencing at Normal Retirement Age").

(4) Determine the single sum as of July 1, 1988, that is the actuarial equivalent of the amount in step (3), following the rules of Rev. Rul. 78-202 and using the interest rate specified in section 411(c)(2)(C)(iii), a conversion factor of 10 percent, and the adjustment factors specified in Rev. Rul. 76-47 ($3,177).

(5) *A*'s vested accrued benefit payable as a single sum upon termination of employment is the greater of (A) the single sum as determined in step 2, or (B) the single sum determined in step (4) ($7,108).

SINGLE SUM DISTRIBUTION OF ACCUMULATED CONTRIBUTIONS UPON TERMINATION OF EMPLOYMENT AND DEFERRED ANNUITY OF EMPLOYER CONTRIBUTIONS

If *A* elects to receive *A*'s employee contributions with interest as a single sum at termination of employment on July 1, 1988, and the remainder of *A*'s accrued benefit as an annual single life annuity commencing at normal retirement age, section 411(c)(3) of the Code is not satisfied unless the single sum and the deferred annuity are the actuarial equivalent of *A*'s vested accrued benefit in the form of an annual single life annuity commencing at normal retirement age. The plan assumptions, including the interest rates described in section 417(e) of the Code, are used to determine this actuarial equivalence. Also, section 411(c)(3) is not satisfied unless the single sum and the deferred annuity are at least as great as the actuarial equivalent of the accrued benefit derived from *A*'s contributions, using the actuarial assumptions and factors specified in section 411(c)(2) and Rev. Rul. 76-47.

Because *A*'s accrued benefit must be the actuarial equivalent of the accrued benefit in the form of a single life annuity commencing at normal retirement age, the minimum deferred annuity is determined as follows:

(1) Determine *A*'s vested accrued benefit in the form of a single life annuity commencing at normal retirement age ($2,949 per year; see steps (1) through (7) under "Single Life Annuity Commencing at Normal Retirement Age").

(2) Determine the amount of *A*'s single-sum distribution by crediting *A*'s accumulated contributions with interest to the date of distribution, using 5 percent for years prior to 1988, and 10.61 percent for January 1, 1988, to July 1, 1988 ($3,177).

(3) Using the plan assumptions, including the section 417(e) interest rates, determine the benefit in the form of an annual single life annuity commencing at normal retirement age that is the actuarial equivalent of the single-sum distribution determined in step (2) ($1,318 paid annually commencing at age 65 is the actuarial equivalent of *A*'s accumulated contributions with interest to the determination date).

(4) Determine the minimum benefit payable at normal retirement age that is necessary to satisfy the requirement that *A*'s accrued benefit be the actuarial equivalent of *A*'s accrued benefit in the form of a single life annuity commencing at normal retirement age. This determination is made by reducing *A*'s vested accrued benefit in the form of a single life annuity commencing at normal retirement age by the annuity determined in step (3) that is equivalent to the single-sum distribution ($2,949 — $1,318 = $1,631 per year). The minimum benefit cannot be less than zero.

The requirement that the amount of *A*'s benefit not be less than the actuarial equivalent of the employee-derived accrued benefit payable in the form of a single life annuity commencing at normal retirement age is satisfied without regard to the amount of the deferred annuity, because *A* will receive a single-sum distribution of *A*'s accumulated contributions with interest at the section 411(c) rates, as illustrated in this ruling. However, if the plan distributes to *A* a single sum that is less than A's accumulated contributions with interest at the section 411(c) rates, additional steps would be needed to determine whether the single sum and deferred annuity meet this requirement.

The above examples address situations where the participant is fully vested. Similar rules apply with respect to a non-vested participant.

HOLDINGS

(1) Under section 411(c)(2), an employee's accumulated contributions are determined using 5-percent interest for all plan years beginning on or after the effective date of section 411(a)(2) and before January 1, 1988. For plan years beginning after December 31, 1987, the rate to be used is 120 percent of the mid-term AFR for the month that includes the first day of the plan year. The interest rate for the plan year that includes the determination date is also used for the period from the determination date to the date on which the employee attains normal retirement age.

(2) If the employee's accumulated contributions with interest are distributed as a single sum at termination of employment before normal retirement age, the annuity commencing at normal retirement age must be at least as great as the annuity determined by (a) using the plan interest rate, subject to the section 417(e) limitation, and plan assumptions to convert the single sum previously distributed to the employee to an actuarially equivalent single life annuity commencing at normal retirement age, and (b) subtracting the resulting annuity from the total vested accrued benefit, expressed as a single life annuity commencing at normal retirement age.

EFFECT ON OTHER REVENUE RULINGS:

Rev. Rul. 78-202, 1978-1 C.B. 124, and Rev. Rul. 76-47, 1976-1 C. B. 109, are amplified to reflect the application of the new interest rate contained in section 411(c)(2)(C)(iii) of the Code, as explained in this ruling.

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26 CFR 1.411(d)-2: Termination or partial termination; discontinuance of contributions.

Minimum vesting standards; discontinuance of contributions. A profit-sharing plan that did not contain a provision that employees' accrued benefits become nonforfeitable upon the complete discontinuance of contributions did not qualify under section 401(a) of the Code during its first plan year, even though contributions were made during the first year. Rev. Rul. 68-137 revoked.

Rev. Rul. 89-53

PURPOSE

The purpose of this revenue ruling is to revoke Rev. Rul. 68-137, 1968-1 C.B. 164, in view of the amendment of section 401(b) of the Internal Revenue Code by the Employee Retirement Income Security Act of 1974 (ERISA), Pub. L. 93-406, 1974-3 C.B. 1.

ISSUE

Does a profit-sharing plan fail to meet the requirements for qualification under section 401(a) of the Code, during the first plan year, because the plan does not initially contain a specific provision requiring that employees' rights to benefits become nonforfeitable upon the complete discontinuance of contributions?

FACTS

An employer established a profit-sharing plan and trust to which it made a contribution for the first plan year. Under the plan, a contribution was required as a precondition of the plan's existence. The plan provided that employer contributions would be nonforfeitable in the event of termination or partial termination of the plan. The plan met all the other requirements for qualification under section 401(a) of the Code, except that it did not contain a specific provision requiring that, in the event of a complete discontinuance of employer contributions, employees' rights to accrued benefits become nonforfeitable. Such a requirement was added to the plan by an amendment that was adopted and made effective for the second plan year.

LAW AND ANALYSIS

Under the holding of Rev. Rul. 68-137, the plan in the present case would not fail to qualify under section 401(a) of the Code. In Rev. Rul. 68-137, a contribution was required as a precondition of the plan's existence, and such a contribution was actually made for the first plan year. Consequently, a discontinuance of contributions could not occur in the first year. Absent this holding, the plan could not have qualified under section 401(a) for the first plan year because section 401(b)(which provides for the retroactive effect of certain plan amendments) had limited applicability prior to ERISA.

Section 401(b) of the Code, as amendment by ERISA, provides that a stock bonus, pension, profit-sharing, or annuity plan shall be considered to satisfy the 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 there was adopted or put into effect any amendment which caused the plan to fail to satisfy such requirements and ending with the time prescribed by law for filing the return of the employer for his taxable year in which such plan or amendment was adopted, including extensions thereof, or such later time as the Secretary may designate, if all provisions of the plan which are necessary to satisfy all qualification requirements are in effect by the end of such period and have been made effective for the whole of such period.

Section 411(d)(3) of the Code provides that a trust shall not constitute a qualified trust under section 401(a) unless the plan of which such trust is a part provides that, upon its termination or partial termination, or in the case of a plan to which section 412 does not apply, upon complete discontinuance of contributions under the plan, the rights of all affected employees to benefits accrued to the date of such termination, partial termination, or discontinuance, to the extent funded as of such date, or the amounts credited to the employees' accounts, are nonforfeitable.

Section 412(h)(1) of the Code provides that section 412 shall not apply to any profit-sharing or stock bonus plan. Consequently, profit-sharing plans are subject to the requirement that employees' rights to their account balances become nonforfeitable upon complete discontinuance of contributions.

Section 411(d)(3) of the Code and section 1.411(d)-2(a) of the Income Tax Regulations require that, in order to qualify under section 401(a), certain plans, including profit-sharing plans, must provide for nonforfeitability of the amounts credited to the employees' accounts upon complete discontinuance of contributions. Section 411(d)(3) neither states nor implies that such a provision is unnecessary for plan qualification if, in actual plan operation, a complete discontinuance of contributions does not or could not occur.

HOLDING

The profit-sharing plan in the present case did not qualify under section 401(a) of the Code for its first plan year because it did not then contain the required provision that employees' accrued benefits become nonforfeitable upon complete discontinuance of contributions. This result obtains whether or not a contribution under the plan is required as a condition of the plan's existence.

However, if a plan amendment effective for the first plan year, adding the required provision is made within the remedial amendment period provided under section 401(b) of the Code and section 1.401(b)-1 of the regulations, the plan will qualify under section 401(a) from the date of its adoption.

PROSPECTIVE APPLICATION

Pursuant to section 7805(b) of the Code, this revenue ruling will be effective, in the case of plans in existence on or before May 10, 1989, for a plan's second year of existence. For plans that come into existence after May 10, 1989, this revenue ruling will be immediately effective.

EFFECT ON OTHER REVENUE RULINGS

Rev. Rul. 68-137 is revoked.

Section 414.—Definition and Special Rules

Governmental plan; volunteer fire company. A retirement plan maintained by an organization is not a governmental plan within the meaning of section 414(d) of the Code since the governmental unit did not have sufficient control over the organization.

Rev. Rul. 89-49

ISSUE

Is a retirement plan, adopted under the circumstances described below, a governmental plan within the meaning of section 414(d) of the Internal Revenue Code?

FACTS

The citizens of a municipality in State *X* organized a volunteer fire company to provide fire protection services to their community. The company was incorporated under State *X*'s nonprofit corporation statute. Under its charter, the company is managed by a board of trustees elected by the volunteer firefighters. The company entered into contracts with several municipalities, including the municipality where it was created, under which the company agreed to provide fire protection services to the municipalities. Under the contracts, the municipalities agreed that the operations of the company would be under the exclusive control of the board of trustees. The funds for the company are provided in part by community donations from the residents of the municipalities served by the company and in part by payments made by municipalities under the contracts with the company. In 1989, the company established a retirement plan for its employees. The municipalities do not make any direct contributions to the retirement plan. The employees were never treated by State *X* as employees of the state or a political subdivision thereof.

LAW AND ANALYSIS

Section 414(d) of the Code provides that a governmental plan means a plan established and maintained for its employees by the Government of the United States, by the government of any state or political subdivision thereof, or by any agency or instrumentality of any of the foregoing.

A plan will not be considered a governmental plan merely because the sponsoring organization has a relationship with a governmental unit or some quasi-governmental power. One of the most important factors to be considered in determining whether an organization is an agency or instrumentality of the United States or any state or political subdivision is the degree of control that the federal or state government has over the organization's everyday operations. Other factors include: (1) whether there is specific legislation creating the organization; (2) the source of funds for the organization; (3) the manner in which the organization's trustees or operating board are selected; and (4) whether the applicable governmental unit considers the employees of the organization to be employees of the applicable governmental unit. Although all of the above factors are considered in determining whether an organization is an agency of a government, the mere satisfaction of one or all of the factors is not necessarily determinative.

In this case, the degree of control which the municipalities exert over the fire company in its everyday operations is minimal. Although the company was incorporated under a nonprofit corporation statute, there was no specific legislation which affiliated the company with the state. Further, the company's expenses are, in part, paid by community donations. In addition, the board of trustees which controls the company's basic operations is elected by the volunteer firefighters. Finally, State *X* has not treated the company's employees as employees of the state or political subdivision thereof.

HOLDING

The retirement plan in this case is not a governmental plan within the meaning of section 414(d) of the Code.

Subpart D.—Treatment of Welfare Benefit Funds

Section 419.—Treatment of Funded Welfare Benefit Plans

Whether the Service will rule as to whether proceeds of "self-insured" life and survivor benefit plans established through a trust qualified under section 501(c)(9) of the Code are excludable from the beneficiary's gross income under section 101(a). See Rev. Proc. 89-36, page 919.

Part II.—Certain Stock Options

Section 423.—Employee Stock Purchase Plan

26 CFR 1.423-2: Employee stock purchase plan defined.

T.D. 8235

TITLE 26—INTERNAL REVENUE SERVICE—CHAPTER I, SUBCHAPTER A, PART 1—INCOME TAX; TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1953; PART 14A—TEMPORARY INCOME TAX REGULATIONS RELATING TO INCENTIVE STOCK OPTIONS

Stockholder Approval of Incentive Stock Option and Employee Stock Purchase Plans

AGENCY: Internal Revenue Service, Treasury.

ACTION: Temporary and final regulations.

SUMMARY: This document contains temporary regulations relating to stockholder approval of incentive stock option plans and final regulations relating to stockholder approval of employee stock purchase plans. Questions have arisen concerning the method and degree of stockholder approval necessary with respect to incentive stock option plans and employee stock purchase plans. The regulations affect corporations establish-

ing incentive stock option or employee stock purchase plans and provide them with guidance concerning plan qualification requirements under sections 422A and 423 of the Code.

EFFECTIVE DATES: Section 14a.422A-2 is effective on August 13, 1981, and applies to options granted on or after such date and to certain options granted after December 31, 1975. Section 1.423-2(c)-(1) is effective on January 1, 1964, and applies to options granted on or after such date.

SUPPLEMENTARY INFORMATION:

BACKGROUND

This document contains amendments to the Income Tax Regulations (26 CFR Part 1) under section 423 of the Internal Revenue Code of 1954, relating to employee stock purchase plans, and to the Temporary Income Tax Regulations Relating to Incentive Stock Options (26 CFR Part 14a) under section 422A of the Code. These amendments prescribe the method and degree of stockholder approval necessary to qualify a plan under sections 423 and 422A.

CURRENT STOCKHOLDER APPROVAL REQUIREMENTS

For a stock option plan to qualify either as an employee stock purchase plan under section 423 or as an incentive stock option plan under section 422A, the plan must be approved by the stockholders of the corporation within 12 months before or after the date such plan is adopted. The regulations under section 423 provide that the stockholder approval must comply with all applicable provisions of the corporate charter and bylaws and the law of the State of incorporation. In addition, they provide that an employee stock purchase plan must be approved at a duly held stockholders' meeting and that the stockholders voting in favor of the plan must hold a majority of the outstanding voting stock of the corporation.

The temporary regulations under section 422A do not address the stockholder approval issue generally, but proposed regulation §1.422A-2(b)(2) would permit stockholder approval in any manner consistent with applicable provisions of the corporate charter, bylaws and applicable State law prescribing the method and degree of approval for the granting of incentive stock options. In the absence of such a prescribed method and degree of stockholder approval, the proposed regulations would require an incentive stock option plan to be approved by a simple majority vote of stockholders, voting either in person or by proxy, at a duly held stockholders' meeting.

EXPLANATION OF PROVISIONS

This document amends the regulations under sections 423 and 422A to provide uniform rules relating to stockholder approval. Stockholder approval of either an employee stock purchase plan or an incentive stock option plan must comply with all applicable provisions of the corporate charter, bylaws and applicable State law prescribing the method and degree of stockholder approval required for the issuance of corporate stock or options. If the applicable State law does not prescribe a method and degree of stockholder approval in such cases, then the plan must be approved either (a) by a majority of the votes cast at a duly held stockholders' meeting at which a quorum representing a majority of all outstanding voting stock is, either in person or by proxy, present and voting on the plan, or (b) by a method and in a degree that would be adequate under applicable State law in the case of an action requiring stockholder approval. For this purpose, an action requiring stockholder approval is an action on which stockholders would be entitled to vote if the action were taken at a duly held stockholders' meeting. Thus, if the applicable State law provides that an action must be approved either by majority vote of the stockholders at an annual or special meeting or by the written consent of stockholders, the action is one that requires stockholder approval and approval of the action through the use of either procedure is adequate.

Although the amendment of the regulations under section 423 was not the subject of a notice of proposed rulemaking, the issues considered in connection with this amendment were the subject of a notice of proposed rulemaking under section 422A (LR-279-81, 49 FR 4,504 (February 7, 1984) [1984-1 C.B. 714]). For this reason, and because the amendment provides a less burdensome standard for stockholder approval than the current regulations, the Service has concluded that it is not necessary to issue a separate notice of proposed rulemaking with respect to the section 423 amendment.

INCONSISTENT RULINGS

In Revenue Ruling 75-256, 1975-2 C.B. 194, the Service ruled that a stockholder approval requirement identical to the requirement in the current regulations under section 423 was not satisfied when votes were cast by stockholders holding 40 percent of the total outstanding voting stock of the corporation, and the plan was approved by 80 percent of the votes cast, because the plan was not approved by stockholders holding a majority of the outstanding voting stock of the corporation. In Revenue Ruling 80-29, 1980-1 C.B. 94, the Service ruled that a stockholders' meeting is not required when, in accordance with State law, a corporation's qualified stock option plan or employee stock purchase plan is approved by unanimous written consent of the stockholders of the corporation, but that a stockholders' meeting is required if there is less than unanimous written consent by the stockholders.

Under the amended regulations, the stockholder approval requirements of sections 423 and 422A may be satisfied even if (a) the stockholders voting in favor of the plan hold less than a majority of the outstanding voting stock, or (b) the plan is approved by written consent that is less than unanimous. Accordingly, the Service will not follow Revenue Rulings 75-256 and 80-29 in determining whether the stockholder approval requirements of sections 423 and 422A are satisfied, and the portion of Revenue Ruling 80-29 that deals with section 423 will be revoked.

SPECIAL ANALYSES

The Commissioner of Internal Revenue has determined that these rules are not major rules as defined in Executive Order 12291. Accordingly, a Regulatory Impact Analysis is not required.

A general notice of proposed rulemaking is not required by 5 U.S.C. 553 for temporary regulations or for final regulations to which 5 U.S.C. 553(b) does not apply. Accordingly, the temporary and final regulations do not constitute regulations subject to the Regulatory Flexibility Act (5 U.S.C. chapter 6).

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Adoption of amendments to the regulations.

For the reasons set out in the preamble, Parts 1 and 14a of Title 26, Chapter 1, Subchapter A of the Code of Federal Regulations are amended as follows:

INCOME TAX REGULATIONS
(26 CFR Part 1)

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

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

Par. 2. Section 1.423-2 is amended by revising paragraph (c)(1) to read as follows:

§1.423-2 Employee stock purchase plan defined.

* * * * * *

(c) *Stockholder approval.* (1) An employee stock purchase plan must be approved by the stockholders of the granting corporation within 12 months before or after the date such plan is adopted. The approval of stockholders must comply with all applicable provisions of the corporate charter, bylaws and applicable State law prescribing the method and degree of stockholder approval required for the issuance of corporate stock or options. If the applicable State law does not prescribe a method and degree of stockholder approval in such cases an employee stock purchase plan must be approved—

(i) By a majority of the votes cast at a duly held stockholders' meeting at which a quorum representing a majority of all outstanding voting stock is, either in person or by proxy, present and voting on the plan; or

(ii) By a method and in a degree that would be treated as adequate under applicable State law in the case of an action requiring stockholder approval (i.e., an action on which stockholders would be entitled to vote if the action were taken at a duly held stockholders' meeting).

* * * * * *

TEMPORARY INCOME TAX REGULATIONS RELATING TO INCENTIVE STOCK OPTIONS
(26 CFR Part 14a)

Par. 3. The authority for Part 14a continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 4. Part 14a is amended by adding §14a.422A-2 to read as follows:

§14a.422A-2 Question and answer relating to the stockholder approval of incentive stock option plans.

The following question and answer relates to the stockholder approval of incentive stock option plans required by section 422A of the Internal Revenue Code as added by section 251 of the Economic Recovery Tax Act of 1981:

Q: In what manner must the stockholders' approval required by section 422A(b)(1) be obtained?

A: The approval of stockholders must comply with all applicable provisions of the corporate charter, bylaws and applicable State law prescribing the method and degree of stockholder approval required for the issuance of corporate stock or options. If the applicable State law does not prescribe a method and degree of stockholder approval in such cases an incentive stock option plan must be approved—

(1) By a majority of the votes cast at a duly held stockholders' meeting at which a quorum representing a majority of all outstanding voting stock is, either in person or by proxy, present and voting on the plan; or

(2) By a method and in a degree that would be treated as adequate under applicable State law in the case of an action requiring stockholder approval (i.e., an action on which stockholders would be entitled to vote if the action were taken at a duly held stockholders' meeting).

There is a need for immediate guidance with respect to the provisions contained in this Treasury decision. For this reason, it is found impracticable to issue it with notice and public procedure under subsection (b) of section 553 of Title 5 of the United States Code or subject to the effective date limitation of subsection (d) of that section.

Lawrence B. Gibbs,
Commissioner of Internal Revenue.

Approved November 2, 1988.

O. Donaldson Chapoton,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on December 1, 1988, 8:45 a.m., and published in the issue of the Federal Register for December 2, 1988, 53 F.R. 48639)

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 Method of Accounting

26 CFR 1.446-1: General rule for method of accounting.

A procedure is provided for certain taxpayers to obtain expeditious consent from the Commissioner to change their method of accounting for package design costs to a capitalization method in accordance with Rev. Rul. 89-23. See Rev. Proc. 89-16, page 822.

26 CFR 1.446-1: General rule for method of accounting.

Taxpayers that incur package design costs are allowed to deem the useful lives of certain package designs to be 60 months. See Rev. Proc. 89-17, page 827.

26 CFR 1.446-1: General rule for method of accounting.

If expenditures are incurred after December 31, 1986, in connection with the development and design of product packages, are those expenditures deductible as ordinary and necessary business expenses under section 162(a) of the Code in the tax year in which the expenditures are incurred, or must they be capitalized under section 263A of the Code. If expenditures are incurred prior to January 1, 1987, must they be capitalized under section 263. If such expenditures must be capitalized under section 263 or section 263A of the Code, are they amortizable under section 1.167(a)-3 of the Regulations. See Rev. Rul. 89-23, page 85.

Subpart C.—Taxable Year for Which Deductions Taken

Section 461.—General Rule for Taxable Year of Deduction

26 CFR 1.461-2: Timing of deductions in certain cases where asserted liabilities are contested.
(Also Section 163; 1.163-1.)

Interest; timing of deduction; contested tax liability; asserted liability. Interest paid by accrual basis corporation in connection with a contested tax liability is deductible under sections 163(a) and 461(f) of the Code in the tax year of payment when the taxpayer remits the total amount of the proposed tax liability and does not designate the amount remitted as a deposit in the nature of a cash bond.

Rev. Rul. 89-6

ISSUE

If an accrual method corporate taxpayer remits the total amount of unassessed tax proposed in a 30-day letter accompanied by an examiner's report, plus appropriate interest, does not designate the amount remitted as a deposit in the nature of a cash bond, and contests the proposed tax and related interest, both before and after making the remittance, is the portion of the remittance that is attributable to interest deductible under sections 163(a) and 461(f) of the Internal Revenue Code in the tax year of the remittance?

FACTS

X is a corporate taxpayer and thus not subject to the disallowance of deduction for personal interest under section 163(h) of the Code. *X* uses the accrual method of accounting for federal income tax purposes. After auditing *X*'s 1986 federal income tax return, a revenue agent proposed several adjustments that would result in an increase in *X*'s tax liability for 1986. The increase in tax liability would also result in liabilities for interest. *X* disagreed with the proposed adjustments and subsequently received a Notice of Proposed Deficiency (30-day letter) from the District Director accompanied by an examiner's report explaining the basis of the proposed deficiency. *X* filed a protest with the District Director contesting the proposed deficiency. While the issues set forth in the protest were pending, *X*, pursuant to section 4.03(1) of Rev. Proc. 84-58, 1984-2 C.B. 501, made a remittance with respect to the proposed deficiency, and the related interest. *X* did not designate that the remittance was to be treated as a deposit in the nature of a cash bond. On the day *X* made the remittance, *X* filed a claim for refund of the remittance. But for the contest posed by the claim for refund, *X* had satisfied all of the requirements for deduction of the interest portion of the remittance under section 163.

LAW AND ANALYSIS

Section 163(a) of the Code provides that there shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness.

Section 461(a) of the Code provides that the amount of any deduction or credit allowed by subtitle A of the Code shall be taken for the taxable year that is the proper taxable year under the method of accounting used in computing taxable income.

Section 1.461-1(a)(2) of the Income Tax Regulations provides that, under an accrual method of accounting, an expense is deductible for the taxable year in which all the events have occurred which determine the fact of the liability and the amount thereof can be determined with reasonable accuracy. In the instant situation, the all events test of section 1.461-1(a)(2) is not met because *X* contests the liability. Nevertheless, the taxpayer may be allowed a deduction if the requirements of section 461(f) of the Code are met.

Section 461(f) of the Code provides an exception to the all events test in certain situations in which a taxpayer transfers money or other property to provide for the satisfaction of a contested liability. The provision provides that if (1) the taxpayer contests an asserted liability, (2) the taxpayer transfers money or other property to provide for the satisfaction of the asserted liability, (3) the contest with respect to the asserted liability exists after the time of the transfer, and (4) but for the fact that the asserted liability is contested, a deduction would be allowed for the taxable year of the transfer (or for an earlier taxable year) determined after application of section 461(h), then the deduction shall be allowed for the taxable year of the transfer.

Section 1.461-2(b)(1) of the regulations provides that the term "asserted liability" means an item with respect to which, but for the existence of any contest in respect of such item, a deduction would be allowable under an accrual method of accounting.

Section 1.461-2(b)(2) of the regulations provides that any contest that would prevent accrual of a liability under section 461(a) of the Code shall be considered to be a contest. A contest arises when there is a bona fide dispute as to the proper evaluation of the law or the facts necessary to determine the existence or correctness of the amount of an asserted liability. It is not necessary to institute suit in a court of law in order to contest an asserted liability. An affirmative act denying the validity or accuracy, or both, of an asserted liability to the person who is asserting the liability, such as including a written protest with payment of the asserted liability, is sufficient to commence a contest.

Section 1.461-2(c)(1) of the regulations provides that a taxpayer may provide for the satisfaction of an asserted liability by transferring money or other property beyond the taxpayer's control to the person who is asserting the liability. In order for money or other property to be beyond the control of the taxpayer, the taxpayer must relinquish all authority over such money or other property.

Section 1.461-2(d) of the regulations provides that, in order for a contest with respect to an asserted liability to exist after the time of transfer, such contest must be pursued subsequent to such time.

Section 1.461-2(e)(1) of the regulations provides that the existence of the contest with respect to an asserted liability must prevent (without regard to section 461(f)) and be the only factor preventing a deduction for the taxable year of transfer (or, in the case of an accrual method taxpayer, for an earlier taxable year for which such amount would be accruable) to provide for the satisfaction of the liability.

Rev. Proc. 84-58, 1984-2 C.B. 501, sets forth procedures for taxpayers to make remittances in order to stop the running of interest on federal income tax deficiencies. Section 4.03 of Rev. Proc. 84-58 provides that a remittance not specifically designated as a deposit in the nature of a cash bond will be treated as a payment of tax if it is made in response to a proposed liability, for example, as proposed in a revenue agent's or examiner's report, and remittance in full of the proposed liability is made.

In order to receive an interest deduction under sections 163(a) and 461(f) of the Code, the taxpayer must meet each of the requirements of section 461(f)(1) through (4).

Section 461(f)(1) provides that the taxpayer must contest an asserted liability. *X* has contested the proposed liability for tax and interest by filing a protest to deny its validity. As required under section 1.461-2(b)(2) of the regulations, there is a bona fide dispute as to the proper evaluation of the law or facts necessary to determine the existence and correctness of the amount of *X*'s liability. Further, the 30-day letter and examiner's report resulted in the existence of an asserted liability within the meaning of section 461(f)(1).

Section 461(f)(2) of the Code provides that the taxpayer must transfer money or other property to provide for the satisfaction of the asserted liability. Here, *X* has made a payment of money to the Service for satisfaction of the asserted liability. Because *X* has made a payment and not a deposit in the nature of a cash bond, the funds are placed beyond X's control within the meaning of section 1.461-2(c)(1) of the regulations.

Section 461(f)(3) of the Code provides that the contest with respect to the asserted liability must exist after the time of the transfer. Thus, the contest must have been neither settled nor abandoned at the time of the transfer. *See* section 1.461-2(d) of the regulations. In the instant situation, *X* has filed a claim for the refund of the amounts paid and continues to contest the validity of the asserted liability even after it is paid.

Section 461(f)(4) of the Code requires that, but for the fact that the asserted liability is contested, a deduction would be allowed for the taxable year of the transfer (or for an earlier taxable year) determined after application of section 461(h). This requirement is also met because *X* has made a payment to the Service for satisfaction of the asserted tax liability and associated interest.

In *Charles Leich and Co. v. United States*, 329 F.2d 649, *reh'g denied*, 333 F.2d 871 (Ct. Cl. 1964), the taxpayer made remittances in response to deficiencies proposed in a revenue agent's report. The taxpayer never signed a waiver agreeing to the assessment of all or any portion of the proposed deficiencies, no statutory notice of deficiency was ever issued to the taxpayer formally proposing any of the deficiencies, and none of the proposed deficiencies were ever assessed. The Court of Claims held that the remittances were not overpayments upon which interest could be recovered, and the portions of the remittances that represented interest could not be deducted as interest expenses in the years of the remittances.

In denying the taxpayer's motion for a rehearing, the Court of Claims considered the language currently contained in section 461(f) of the Code. The court noted that the legislative history of that language seems to indicate that before section 461(f) "becomes operative taxpayer must be put in a position where inaction on his part will cause him to have a legal obligation to pay the tax." 333 F.2d at 872. The court stated that Congress intended an asserted liability to be "something akin to a 'tax assessment.'" *Id.* The court concluded that there was no asserted liability in the *Leich* case, since there had not been an assessment with respect to the tax.

Unlike the administrative procedures of the Service when *Leich* was decided, currently, as provided in section 4.03 of Rev. Proc. 84-58, assessment of the amount remitted by a taxpayer in response to a liability proposed in a revenue agent's or examiner's report is not required for such a remittance to qualify as a payment of tax. Thus, a remittance not specifically designated as a deposit in the nature of a cash bond is considered a payment of tax if it is made in response to a revenue agent's or examiner's report, and remittance in full of the proposed liability is made, even if there has not been an assessment of the tax. Because of this change in administrative procedures, the Service will no longer follow the court's conclusion in *Leich* that, in the absence of a tax assessment, an amount proposed in a revenue agent's or examiner's report is not an asserted liability within the meaning of section 461(f) of the Code.

HOLDING

If an accrual method corporate taxpayer remits the total amount of unassessed tax proposed in a 30-day letter accompanied by an examiner's report, plus appropriate interest, does not designate the amount remitted as a deposit in the nature of a cash bond, and contests the proposed tax and related interest, both before and after making the remittance, then the portion of the remittance that is attributable to interest is deductible under sections 163(a) and 461(f) of the Code in the tax year of the remittance.

APPLICATION

This revenue ruling is not restricted to instances in which a taxpayer makes a remittance of the full amount of proposed liability. Rather, it applies also to partial remittances that constitute payments of tax and interest under section 4.03 of Rev. Proc. 84-58.

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 January 1989. See Rev. Rul. 89-1, page 260.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of February 1989. See Rev. Rul. 89-15, page 262.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of March 1989. See Rev. Rul. 89-34, page 263.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of April 1989. See Rev. Rul. 89-39, page 264.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of May 1989. See Rev. Rul. 89-65, page 265.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of June 1989. See Rev. Rul. 89-77, page 266.

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 January 1989. See Rev. Rul. 89-1, page 260.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of February 1989. See Rev. Rul. 89-15, page 262.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of March 1989. See Rev. Rul. 89-34, page 263.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of April 1989. See Rev. Rul. 89-39, page 264.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of May 1989. See Rev. Rul. 89-65, page 265.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of June 1989. See Rev. Rul. 89-77, page 266.

Section 469.—Passive Activity Losses and Credits Limited

26 CFR 1.469-0T: Table of contents (temporary).

T.D. 8253

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

Limitations on Passive Activity Losses and Credits—Definition of Activity

AGENCY: Internal Revenue Service, Treasury.

ACTION: Temporary regulations.

SUMMARY: This document contains temporary regulations relating to the definition of "activity" for purposes of applying the limitations on passive activity losses and passive activity credits and amends previously issued temporary regulations relating to the limitations. Changes to the applicable tax law were made by the Tax Reform Act of 1986, the Revenue Act of 1987, and the Technical and Miscellaneous Revenue Act of 1988. The temporary regulations affect taxpayers subject to the limitations on passive activity losses and passive activity credits and provide them

with the guidance needed to comply with the law. The text of the temporary regulations set forth in this document also serves as the text of the proposed regulations for the notice of proposed rulemaking on this subject in * * * [PS-001-89, page 1057, this Bulletin].

EFFECTIVE DATE: These regulations are effective for taxable years beginning after December 31, 1986, except for §§1.469-2T(f)(3) through (7), which are effective for taxable years beginning after December 31, 1987.

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

This regulation is being issued without prior notice and public procedure pursuant to the Administrative Procedure Act (5 U.S.C. 553). For this reason, the requirements for collecting information contained in this regulation have been reviewed and, pending receipt and evaluation of public comments, approved for use through January 31, 1991, by the Office of Management and Budget (OMB) under control number 1545-1037. The estimated annual burden per respondent for making a written election varies from 5 minutes to 15 minutes, depending on individual circumstances, with an estimated average of 6 minutes.

These estimates are an approximation of the average time expected to be necessary for a collection of information. They are based on such information as is available to the Internal Revenue Service. Individual respondents may require more or less time, depending on their circumstances. For further information concerning this collection of information, and where to submit comments on this collection of information, the accuracy of the estimated burden, and suggestions for reducing this burden, please refer to the preamble to the cross-reference notice of proposed rulemaking published in * * * [PS-001-89, page 1057, this Bulletin].

Issuance of Proposed Regulation and Submission to Small Business Administration

The rules contained in this document are also being issued as proposed regulations by the notice of proposed rulemaking on this subject in * * * [page 1057, this Bulletin]. Pursuant to section 7805(f) of the Internal Revenue Code, a copy of the rules will be submitted to the Administrator of the Small Business Administration for comment on their impact on small business.

Background

Temporary regulations under section 469 were published in the Federal Register for February 25, 1988 (53 FR 5686, T.D. 8175) [1988-1 C.B. 191]. Those regulations added §§1.469-0T, 1.469-1T, 1.469-2T, 1.469-3T, 1.469-5T, and 1.469-11T to Title 26 of the Code of Federal Regulations, and indicated that the definition of activity would be contained in §1.469-4T. This document adds rules for identifying activities in §1.469-4T and amends §§1.469-0T, 1.469-1T, 1.469-2T, 1.469-3T, 1.469-5T, and 1.469-11T in certain respects.

The temporary regulations reflect the amendment of the Internal Revenue Code by sections 501 and 502 of the Tax Reform Act of 1986 (Pub. L. 99-514) [1986-3 C.B. (Vol. 1) 1, 150, 158], which added section 469, and the amendment of section 469 by section 10212 of the Revenue Act of 1987 (Pub. L. 100-203) and sections 1005(a) and 2004(g) of the Technical and Miscellaneous Revenue Act of 1988 (Pub. L. 100-647). Section 469 disallows the passive activity loss and the passive activity credit for the taxable year. Section 469(l)(1) provides that the Secretary of the Treasury or his delegate shall prescribe such regulations as may be necessary or appropriate to carry out provisions of section 469, including regulations which specify what constitutes an activity.

Definition of activity

I. Description of provisions.

A. Scope and structure of §1.469-4T.

Section 1.469-4T provides rules under which endeavors to which the passive loss and credit limitations apply (business and rental operations) are treated as one or more activities for purposes of those limitations. In general, these rules are divided into three groups: (i) rules that identify the business and rental operations that constitute an undertaking (the undertaking rules); (ii) rules that identify the undertaking or undertakings that constitute an activity (the activity rules); and (iii) rules that apply only under certain special circumstances (the special rules).

B. Undertaking rules.

The undertaking is generally the smallest unit that can constitute an activity, and an undertaking may include diverse business and rental operations. The basic undertaking rule identifies the business and rental operations that constitute an undertaking by reference to their location and ownership. Under this rule, business and rental operations that are conducted at the same location and are owned by the same person are generally treated as part of the same undertaking. Conversely, business and rental operations generally constitute separate undertakings to the extent that they are conducted at different locations or are not owned by the same person.

In some circumstances the undertaking in which business and rental operations are included does not depend on the location at which the operations are conducted. Operations that are not conducted at any fixed place of business or that are conducted at the customer's place of business are treated as part of the undertaking with which the operations are most closely associated. In addition, operations that are conducted at a location but do not relate to the production of property at that location or to the transaction of business with customers at that location are treated, in effect, as part of the undertaking or undertakings that the operations support.

The basic undertaking rule is also modified if the undertaking determined under that rule includes both rental and nonrental operations. In such cases, the rental operations and the nonrental operations generally must be treated as separate undertakings. This rule does not apply, however, if more than 80 percent of the income of the undertaking determined under the basic rule is attributable to one class of operations (*i.e.*, rental or nonrental) or if the rental operations would not be treated as part of a rental activity because of the exceptions contained in §1.469-1T(e)(3)(ii). For purposes of this rule, short-term rentals of real property (*e.g.*, hotel-room rentals) are generally treated as nonrental operations. The regulations also treat oil and gas wells that are subject to the working-interest exception in §1.469-1T(e)(4) as separate undertakings.

C. Activity rules.

The basic activity rule treats each undertaking in which a taxpayer owns an interest as a separate activity of the taxpayer. In the case of trade or business undertakings, professional service undertakings, and rental real estate undertakings, additional rules may either require or permit the aggregation of two or more undertakings into a single activity.

Trade or business undertakings include all nonrental undertakings other than oi and gas undertakings described above and professional service undertakings described below. An aggregation rule treats trade or business undertakings that are both similar and controlled by the same interests as part of the same activity. This rule is, however, generally inapplicable to small interests held by passive investors in such undertakings, except to the extent such interests are held through the same passthrough entity. Undertakings are similar for purposes of this rule if more than half (by value) of their operations are in the same line of business (as defined in a revenue procedure that the Service is issuing in conjunction with these regulations) or if the undertakings are vertically integrated. All the facts and circumstances are taken into account in determining whether undertakings are controlled by the same interests. If, however, each member of a group of five or fewer persons owns a substantial interest in each of the undertakings, the undertakings may be rebuttably presumed to be controlled by the same interests.

Trade or business undertakings (including undertakings that are aggregated under the rules described above) are also subject to a second aggregation rule. Under this rule, undertakings that constitute an integrated business and are controlled by the same interests must be treated as part of the same activity.

Broader aggregation rules apply to professional service undertakings (*i.e.*, undertakings that predominantly involve the provision of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts or consulting). In general, professional service undertakings that are either similar, related, or controlled by the same interests must be treated as part of the same activity. The rules for determining whether trade or business undertakings are controlled by the same interests also apply with respect to professional service undertakings. Professional service undertakings are similar, however, if more than 20 percent (by value) of their operations are in the same field, and two professional service undertakings are related if one of the undertakings derives more than 20 percent of its gross income from persons who are customers of the other undertaking.

The rules for aggregating rental real estate undertakings are generally elective. They permit taxpayers to treat any combination of rental real estate undertakings as a single activity. Taxpayers may also divide their rental real estate undertakings and then treat portions of the undertakings as separate activities or recombine the portions into activities that include parts of different undertakings. The fragmentation of rental real estate into separate activities is limited by two consistency requirements. Taxpayers may not fragment their rental real estate in a manner that is inconsistent with their treatment of such property in prior taxable years or with the treatment of such property by the passthrough entity through which it is held. There are no comparable limitations on the aggregation of rental real estate into a single activity. A coordination rule provides, however, that a rental real estate undertaking must be treated as a separate activity if income or gain from the undertaking is subject to recharacterization under §1.469-2T(f)(3) (relating to the rental of nondepreciable property).

Another elective rule permits taxpayers to treat a nonrental undertaking as a separate activity even if the undertaking would be treated as part of a larger activity under the aggregation rules applicable to the undertaking. This elective rule is limited by consistency requirements similar to those that apply to rental real estate operations. Moreover, in cases in which a taxpayer elects to treat a nonrental undertaking as a separate activity, the taxpayer's level of participation (*i.e.*, material, significant, or otherwise) in the separate activity is the same as the taxpayer's level of participation in the larger activity in which the undertaking would be included but for the election.

D. Special rules.

Special rules apply to the business and rental operations of consolidated groups of corporations and publicly traded partnerships. Under these rules, a consolidated group is treated as one taxpayer in determining its activities and those of its members, and business and rental operations owned through a publicly traded partnership cannot be aggregated with operations that are not owned through the partnership.

There is also a special rule for taxable years ending before August 10, 1989. In those years, taxpayers may organize business and rental operations into activities under any reasonable method. A taxpayer will also be permitted to use any reasonable method to allocate disallowed deductions and credits among activities for the first taxable year in which the taxpayer's activities are determined under the general rules of §1.469-4T.

II. Significant policy issues.

A. Definition of undertaking.

Under the regulations, an activity of a taxpayer generally consists of either a single undertaking or a combination of two or more undertakings. Thus, the definition of undertaking should be broad enough to provide a useful intermediate step in determining a taxpayer's activities, but not so broad that unrelated business and rental operations are inappropriately combined in the same activity. Moreover, an undertaking should be defined with such precision that the business and rental operations that constitute an activity can be determined with reasonable certainty. The Service recognizes that no single definition of undertaking can reconcile these objectives in all cases. It believes, however, that a definition that strikes a reasonable balance among these competing objectives is essential to carry out the purposes of section 469 and to comply with section 469(l)(1), which directs the Service to prescribe regulations that specify what constitutes an activity.

Location and ownership are the primary factors used to identify the business and rental operations that constitute an undertaking. Thus, the number of a taxpayer's undertakings is generally limited to the number of locations at which the taxpayer conducts business directly plus the number of locations at which business is conducted by passthrough entities in which the taxpayer owns an interest. In most cases, the number of undertakings should be small enough to avoid the need for extensive application of the aggregation rules contained in the regulations. In fact, for the large number of taxpayers who conduct all their business operations at a single location, either directly or through a single passthrough entity, the determination that such operations constitute a single undertaking is generally the only analysis that the regulations require.

The use of location and ownership as the primary factors in determining undertakings also contributes to certainty in the determination of activities. While some uncertainty is likely in the case of operations that are included in an undertaking without regard to the location at which the operations are conducted (*i.e.*, operations that are not conducted at a fixed place of business, operations that are conducted at the customer's place of business, and support operations), the Service contemplates that reasonable methods will be used in determining the undertaking with which such operations are associated and that any reasonable method will be respected. The Service invites public comment regarding the desirability of detailed rules for determining the undertakings with which such operations are associated.

The Service recognizes that unrelated business operations may be treated as part of a single undertaking under these rules. In the typical case, however, operations that are conducted at the same location and are owned by the same person constitute an integrated and interrelated economic unit. Moreover, identification of the exceptional case in which such operations do not constitute an integrated and interrelated economic unit and might appropriately be treated as multiple undertakings would require additional analysis that would greatly undermine the certainty that these regulations are intended to provide. In addition, the accurate measurement of gain or loss from, and participation in, such multiple undertakings would generally require unduly burdensome allocations of income, expenses, and participation among the undertakings. For these reasons, the regulations do not provide an exception to the basic undertaking rule for those few cases in which, based on all the facts and circumstances, the operations conducted at a single location might appropriately be treated as multiple undertakings.

B. Rental undertaking.

All rental activities are passive, but other activities are passive only if the taxpayer does not materially participate. Because of this difference in treatment, it is inappropriate in most cases to combine rental operations and nonrental operations in a single activity. In the absence of a special rule, however, the basic undertaking rule would often treat rental operations and nonrental operations that are conducted at the same location as part of the same undertaking. To prevent this, the regulations provide in such cases that the rental operations and the nonrental operations are generally treated as two separate undertakings.

In some cases, however, it is appropriate to treat rental operations and nonrental operations as part of the same activity. For example, operations that are incidental to other operations should be treated as part of the same activity even if they are not in the same class (*i.e.*, rental or nonrental) as such other operations. Although all the facts and circumstances should be taken into account in determining whether operations in one class are incidental to operations in the other class, one of the most significant factors is the substantiality of the operations in each class relative to those in the other class. Moreover, even though it is generally more appropriate to separate rental and nonrental operations, the separation of those operations increases accounting burdens because of the need to allocate income, expenses, and participation between the rental and nonrental undertakings. As a result, it is difficult to justify treating rental and nonrental operations that are conducted at the same location as separate undertakings unless substantial operations are included in each undertaking. For these reasons, the rule separating rental and nonrental operations conducted at the same location does not apply if more than 80 percent of the aggregate income from the operations is attributable to one class of operations.

C. Aggregation of nonrental undertakings.

The purpose of the aggregation rules applicable to nonrental undertakings is to identify undertakings that constitute an integrated and interrelated economic unit. This purpose suggests that all the facts and circumstances should be taken into account in determining whether undertakings are aggregated into a single activity. On the other hand, a rule requiring consideration of all relevant facts and circumstances would necessitate difficult and time-consuming analyses of the relationships between undertakings and would also introduce substantial uncertainty into the identification of activities. Accordingly, the regulations generally limit the relevant factors to the two that the Service believes are most significant (similarity and control) and provide specific rules for taking those factors into account.

The first of these factors, similarity, involves either common lines of business or different stages in the production or distribution of the same product or group of products. The function of this factor is to ascertain whether the nature of the businesses in which the undertakings are engaged is such that there can be meaningful interactions among undertakings, whether in the form of economies of scale, transactions between undertakings, or otherwise. Such interactions are an essential characteristic of an integrated and interrelated economic unit and do not typically occur between businesses that are conducted at different locations unless the businesses are similar within the meaning of the regulations.

Businesses that, by their nature, could constitute an integrated and interrelated economic unit may, nevertheless, be competitors (if they involve a common line of business) or adversarial in their dealings (if they involve different stages in production or distribution) unless they serve and are coordinated by common interests. Conversely, businesses that are commonly controlled are typically integrated if the nature of the businesses is such that integration would result in economies of scale or other efficiencies. Accordingly, the second factor that must be taken into account under the regulations is control of the undertakings.

The rules for determining whether undertakings are similar and are controlled by the same interests further limit the need to consider all relevant facts and circumstances. The regulations provide bright-line tests for determining whether undertakings are similar. Under these tests, the only relevant factors are the line of business (if any) from which more than 50 percent of an undertaking's gross income is derived and whether the undertaking provides more than 50 percent (by value) of its property and services to related undertakings or obtains more than 50 percent (by value) of its property and services from a related undertaking. Moreover, the lines of business used to determine similarity are generally adapted from the Standard Industrial Classification (SIC) of the United States, and thus are consistent with an established method of distinguishing and categorizing business operations. Similarly, the regulations simplify and minimize the uncertainty in determinations of common control by providing a rebuttable presumption under which undertakings are generally presumed to be controlled by the same interests if more than 50 percent of the interests in the undertakings are owned by the members of a group of five or fewer persons.

The Service recognizes that unrelated business operations may be treated as part of the same activity under these rules. This raises essentially the same issue as treating unrelated business operations as part of the same undertaking, and the considerations taken into account in that context are equally applicable here. Accordingly, the regulations do not provide an exception to the aggregation rules for those few cases in which, based on all the facts and circumstances, similar and commonly-controlled undertakings might appropriately be treated as multiple activities.

The aggregation rules are generally inapplicable to small interests held by passive investors in the undertakings, except to the extent such interests are held through the same passthrough entity. The purpose of this exception is not to ascertain more accurately whether undertakings constitute an integrated and interrelated business activity, but rather to simplify the determination of activities for the taxpayers to whom it applies. In general, such taxpayers may accept a passthrough entity's identification and aggregation of undertakings and need not engage in further analysis to determine whether undertakings held through the entity should be aggregated with undertakings held directly or through other passthrough entities.

In some cases, businesses that are not similar within the meaning of the regulations nonetheless constitute an integrated business if all the facts and circumstances are taken into account. The Service believes that a rule requiring such businesses to be treated as a single activity, if applied after the rule aggregating similar and commonly controlled undertakings, would not affect a large number of taxpayers. Moreover, even though such a rule requires consideration of all relevant facts and circumstances, this should not be a substantial burden if the only analysis required is of the relationships among a few large groups of operations. Accordingly, the regulations provide that one or more undertakings (or groups of undertakings that have been aggregated because of their similarity) are treated as a single activity if the undertakings (or groups of undertakings) are controlled by the same interests and, based on all the facts and circumstances, their operations constitute a single integrated business.

Special aggregation rules are provided for professional service undertakings. These rules are necessary, in part, because of the material participation rule applicable to personal service activities. Thus, the rules do not permit the aggregation of professional service activities and other activities. In addition, the rules are significantly broader than those applicable to other nonrental undertakings. The Service believes that broader aggregation rules are appropriate in this context because all professional services share certain similarities and it is increasingly common for professional-service firms to provide services in more than one field. Moreover, a professional-service firm's success in one field is more likely to be attributable to expertise and goodwill developed in another field than is the case with other nonrental businesses.

D. Rental real estate undertakings.

The treatment of a taxpayer's nonrental operations as one or more activities significantly affects the computation of the taxpayer's passive activity loss and credit, primarily because material and significant participation are measured on an activity-by-activity basis and because certain rules that recharacterize income associated with nonrental operations also apply on an activity-by-activity basis. Thus, to prevent avoidance of the passive loss rules by inappropriately grouping operations into activities that do not constitute integrated and interrelated economic units, taxpayers are required to conform to precise rules for identifying the operations that are included in a nonrental activity.

The organization of rental operations into activities does not provide comparable opportunities for avoidance of the passive loss rules because the character of the income or loss from rental operations is generally not affected by the taxpayer's participation in the activity in which the operations are included and the rules recharacterizing income from rental operations generally apply on a property-by-property basis. A taxpayer's participation is relevant in computing the $25,000 offset for rental real estate activities. The purpose of the offset, however, is to provide targeted relief to moderate income taxpayers, and its amount and the taxpayers to which it applies are limited accordingly. Thus, the Service does not believe it is necessary to provide rules in these regulations that further restrict the availability of the offset.

Because specific rules similar to those applicable to nonrental operations are not necessary in the case of rental operations, the regulations generally permit taxpayers to organize their rental real estate operations into activities in any manner they find convenient or advantageous. Taxpayers are not permitted, however, to fragment their rental real estate operations into separate activities to a greater extent than in preceding taxable years or to a greater extent than such operations are fragmented by the passthrough entity through which they are held. The first limitation prevents taxpayers from treating operations as an activity in cases in which their records are not likely to contain sufficient detail to permit them to compute the suspended loss from the activity. Similarly, the second limitation prevents taxpayers from treating operations as an activity in cases in which the accounting information provided to them by the passthrough entity is unlikely to be detailed enough to permit them to compute the net income or loss from the activity. A third limitation provides that a rental real estate undertaking must be treated as a separate activity if income from the undertaking is subject to recharacterization under §1.469-2T(f)(3). This limitation is necessary to maintain the integrity of the recharacterization rule.

The rules described above apply only to rental operations involving real property. The Service invites public comment regarding the desirability of providing similar flexibility with respect to rental operations involving personal property.

E. Election to treat nonrental undertakings as separate activities.

Although a nonrental undertaking may, with other nonrental undertakings, constitute an integrated and interrelated economic unit, the synergistic effects resulting from the conduct of the undertaking as part of an integrated business generally cease when there is a disposition of the undertaking. Thus, the activity that remains after such a disposition is fundamentally different from the activity conducted before the disposition. As a result, the disposition of an undertaking will often be an appropriate time to measure economic income or loss. Moreover, an undertaking generally consists of identifiable operations that are conducted at a single location, and a disposition of such operations should, in most cases, permit the accurate measurement of the economic income or loss from the portion of a business that is conducted at the location.

For the reasons described above, the Service believes that an undertaking may constitute an appropriate unit for measuring gain or loss even in cases in which it is part of a larger integrated business. Accordingly, the regulations permit taxpayers to elect to treat a nonrental undertaking as a separate activity (other than for purposes of measuring participation) even though under the aggregation rules the undertaking would be treated as part of a larger activity. This election is not available, however, if the taxpayer treated the undertaking as part of a larger activity in a preceding taxable year or if the passthrough entity through which the undertaking is held treats it as part of a larger activity. The purpose of these exceptions is the same as the purpose of the similar limitations that apply to the election to treat rental real estate operations as separate activities.

In some cases, an undertaking may be conducted in a manner that enhances the value of other undertakings to the detriment of its own value. In such cases, the economic income or loss from an undertaking cannot be accurately measured at the time of its disposition. Accordingly, the Service is considering a rule that would provide in such cases that a disposition of a taxpayer's interest in such an undertaking is not treated as a disposition of the taxpayer's entire interest in an activity for purposes of section 469(g). If adopted, this rule would be contained in the regulations to be issued under §1.469-6T (relating to the treatment of losses upon certain dispositions of passive and former passive activities).

Amendments made to existing regulations

This document also amends portions of the existing regulations under section 469 to coordinate those regulations with the definition of activity contained in §1.469-4T and to make certain clarifying and corrective changes to the existing regulations. The significant changes made to the existing regulations by these amendments are described below.

I. Section 1.469-1T.

The determination of whether an activity is a rental activity under §1.469-1T(e)(3) generally requires the computation of an average period of customer use for the activity. The average period of customer use, as defined in §1.469-1T(e)(3)(iii), is not weighted to reflect differences in the rental value of the activity's property. Thus, property that produces an insignificant amount of an activity's rental income might significantly affect the activity's average period of customer use. Therefore, this document amends the definition of average period of customer use to take into account the amount of income generated by an item of property.

This document also amends the rules contained in §1.469-1T(f)(4) (relating to the allocation of disallowed deductions and credits among activities) to reflect the possibility that the composition of an activity may change from year to year.

II. Section 1.469-2T.

This document amends §1.469-2T(c) and (d) to provide rules for characterizing the gain and loss from the sale of property held in a dealing activity at the time of the sale. For purposes of characterizing the gain or loss from the sale of any such property that was used predominantly in one or more nondealing activities and was not acquired for the principal purpose of dealing in such property, the rules provide that holding the property in the dealing activity is treated as the use of the property in the last nondealing activity in which such property was used before its sale. In all other cases, the rules provide that the property is treated as used in the dealing activity, and treat such property as used in a dealing activity for any period during which it is simultaneously offered for sale to customers and used in a nondealing activity. These rules replace the provision contained in §1.469-1T(e)(3)(vi)(D) of the existing regulations. Under that provision, certain rentals of property were treated as incidental to an activity of dealing in such property rather than as part of a rental activity.

The Service has received numerous comments regarding the income-recharacterization rule contained in §1.469-2T(f)(5), relating to the treatment of net income from certain property rented incidental to a development activity. Some commentators have argued that there are a substantial number of cases in which the gain on the disposition of property that is used in a rental activity for less than 24 months after its development is predominantly attributable to its use in a rental activity rather than to the development of the property. Other commentators have argued that there should be no special recharacterization rule with respect to development activities. After careful consideration, it has been determined that §1.469-2T(f)(5) should apply only if the use of an item of property in an activity involving the rental of such property commenced less than 12 months prior to its sale (or contracting for its sale). Accordingly, this document amends the existing regulations to provide for this result.

III. Section 1.469-5T.

Under §1.469-4T, the business and rental operations that constitute an activity may change from year to year. The existing regulations do not address how the material participation tests that are based on participation in prior years will apply in cases in which such changes occur. Accordingly, this document amends §1.469-5T to provide that, for purposes of the material participation tests that are based on participation in prior years, a taxpayer is treated as materially participating in an activity for a prior taxable year if the activity includes an undertaking involving substantially the same operations as an undertaking that was included in an activity in which the taxpayer materially participated during such prior taxable year.

Special Analyses

These rules are not major rules as defined in Executive Order 12291. Therefore, a Regulatory Impact Analysis is not required.

* * * * * *

Adoption of amendments to the regulations

Accordingly, Title 26, Chapter 1, Parts 1 and 602 of the Code of Federal Regulations are amended as follows:

PART 1—INCOME TAX; TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1953

Paragraph 1. The authority for Part 1 is amended by adding the following citation:

Authority: 26 U.S.C. 7805. * * * Section 1.469-4T also issued under 26 U.S.C. 469(l)(1).

Par. 2. Section 1.469-0T is revised to read as follows:

§ 1.469-0T Table of contents (temporary).

This section lists the captions that appear in the temporary regulations under section 469.

§ 1.469-1T General rules (temporary).

(a) Passive activity loss and credit disallowed.

(1) In general.

(2) Exceptions.

(b) Taxpayers to whom these rules apply.

(c) Cross references.
(1) Definition of passive activity.
(2) Passive activity loss.
(3) Passive activity credit.
(4) Effect of rules for other purposes.
(5) Special rule for oil and gas working interests.
(6) Treatment of disallowed losses and credits.
(7) Corporations subject to section 469.
(8) Consolidated groups.
(9) Joint returns.
(10) Material participation.
(11) Effective date and transition rules.
(12) Future regulations.
(d) Effect of section 469 and the regulations thereunder for other purposes.
(1) Treatment of items of passive activity income and gain.
(2) Coordination with sections 613A(d) and 1211.
(3) Treatment of passive activity losses.
(e) Definition of ''passive activity.''
(1) In general.
(2) Trade or business activity.
(3) Rental activity.
(i) In general.
(ii) Exceptions.
(iii) Average period of customer use.
(A) In general.
(B) Average use factor.
(C) Average period of customer use for class of property.
(D) Period of customer use.
(E) Class of property.
(F) Gross rental income and daily rent.
(iv) Significant personal services.
(A) In general.
(B) Excluded services.
(v) Extraordinary personal services.
(vi) Rental of property incidental to a nonrental activity of the taxpayer.
(A) In general.
(B) Property held for investment.
(C) Property used in a trade or business.
(D) Lodging rented for convenience of employer.
(E) Unadjusted basis.
(vii) Property made available for use in a nonrental activity conducted by a partnership, S corporation, or joint venture in which the taxpayer owns an interest.
(viii) Examples.
(4) Special rule for oil and gas working interests.
(i) In general.
(ii) Exception for deductions attributable to a period during which liability is limited.
(A) In general.
(B) Coordination with rules governing the identification of disallowed passive activity deductions.
(C) Meaning of certain terms.
(*1*) Allocable deductions.
(*2*) Disqualified deductions.
(*3*) Net loss.
(*4*) Ratable portion.
(iii) Examples.
(iv) Definition of ''working interest.''
(v) Entities that limit liability.
(A) General rule.
(B) Other limitations disregarded.
(C) Examples.
(vi) Cross reference to special rule for income from certain oil or gas properties.
(5) Rental of dwelling unit.
(6) Activity of trading personal property.
(i) In general.
(ii) Personal property.
(iii) Example.
(f) Treatment of disallowed passive activity losses and credits.
(1) Scope of this paragraph.
(2) Identification of disallowed passive activity deductions.
(i) Allocation of disallowed passive activity loss among activities.
(A) General rule.
(B) Loss from an activity.
(C) Significant participation passive activities.
(D) Examples.
(ii) Allocation within loss activities.
(A) In general.
(B) Excluded deductions.
(iii) Separately identified deductions.
(3) Identification of disallowed credits from passive activities.
(i) General rule.
(ii) Coordination rule.
(iii) Separately identified credits.
(4) Carryover of disallowed deductions and credits.
(i) In general.
(ii) Operations continued through C corporations or similar entities.
(iii) Examples.
(g) Application of these rules to C corporations.
(1) In general.
(2) Definitions.
(3) Participation of corporations.
(i) Material participation.
(ii) Significant participation.
(iii) Participation of individual.
(4) Modified computation of passive activity loss in the case of closely held corporations.
(i) In general.
(ii) Net active income.
(iii) Examples.
(5) Allowance of passive activity credit of closely held corporations to extent of net active income tax liability.
(i) In general.
(ii) Net active income tax liability.
(h) Special rules for affiliated group filing consolidated return.
(1) In general.
(2) Definitions.
(3) Disallowance of consolidated group's passive activity loss or credit.
(4) Status and participation of members.
(i) Determination by reference to status and participation of group.
(ii) Determination of status and participation of consolidated group.
(5) Modification of rules for identifying disallowed passive activity deductions and credits.
(i) Identification of disallowed deductions.
(ii) Ratable portion of disallowed passive activity loss.
(iii) Identification of disallowed credits.
(6) Transactions between members of a consolidated group.
(i) Scope.
(ii) Recharacterization of gain or loss from intercompany transactions other than deferred intercompany transactions.
(A) In general.
(B) Recharacterization of gain or loss as portfolio items.
(iii) Deferred intercompany transactions.
(A) In general.
(B) Deferred intercompany transactions involving property subject to depreciation, amortization, or depletion.
(C) Restoration of deferred gain or loss on dispositions.

(D) Certain recharacterized items treated as portfolio items.

(E) Property involved in deferred intercompany transaction.

(iv) Definitions.

(A) Deferred intercompany transaction.

(B) Directly related.

(C) Intercompany transaction.

(D) Purchasing member.

(E) Selling member.

(7) Disposition of stock of a member of an affiliated group.

(8) Dispositions of property used in multiple activities.

(i) [Reserved.]

(j) Spouses filing joint return.

(1) In general.

(2) Exceptions to treatment as one taxpayer.

(i) Identification of disallowed deductions and credits.

(ii) Treatment of deductions disallowed under sections 704(d), 1366(d), and 465.

(iii) Treatment of losses from working interests.

(3) Joint return no longer filed.

(4) Participation of spouses.

(k) Former passive activities and changes in status of corporations. [Reserved.]

§1.469-2T Passive activity loss (temporary).

(a) Scope of this section.

(b) Definition of passive activity loss.

(1) In general.

(2) Cross references.

(c) Passive activity gross income.

(1) In general.

(2) Treatment of gain from disposition of an interest in an activity or an interest in property used in an activity.

(i) In general.

(A) Treatment of gain.

(B) Dispositions of partnership interests and S corporation stock.

(C) Interest in property.

(D) Examples.

(ii) Disposition of property used in more than one activity in 12-month period preceding disposition.

(iii) Disposition of substantially appreciated property formerly used in nonpassive activity.

(A) In general.

(B) Date of disposition.

(C) Substantially appreciated property.

(D) Investment property.

(E) Coordination with paragraph (c)-(2)(ii) of this section.

(F) Coordination with section 163(d).

(G) Examples.

(iv) Taxable acquisitions.

(v) Property held for sale to customers.

(A) Sale incidental to another activity.

(*1*) Applicability.

(*i*) In general.

(*ii*) Principal purpose.

(*2*) Dealing activity not taken into account.

(B) Use in a nondealing activity incidental to sale.

(C) Examples.

(3) Items of portfolio income specifically excluded.

(i) In general.

(ii) Gross income derived in the ordinary course of a Trade or business.

(iii) Special rules.

(A) Income from property held for investment by dealer.

(B) Royalties derived in the ordinary course of the trade or business of licensing intangible property.

(*1*) In general.

(*2*) Substantial services or costs.

(*i*) In general.

(*ii*) Exception.

(*iii*) Expenditures taken into account.

(*3*) Passthrough entities.

(*4*) Cross reference.

(C) Mineral production payments.

(iv) Examples.

(4) Items of personal service income specifically excluded.

(i) In general.

(ii) Example.

(5) Income from section 481 adjustment.

(i) In general.

(ii) Positive section 481 adjustments.

(iii) Ratable portion.

(6) Gross income from certain oil or gas properties.

(i) In general.

(ii) Gross and net passive income from the property.

(iii) Property.

(iv) Examples.

(7) Other items specifically excluded.

(d) Passive activity deductions.

(1) In general.

(2) Exceptions.

(3) Interest expense.

(4) Clearly and directly allocable expenses.

(5) Treatment of loss from disposition.

(i) In general.

(ii) Disposition of property used in more than one activity in 12-month period preceding disposition.

(iii) Other applicable rules.

(A) Applicability of rules in paragraph (c)(2).

(B) Dispositions of partnership interests and S corporation stock.

(6) Coordination with other limitations on deductions that apply before section 469.

(i) In general.

(ii) Proration of deductions disallowed under basis limitations.

(A) Deductions disallowed under section 704(d).

(B) Deductions disallowed under section 1366(d).

(iii) Proration of deductions disallowed under at-risk limitation.

(iv) Coordination of basis and at-risk limitations.

(v) Separately identified items of deduction and loss.

(7) Deductions from section 481 adjustment.

(i) In general.

(ii) Negative section 481 adjustments.

(iii) Ratable portion.

(8) Taxable year in which item arises.

(e) Special rules for partners and S corporation shareholders.

(1) In general.

(2) Payments under sections 707(a), 707(c), and 736(b).

(i) Section 707(a).

(ii) Section 707(c).

(iii) Payments in liquidation of a partner's interest in partnership property.

(A) In general.

(B) Payments in liquidation of a partner's interest in unrealized receivables and goodwill under section 736(a).

(3) Sale or exchange of interest in passthrough entity.

(i) Application of this paragraph (e)-(3).

(ii) General rule.

(A) Allocation among activities.

(B) Ratable portion.

§1.469-11T Effective date and transition rules (temporary).

(a) Effective date.

(1) In general.

(2) Application of certain income recharacterization rules.

(i) In general.

(ii) Property rented to a nonpassive activity.

(3) Qualified low-income housing projects.

(4) Effect of events occurring in years prior to 1987.

(5) Examples.

(b) Transitional rule for pre-enactment loss and pre-enactment credit.

(1) In general.

(2) Applicable percentage.

(3) Pre-enactment loss.

(4) Pre-enactment credit.

(5) Examples.

(c) Definition of pre-enactment interest.

(1) General rule.

(2) Qualified interest.

(i) In general.

(ii) Stock in a C corporation.

(3) Pre-enactment activity.

(i) In general.

(ii) Character before 1987 irrelevant.

(4) Examples.

(5) Effect of changes in a taxpayer's interest in a pre-enactment activity.

(i) In general.

(ii) Partnership terminations under section 708(b)(1)(B).

(iii) Examples.

(6) Special rule for beneficiaries of trusts or estates.

(i) In general.

(ii) Interests distributed to beneficiaries.

(7) Written binding contract.

(i) In general.

(ii) Special rule for contract of partnership or S corporation.

(iii) Application of rule to partnership agreements.

§1.469-1T [Amended]

Par. 3. Section 1.469-1T is amended as follows:

1. Paragraph (d)(2) is amended by revising the heading and first sentence to read as follows:

(d) * * *

(2) *Coordination with sections 613A(d) and 1211.* A passive activity deduction that is not disallowed for the taxable year under section 469 and the regulations thereunder may nonetheless be disallowed for the taxable year under section 613A(d) or 1211. * * *

* * * * *

2. Paragraph (e)(2) is revised to read as follows:

(e) * * *

(2) *Trade or business activity.* An activity (within the meaning of §1.469-4T) is a trade or business activity for a taxable year if and only if such activity—

(i) Is not a rental activity for such taxable year; and (ii) Involves the conduct during such taxable year of business or rental operations (within the meaning of §1.469-4T(b)(2)(ii)) that are not treated under paragraph (e)(3)(vi)(B) of this section as incidental to an activity of holding property for investment.

* * * * *

3. Paragraph (e)(3)(iii) is revised to read as follows:

(e) * * *

(3) * * *

(iii) *Average period of customer use*—(A) *In general.* For purposes of this paragraph (e)(3), the average period of customer use for property held in connection with an activity (the "activity's average period of customer use") is the sum of the average use factors for each class of property held in connection with the activity.

(B) *Average use factor.* The average use factor for a class of property held in connection with an activity is the average period of customer use for such class of property multiplied by the fraction obtained by dividing—

(*1*) The activity's gross rental income attributable to such class of property; by

(*2*) The activity's gross rental income.

(C) *Average period of customer use for class of property.* In determining an activity's average period of customer use for a taxable year, the average period of customer use for a class of property held in connection with an activity is determined by dividing—

(*1*) The aggregate number of days in all periods of customer use for property in such class (taking into account only periods that end during such taxable year or that include the last day of such taxable year); by

(*2*) The number of such periods of customer use.

(D) *Period of customer use.* Each period during which a customer has a continuous or recurring right to use an item of property held in connection with the activity (without regard to whether the customer uses the property for the entire period or whether such right to use the property is pursuant to a single agreement or to renewals thereof) is treated for purposes of this paragraph (e)(3)(iii) as a separate period of customer use. The duration of a period of customer use that includes the last day of a taxable year may be determined on the basis of reasonable estimates.

(E) *Class of property.* Taxpayers may organize property into classes for purposes of this paragraph (e)(3)(iii) using any method under which items of property for which the daily rent differs significantly are not included in the same class.

(F) *Gross rental income and daily rent.* In determining an activity's average period of customer use for a taxable year—

(*1*) The activity's gross rental income is the gross income from the activity for such taxable year taking into account only income that is attributable to amounts paid for the use of property;

(*2*) The activity's gross rental income attributable to a class of property is the gross income from the activity for such taxable year taking into account only income that is attributable to amounts paid for the use of property in such class; and

(*3*) The daily rent for items of property may be determined on any basis that reasonably reflects differences during the taxable year in the amounts ordinarily paid for one day's use of such items of property.

* * * * *

4. Paragraph (e)(3)(vi) is amended by removing paragraph (e)(3)(vi)(D) and by redesignating paragraph (e)(3)(vi)(E) and (F) as paragraph (e)(3)(vi)(D) and (E).

5. Paragraph (e)(4)(iv) is revised to read as follows:

(e) * * *

(4) * * *

(iv) *Definition of "working interest."* For purposes of section 469 and the regulations thereunder, the term "working interest" means a working or operating mineral interest in any tract or parcel of land (within the meaning of §1.612-4(a)).

* * * * *

6. Paragraph (e)(5) is revised to read as follows:

(e) * * *

(5) *Rental of dwelling unit.* An activity involving the rental of a dwelling unit is not a passive activity of a taxpayer for any taxable year in which section 280A(c)(5) applies to the taxpayer's use of such dwelling unit.

* * * * *

7. Paragraph (f)(4) is revised to read as follows:

(f) * * *

(4) *Carryover of disallowed deductions and credits*—(i) *In general.* If any deductions or credits from an activity of a taxpayer (the loss activity) are disallowed for a taxable year under paragraph (f)(2) or (f)(3) of this section—

(A) The disallowed deductions or credits shall be allocated among the taxpayer's activities for the succeeding taxable year in a manner that reasonably reflects the extent to which each such activity continues the business and rental operations that constituted the loss activity; and

(B) The disallowed deductions or credits allocated to an activity under paragraph (f)(4)(i)(A) of this section shall be treated as deductions or credits from such activity for the succeeding taxable year.

(ii) *Operations continued through C corporations or similar entities.* (A) If a taxpayer continues part or all of the business and rental operations that constitute a loss activity through a C corporation or similar entity, the taxpayer's interest in such entity shall be treated for purposes of this paragraph (f)(4) as an interest in a passive activity that continues such operations. An entity is similar to a C corporation for this purpose if the owners of interests in the entity derive only portfolio income (within the meaning of §1.469-2T(c)(3)(i)) from such interests.

(B) If, after the application of this paragraph (f)(4)(ii), an interest in a C corporation or similar entity is a loss activity for a taxable year, such interest shall be treated for purposes of applying this paragraph (f)(4) in the succeeding taxable year as an interest in a passive activity that continues the business and rental operations of such loss activity.

(iii) *Examples.* The following examples illustrate the application of this paragraph (f)(4). In each example, the taxpayer is an individual whose taxable year is the calendar year.

Example (1). (i) The taxpayer owns interests in a convenience store and an apartment building. In each taxable year, the taxpayer's interests in the convenience store and the apartment building are treated under §1.469-4T as interests in two separate passive activities of the taxpayer. A $5,000 loss from the convenience-store activity and a $3,000 loss from the apartment-building activity are disallowed under paragraph (f)(2) of this section for 1989.

(ii) Under paragraph (f)(2) of this section, the $5,000 loss from the convenience-store activity is allocated among the passive activity deductions from that activity for 1989, and the $3,000 loss from the apartment-building activity is treated similarly. In 1990, the business and rental operations that constituted the convenience-store activity are continued in a single activity, and the business and rental operations that constituted the apartment-building activity are similarly continued in a separate activity. Thus, the disallowed deductions from the convenience-store activity for 1989 must be allocated under paragraph (f)(4)(i)(A) of this section to the taxpayer's convenience-store activity in 1990. Similarly, the disallowed deductions from the apartment-building activity for 1989 must be allocated to the taxpayer's apartment-building activity in 1990. Under paragraph (f)(4)(i)(B) of this section, the disallowed deductions allocated to the convenience-store activity in 1990 are treated as deductions from that activity for 1990, and the disallowed deductions allocated to the apartment-building activity for 1990 are treated as deductions from the apartment-building activity for 1990.

Example (2). (i) In 1991, the taxpayer acquires a restaurant and a catering service. In 1991 and 1992, the restaurant and the catering service are conducted at the same location, and the taxpayer's interests in the restaurant and catering service are treated under §1.469-4T as an interest in a single passive activity of the taxpayer. A $10,000 loss from the activity is disallowed under paragraph (f)-(2) of this section for 1992. In 1993, the restaurant and the catering service are conducted at different locations, and the taxpayer's interests in the restaurant and the catering service are treated under §1.469-4T as interests in two separate passive activities of the taxpayer.

(ii) Under paragraph (f)(2) of this section, the $10,000 loss from the restaurant and catering activity is allocated among the passive activity deductions from that activity for 1992. In 1993, the business and rental operations that constituted the restaurant and catering activity are continued, but are treated as two separate activities under §1.469-4T. Thus, the disallowed deductions from the restaurant and catering activity for 1992 must be allocated under paragraph (f)(4)(i)(A) of this section between the restaurant activity and the catering activity in 1993 in a manner that reasonably reflects the extent to which each of the activities continues the operations of the restaurant and catering activity. Under paragraph (f)(4)(i)(B) of this section, the disallowed deductions allocated to the restaurant activity in 1993 are treated as deductions from the restaurant activity for 1993, and the disallowed deductions allocated to the catering activity in 1993 are treated as deductions from the catering activity for 1993.

Example (3). (i) The facts are the same as in example (2). In addition, a $20,000 loss from the activity was disallowed under paragraph (f)(2) of this section for 1991, and the gross income and deductions (including deductions that were disallowed for 1991 under paragraph (f)(2) of this section) from the restaurant and catering service for 1991 and 1992 are as follows:

	Restaurant	*Catering service*
1991		
Gross income	$20,000	$60,000
Deductions	40,000	60,000
Net income (loss)	($20,000)	—
1992		
Gross income	$40,000	$50,000
Deductions	30,000*	70,000**
Net income (loss)	$10,000	($20,000)

*Includes $8,000 of deductions that were disallowed for 1991 ($20,000 × $40,000/$100,000).

**Includes $12,000 of deductions that were disallowed for 1991 ($20,000 × $60,000/$100,000).

(ii) Under paragraph (f)(4)(i)(A) of this section, the disallowed deductions from the restaurant and catering operations must be allocated among the taxpayer's activities for the succeeding year in a manner that reasonably reflects the extent to which such activities continue the restaurant and catering operations. The remainder of this example describes a number of allocation methods that will ordinarily satisfy the requirement of paragraph (f)-(4)(i)(A) of this section. One or more of the allocation methods described in this example may, however, be unreasonable in certain cases. In addition, the description of specific allocation methods in this example does not preclude the use of other reasonable allocation methods for purposes of paragraph (f)(4)(i)(A) of this section.

(iii) Ordinarily, an allocation of disallowed deductions from the restaurant operations to the restaurant activity and disallowed deductions from the catering operations to the catering activity would satisfy the requirement of paragraph (f)(4)-(i)(A) of this section. Under paragraph (f)(2)(ii) of this section, a ratable portion of each deduction from the restaurant and catering activity is disallowed for 1992. Thus, $3,000 of the 1992 deductions from the restaurant operations are disallowed ($10,000 × $30,000/$100,000), and $7,000 of the 1992 deductions from the catering operations are disallowed ($10,000 × $70,000/$100,000). Thus, the taxpayer can ordinarily treat $3,000 of the disallowed deductions as deductions from the restaurant activity for 1993, and $7,000 of the disallowed deductions as deductions from the catering activity for 1993.

(iv) Ordinarily, an allocation of disallowed deductions between the restaurant and catering activities in proportion to the losses from the restaurant operations and the catering operations for 1992 would also satisfy the requirement of paragraph (f)(4)(i)(A) of this section. If the restaurant operations and the catering operations had been treated as separate activities in 1992, the restaurant activity would have had net income of $10,000 and the catering activity would have had a $20,000 loss. Thus, the taxpayer can ordinarily treat all $10,000 of disallowed deductions as deductions from the catering activity for 1993.

(v) Ordinarily, an allocation of disallowed deductions between the restaurant and catering activities in proportion to the losses from the restaurant operations and catering operations for 1992 (determined as if the restaurant operations and the catering operations had been separate activities for all taxable years) would also satisfy the requirement of paragraph (f)(4)(i)(A) of this section. If the restaurant operations and the catering operations had been treated as separate activities for all taxable years, the entire $20,000 loss from the restaurant operations in 1991 would have been allocated to the restaurant activity in 1992, and the gross income and deductions from such separate activities for 1992 would be as follows:

	Restaurant	Catering service
Gross income	$40,000	$50,000
Deductions	42,000	58,000
Net income (loss)	($2,000)	($8,000)

Thus, the taxpayer can ordinarily treat $2,000 of the disallowed deductions as deductions from the restaurant activity for 1993, and $8,000 of the disallowed deductions as deductions from the catering activity for 1993.

Example (4). (i) The taxpayer is a partner in a law partnership that acquires a building in December 1988 for use in the partnership's law practice. In taxable year 1989, four floors that are not needed in the law practice are leased to tenants; in taxable year 1990, two floors are leased to tenants; in taxable years after 1990, only one floor is leased to tenants. Under §1.469-4T(d), the law practice and the rental operations with respect to the leased property are treated as a trade or business activity and a separate rental activity for taxable years 1989 and 1990 and as a single trade or business activity for taxable years after 1990. The trade or business activity is not a passive activity of the taxpayer. The rental activity, however, is a passive activity. Under paragraph (f)(2) of this section, a $12,000 loss from the rental activity is disallowed for 1989, and a $9,000 loss from the rental activity is disallowed for 1990.

(ii) Under paragraph (f)(2) of this section, the $12,000 loss from the rental activity for 1989 is allocated among the passive activity deductions from that activity for 1989. In 1990, the business and rental operations that constituted the rental activity are continued in two separate activities. Only the business and rental operations with respect to two floors of the building are continued in the rental activity, and the other two floors (*i.e.*, the floors that were leased to tenants in 1989, but not in 1990) are used in the taxpayer's law-practice activity. Thus, the disallowed deductions from the rental activity for 1989 must be allocated under paragraph (f)(4)(i)(A) of this section between the rental activity and the law-practice activity in a manner that reasonably reflects the extent to which each of the activities continues the operations with respect to the four floors that were leased to tenants in 1989. In these circumstances, the requirement of paragraph (f)(4)(i)(A) of this section would ordinarily be satisfied by any of the allocation methods illustrated in example (3) or by an allocation of 50 percent of the disallowed deductions ($6,000) to each activity. Under paragraph (f)(4)(i)(B) of this section, the disallowed deductions allocated to the rental activity in 1990 are treated as deductions from the rental activity for 1990, and the disallowed deductions allocated to the law-practice activity in 1990 are treated as deductions from the law-practice activity for 1990.

(iii) Under paragraph (f)(2) of this section, the $9,000 loss from the rental activity for 1990 is allocated among the passive activity deductions from that activity for 1990. In 1991, the business and rental operations that constituted the rental activity are continued in the taxpayer's law-practice activity. Thus, the disallowed deductions from the rental activity for 1990 must be allocated under paragraph (f)(4)(i)(A) of this section to the taxpayer's law-practice activity in 1991. Under paragraph (f)(4)(i)(B) of this section, the disallowed deductions allocated to the law-practice activity are treated as deductions from the law-practice activity for 1991.

(iv) Rules relating to former passive activities will be contained in paragraph (k) of this section. Under those rules, any disallowed deductions from the rental activity that are treated as deductions from the law-practice activity will be treated as unused deductions that are allocable to a former passive activity.

Example (5). (i) The taxpayer owns stock in a corporation that is an S corporation for the taxpayer's 1991 taxable year and a C corporation thereafter. The only activity of the corporation is a rental activity. For 1991, the taxpayer's pro rata share of the corporation's loss from the rental activity is $5,000, and the entire loss is disallowed under paragraph (f)(2) of this section.

(ii) Under paragraph (f)(2) of this section, the taxpayer's $5,000 loss from the rental activity is allocated among the taxpayer's deductions from that activity for 1991. In 1992, the business and rental operations that constituted the rental activity are continued through a C corporation, and the taxpayer's interest in the C corporation is treated under paragraph (f)(4)(ii)(A) of this section as a passive activity that continues such operations (the C corporation activity). Thus, the disallowed deductions from the rental activity for 1991 must be allocated under paragraph (f)(4)(i)(A) of this section to the taxpayer's C corporation activity in 1992, and are treated under paragraph (f)(4)(i)(B) of this section as deductions from the C corporation activity for 1992.

(iii) Treating the taxpayer's interest in the C corporation as an interest in a passive activity that continues the operations of the rental activity does not change the character of the taxpayer's dividend income from the C corporation. Thus, the taxpayer's dividend income is portfolio income (within the meaning of §1.469-2T(c)(3)(i)) and is not included in passive activity gross income. Accordingly, the taxpayer's loss from the C corporation activity for 1992 is $5,000.

Example (6). (i) The facts are the same as in example (5), except that the taxpayer has income from other passive activities for 1992, and only 60 percent of the taxpayer's loss from the C corporation activity ($3,000) is disallowed for 1992 under paragraph (f)(2) of this section.

(ii) Under paragraph (f)(2) of this section, the $3,000 disallowed loss from the C corporation activity is allocated among the passive activity deductions from that activity for 1992. In effect, therefore, 60 percent of each disallowed deduction from the rental activity for 1991 is again disallowed for 1992.

(iii) Under paragraph (f)(4)(ii)(B) of this section, the taxpayer's interest in the C corporation is treated for years after 1992 as an interest in a passive activity that continues the business and rental operations of the C corporation activity. Thus, the disallowed deductions from the C corporation activity for 1992 must be allocated under paragraph (f)(4)(i)(A) of this section to the taxpayer's C corporation activity in 1993, and are treated under paragraph (f)(4)(i)(B) of this section as deductions from that activity for 1993.

* * * * *

8. Paragraph (g)(4)(ii)(C) is amended by removing "§1.469-2T(c)(2)(iii)(E)" and adding in its place "§1.469-2T(c)(2)(iii)(F)".

9. Paragraph (h)(4) is amended by removing the word "material" from the captions of paragraphs (h)(4) and (h)(4)(ii) and by adding the words "or significantly" immediately after the word "materially" in paragraph (h)(4)(ii).

§1.469-2T [Amended]

Par. 4. Section 1.469-2T is amended as follows:

1. Paragraphs (c)(2)(iii)(D) through (c)(2)(iii)(F) are redesignated as paragraphs (c)(2)(iii)(E) through (c)(2)(iii)(G) and the following new paragraph (c)(2)(iii)(D) is added:

(c) * * *

(2) * * *

(iii) * * *

(d) *Investment property.* For purposes of this paragraph (c)(2)(iii), an interest in property shall be treated as an interest in property used in an activity other than a passive activity and as an interest in property held for investment for any period during which such interest is held through a C corporation or similar entity. An entity is similar to a C corporation for this purpose if the owners of interests in the entity derive only portfolio income (within the meaning of paragraph (c)(3)(i) of this section) from such interests.

* * * * *

2. Paragraph (c)(2)(iii)(G) (as redesignated by this Treasury decision) is revised to read as follows:

(c) * * *

(2) * * *

(iii) * * *

(G) *Examples.* The following examples illustrate the application of this paragraph (c)(2)(iii):

Example (1). A acquires a building on January 1, 1987, and uses the building in a trade or business activity in which A materially participates until March 31, 1998. On April 1, 1998, A leases the building to B. On December 31, 1999, A sells the building. At the time of the sale, A's interest in the building is substantially appreciated (within the meaning of paragraph (c)(2)(iii)(C) of this section). Assuming A's lease of the building to B constitutes a rental activity (within the meaning of §1.469-1T(e)(3)), the building is used in a passive activity for 21 months (April 1, 1998, through December 31, 1999). Thus, the building was not used in a passive activity for the entire 24-month period ending on the date of the sale. In addition, the 21-month period during which the building was used in a passive activity is less than 20 percent of A's holding period for the building (13 years). Therefore, the gain from the sale is treated under this paragraph (c)(2)(iii) as not from a passive activity.

Example (2). (i) A, an individual, is a stockholder of corporation X. X is a C corporation until December 31, 1990, and is an S corporation thereafter. X acquires a building on January 1, 1990, and sells the building on March 1, 1991. At the time of the sale, A's interest in the building held through X is substantially appreciated (within the meaning of paragraph (c)(2)(iii)(C) of this section). The building is leased to various tenants at all times during the period in which it is held by X. Assume that the lease of the building would constitute a rental activity (within the meaning of §1.469-1T(e)(3)) with respect to a person that holds the building directly or through an S corporation.

(ii) Paragraph (c)(2)(iii)(D) of this section provides that an interest in property is treated for purposes of this paragraph (c)(2)(iii) as used in an activity other than a passive activity and as held for investment for any period during which such interest is held through a C corporation. Thus, for purposes of determining the character of A's gain from the sale of the building, A's interest in the building is treated as an interest in property held for investment for the period from January 1, 1990 to December 31, 1990, and as an interest in property used in a passive activity for the period from January 1, 1991 to February 28, 1991.

(iii) A's interest in the building was not used in a passive activity for the entire 24-month period ending on the date of the sale. In addition, the 2-month period during which A's interest in the building was used in a passive activity is less than 20 percent of the period during which A held an interest in the building (14 months). Therefore, the gain from the sale is treated under this paragraph (c)(2)(iii) as not from a passive activity.

(iv) Under paragraph (c)(2)(iii)(F) of this section, gain that is treated as nonpassive under this paragraph (c)(2)(iii) is treated as portfolio income (within the meaning of paragraph (c)(3)(i) of this section) if the gain is from the disposition of an interest in property that was held for investment for more than 50 percent of the period during which the taxpayer held such interest in activities other than passive activities. In this case, A's interest in the building was treated as held for investment for the entire period during which it was used in activities other than passive activities (*i.e.*, the 12-month period from January 1, 1990 to December 31, 1990). Accordingly, A's gain from the sale is treated under this paragraph (c)(2)(iii) as portfolio income.

* * * * *

3. New paragraphs (c)(2)(iv) and (c)-(2)(v) are added to read as follows:

(c) * * *

(2) * * *

(iv) *Taxable acquisitions.* If a taxpayer acquires an interest in property in a transaction other than a nonrecognition transaction (within the meaning of section 7701(a)(45)), the ownership and use of such interest in property before such transaction shall not be taken into account for purposes of applying this paragraph (c)(2) to any subsequent disposition of such interest in property by the taxpayer. For example, if a taxpayer is a partner in a partnership that owns an interest in property and the taxpayer acquires such interest in property from the partnership in a fully taxable sale or exchange, such interest shall be treated, in applying this paragraph (c)(2) to any subsequent disposition of such interest, as an interest in property that was not held by the taxpayer until the date on which such interest was acquired from the partnership and that was not used before such date in any activity of the taxpayer.

(v) *Property held for sale to customers*—(A) *Sale incidental to another activity*—(*1*)—*Applicability*—(*i*) *In general.* This paragraph (c)(2)(v)(A) applies to the disposition of a taxpayer's interest in property if and only if—

(*A*) At the time of the disposition, the taxpayer holds the interest in property in an activity that involves holding similar property that is treated for purposes of section 1221(1) as property held primarily for sale to customers in the ordinary course of a trade or business (a "dealing activity");

(*B*) One or more other activities of the taxpayer do not involve holding similar property for sale to customers in the ordinary course of a trade or business ("nondealing activities") and the interest in property was used in such activity or activities for more than 80 percent of the period during which the taxpayer held such interest in property; and

(*C*) The interest in property was not acquired and held by the taxpayer for the principal purpose of selling such interest to customers in the ordinary course of a trade or business.

(*ii*) *Principal purpose.* For purposes of this paragraph (c)(2)(v)(A), a taxpayer is rebuttably presumed to have acquired and held an interest in property for the principal purpose of selling such interest to customers in the ordinary course of a trade or business if—

(*A*) The period during which the interest in property was used in nondealing activities of the taxpayer does not exceed the lesser of 24 months or 20 percent of the recovery period (within the meaning of section 168) applicable to such property; or

(*B*) The interest in property was simultaneously offered for sale to customers and used in a nondealing activity of the taxpayer for more than 25 percent of the period during which such interest in property was used in nondealing activities of the taxpayer.

For purposes of the preceding sentence, an interest in property shall not be considered to be offered for sale to customers solely because a lessee of the property has been granted an option to purchase the property.

(*2*) *Dealing activity not taken into account.* If this paragraph (c)(2)(v)(A) applies to the disposition of a taxpayer's interest in property, holding such interest in the dealing activity shall, for purposes of this paragraph (c)(2), be treated as the use of such interest in the last nondealing activity of the taxpayer in which such interest in property was used prior to its disposition.

(B) *Use in a nondealing activity incidental to sale.* If paragraph (c)(2)(v)(A) of this section does not apply to the disposition of a taxpayer's interest in property that is held in a dealing activity of the taxpayer at the time of disposition, the use of such interest in property in a nondealing activity of the taxpayer for any period during which such interest in property is also offered for sale to customers shall, for purposes of this paragraph (c)(2), be treated as the use of such interest in property in the dealing activity of the taxpayer.

(C) *Examples.* The following examples illustrate the application of this paragraph (c)(2)(v):

Example (1). (i) The taxpayer acquires a residential apartment building on January 1, 1987, and uses the building in a rental activity. In January 1990, the taxpayer converts the apartments into condominium units. After the conversion, the taxpayer holds the condominium units for sale to customers in the ordinary course of a trade or business of dealing in such property. (Assume that these dealing operations are treated as a separate activity under §1.469-4T, and that the taxpayer materially participates in this activity.) In addition, the taxpayer continues to use the units in the rental activity until they are sold. The units are first held for sale on January 1, 1990, and the last unit is sold on December 31, 1990.

(ii) This paragraph (c)(2)(v) provides that holding an interest in property in a dealing activity (the marketing of the property) is treated for purposes of this paragraph (c)(2) as the use of such interest in a nondealing activity if the marketing of the property is incidental to such use. Under paragraph (c)(2)-(v)(A)(*2*) of this section, such interests in property are treated as used in the last nondealing activity in which they were used prior to their disposition. In addition, paragraph (c)(2)(v)(A)(*1*) of this section provides rules for determining whether the marketing of the property is incidental to the use of an interest in property in a nondealing activity. Under these rules, the marketing of the property is treated as incidental to such use if (a) the interest in property was used in nondealing activities for more than 80 percent of the taxpayer's holding period in the property (the holding period requirement) and (b) the taxpayer did not acquire and hold the interest in property for the principal purpose of selling it to customers in the ordinary course of a trade or business (a dealing purpose).

(iii) In this case, the apartments were used in a rental activity for the entire period during which they were held by the taxpayer. Thus, the apartments were used in a nondealing activity for more than 80 percent of the taxpayer's holding period in the property, and the marketing of the property satisfies the holding period requirement.

(iv) Paragraph (c)(2)(v)(A)(*1*)(*ii*) of this section provides that a taxpayer is rebuttably presumed to have a dealing purpose unless the interest in property was used in nondealing activities for more than 24 months or 20 percent of the property's recovery period (whichever is less). The same presumption applies if the interest in property was offered for sale to customers during more than 25 percent of the period in which the interest was held in nondealing activities. In this case, the taxpayer used each apartment in a nondealing activity (the rental activity) for a period of 36 to 48 months (*i.e.*, from January 1, 1987, to the date of sale in the period from January through December 1990). Thus, the apartments were used in nondealing activities for more than 24 months, and the first of the rebuttable presumptions described above does not apply. In addition, the apartments were offered for sale to customers for up to 12 months (depending on the month in which the apartment was sold) during the period in which the apartments were used in a nondealing activity. The percentage obtained by dividing the period during which an apartment was held for sale to customers by the period during which the apartment was used in nondealing activities ranges from zero in the case of apartments sold on January 1, 1990, to 25 percent (*i.e.*, 12 months/48 months) in the case of apartments sold on December 31, 1990. Thus, no apartment was offered for sale to customers during more than 25 percent of the period in which it was used in nonrental activities, and the second rebuttable presumption does not apply.

(v) Because neither of the rebuttable presumptions in paragraph (c)(2)(v)(A)(*1*)(*ii*) of this section applies in this case, the taxpayer will not be treated as having a dealing purpose unless other facts and circumstances establish that the taxpayer acquired and held the apartments for the principal purpose of selling the apartments to customers in the ordinary course of a trade or business. Assume that none of the facts and circumstances suggest that the taxpayer had such a purpose. If that is the case, the taxpayer does not have a dealing purpose.

(vi) The marketing of the property satisfies the holding period requirement, and the taxpayer does not have a dealing purpose. Thus, holding the apartments in the taxpayer's dealing activity is treated for purposes of this paragraph (c)(2) as the use of the apartments in a nondealing activity. In this case, the rental activity is the only nondealing activity in which the apartments were used prior to their disposition. Thus, the apartments are treated under paragraph (c)(2)(v)(A)(*2*) of this section as interests in property that were used only in the rental activity for the entire period during which the taxpayer held such interests. Accordingly, the rules in paragraph (c)(2)(ii) and (iii) of this section do not apply, and all gain from the sale of the apartments is treated as passive activity gross income.

Example (2). (i) The facts are the same as in example (1), except that the taxpayer converts the apartments into condominium units on July 1, 1987, and the first unit is sold on January 1, 1988.

(ii) In this case, all of the apartments were simultaneously offered for sale to customers and used in a nondealing activity of the taxpayer for more than 25 percent of the period during which the apartments were used in nondealing activities. Thus, the taxpayer is rebuttably presumed to have acquired the apartments (including apartments that are used in the rental activity for at least 24 months) for the principal purpose of selling them to customers in the ordinary course of a trade or business. Assume that the facts and circumstances do not rebut this presumption. If that is the case, the taxpayer has a dealing purpose, and paragraph (c)-(2)(v)(A) of this section does not apply to the disposition of the apartments.

(iii) Paragraph (c)(2)(v)(B) of this section provides that if paragraph (c)(2)(v)(A) of this section does not apply to the disposition of a taxpayer's interest in property that is held in a dealing activity of the taxpayer at the time of the disposition, the use of the interest in property in any nondealing activity of the taxpayer for any period during which the interest is also offered for sale to customers is treated as incidental to the use of the interest in the dealing activity. Accordingly, for purposes of applying the rules of this paragraph (c)-(2) to the disposition of the apartments, the rental of the apartments after July 1, 1987, is treated as the use of the apartments in the taxpayer's dealing activity.

Example (3). (i) The facts are the same as in example (1), except that the last unit is sold in 1991.

(ii) The treatment of apartments sold in 1990 is the same as in example (1). The apartments sold in 1991, however, were simultaneously offered for sale to customers and used in a nondealing activity for more than 25 percent of the period during which such apartments were used in nondealing activities. (For example, an apartment that is sold on January 31, 1991, has been offered for sale for 13 months or 26.1 percent of the 49-month period during which it was used in nondealing activities.) Thus, the taxpayer is rebuttably presumed to have acquired the apartments sold in 1991 for the principal purpose of selling them to customers in the ordinary course of a trade or business. Assume that the facts and circumstances do not rebut this presumption. In that case, the marketing of the apartments sold in 1991 does not satisfy the principal purpose requirement, and paragraph (c)(2)(v)(A) of this section does not apply to the disposition of those apartments. Accordingly, for purposes of applying the rules of this paragraph (c)(2) to the disposition of the apartments sold in 1991, the rental of the apartments after January 1, 1990, is treated, under paragraph (c)(2)(v)(B) of this section, as the use of the apartments in the taxpayer's dealing activity.

4. Paragraph (c)(6)(i), (ii), and (iii) is revised to read as follows:

(c) * * *

(6) *Gross income from certain oil or gas properties*—(i) *In general.* Notwithstanding any other provision of the regulations under section 469, passive activity gross income for any taxable year does not include an amount of the taxpayer's gross passive income for such year from—

(A) An oil or gas property that includes an oil or gas well if, for any prior taxable year beginning after December 31, 1986, any of the taxpayer's loss from the well was treated, solely by reason of §1.469-1T(e)(4) (relating to a special rule for losses from oil and gas working interests), and not by reason of the taxpayer's material participation in the activity, as a loss that is not from a passive activity; or

(B) Any property the basis of which is determined in whole or in part by reference to the basis of property described in paragraph (c)(6)(i)(A) of this section; equal to the taxpayer's net passive income from such property for the taxable year.

(ii) *Gross and net passive income from the property.* For purposes of this paragraph (c)(6)—

(A) The taxpayer's gross passive income for any taxable year from any property described in paragraph (c)(6)(i) of this section is any passive activity gross income for such year (determined without regard to this paragraph (c)(6) and paragraph (f) of this section) from such property;

(B) The taxpayer's net passive income for any taxable year from any property described in paragraph (c)(6)(i) of this section is the excess, if any, of—

(*1*) The taxpayer's gross passive income for the taxable year from such property; over

(*2*) Any passive activity deductions for the taxable year (including any deduction treated as a deduction for such year under §1.469-1T(f)(4)) that are reasonably allocable to such income; and

(C) If any oil or gas well or other item of property (the item) is included in two or more properties described in paragraph (c)(6)(i) of this section (the properties), the taxpayer shall allocate the passive activity gross income (determined without regard to this paragraph (c)(6) and paragraph (f) of this section) from such item and the passive activity deductions reasonably allocable to such item among such properties.

(iii) *Property.* For purposes of paragraph (c)(6)(i)(A) of this section, the term "property" does not have the meaning given such term by section 614 (a) or the regulations thereunder, and an oil or gas property that includes an oil or gas well is—

(A) The well; and

(B) Any other item of property (including any oil or gas well) the value of which is directly enhanced by any drilling, logging, seismic testing, or other activities the costs of which were taken into account in determining the amount of the taxpayer's income or loss from the well.

* * * * *

5. Paragraph (c)(6)(iv) is amended by removing the phrase "net income" in the last sentences of examples (1) and (2), and adding the phrase "net passive income" in its place.

6. Paragraph (d)(1), *Example*, is amended by removing "sections 469 and 1211" and adding "sections 469, 613A(d), and 1211" each place the former occurs.

7. Paragraph (d)(2)(ix) is amended by adding "section 613A(d)," immediately before "section 1212(a)(1)(B)".

8. Paragraph (d)(5)(iii)(A) is revised to read as follows:

(d) * * *

(5) * * *

(iii) * * *

(A) *Applicability of rules in paragraph (c)(2).* For purposes of this paragraph (d)(5), a taxpayer's interests in property used in an activity and the amounts allocated to such interests shall be determined under paragraph (c)(2)(i)-(C) of this section. In addition, the rules contained in paragraph (c)(2)(iv) and (v) of this section shall apply in determining for purposes of this paragraph (d)(5) the activity (or activities) in which an interest in property is used at the time of its disposition and during the 12-month period ending on the date of its disposition.

* * * * *

9. Paragraph (d)(6)(v)(E) is revised to read as follows:

(d) * * *

(6) * * *

(v) * * *

(E) Are taken into account under section 613A(d) (relating to limitations on certain depletion deductions), section 1211 (relating to the limitation on capital losses), or section 1231 (relating to property used in a trade or business and involuntary conversions); or

* * * * *

10. Paragraph (d)(8) is amended by removing the phrase "sections 469 and 1211" and adding the following in its place: "sections 469, 613A(d), and 1211".

11. Paragraphs (e)(2)(ii) and (iii) are revised to read as follows:

(e) * * *

(2) * * *

(ii) *Section 707(c).* Except as provided in paragraph (e)(2)(iii)(B) of this section, any payment to a partner for services or the use of capital that is described in section 707(c) (including any payment described in section 736(a)-(2)) (relating to guaranteed payments made in liquidation of the interest of a retiring or deceased partner) shall be characterized as a payment for services or as the payment of interest, respectively, and not as a distributive share of partnership income.

(iii) *Payments in liquidation of a partner's interest in partnership property*—(A) *In general.* If any gain or loss is taken into account by a retiring partner (or any other person that owns (directly or indirectly) an interest in such partner if such partner is a passthrough entity) or a deceased partner's successor in interest as a result of a payment to which section 736(b) (relating to payments made in exchange for a retired or deceased partner's interest in partnership property) applies, such gain or loss shall be treated as passive activity gross income or a passive activity deduction only to the extent that such gain or loss would have been passive activity gross income or a passive activity deduction of such retiring or deceased partner (or such other person) if it had been recognized at the time the liquidation of such partner's interest commenced.

(B) *Payments in liquidation of a partner's interest in unrealized receivables and goodwill under section 736(a).*

(*1*) If a payment is made in liquidation of a retiring or deceased partner's interest, such payment is described in section 736(a), and any income—

(*i*) Is taken into account by the retiring partner (or any other person that owns (directly or indirectly) an interest in such partner if such partner is a passthrough entity) or the deceased partner's successor in interest as a result of such payment; and

(*ii*) Is attributable to the portion (if any) of the payment that is allocable to the unrealized receivables (within the meaning of section 751(c)) and goodwill of the partnership;

the percentage of such income that is treated as passive activity gross income shall not exceed the percentage of passive activity gross income that would be included in the gross income that such retiring or deceased partner (or such other person) would have recognized if such unrealized receivables and goodwill had been sold at the time that the liquidation of such partner's interest commenced.

(*2*) For purposes of this paragraph (e)-(2)(iii)(B), the portion (if any) of a payment under section 736(a) that is allocable to unrealized receivables and goodwill of a partnership shall be determined in accordance with the principles employed under §1.736-1(b) for determining the portion of a payment made under section 736 that is treated as a distribution under section 736(b).

* * * * *

12. Paragraph (e)(3)(iii)(B) is revised to read as follows:

(e) * * *

(3) * * *

(iii) * * *

(B) An amount of gain that would have been treated as gain that is not from a passive activity under paragraph (c)(2)-(iii) (relating to substantially appreciated property formerly used in a nonpassive activity), (c)(6) (relating to certain oil or gas properties), (f)(5) (relating to certain property rented incidental to development), (f)(6) (relating to property rented to a nonpassive activity), or (f)(7) (relating to certain interests in a passthrough entity engaged in the trade or business of licensing intangible property) of this section would have been allocated to such holder (or such other person) with respect to such interest if all of the property used in such passive activity had been sold immediately prior to the disposition for its fair market value on the applicable valuation date (within the meaning of paragraph (e)(3)(ii)(D)(*1*) of this section); and

* * * * *

13. Paragraph (f)(5)(i) is amended by removing the phrase "used in a rental activity for such year", by removing "24" and adding "12" in its place, and by removing the phrase ", but without regard to paragraph (e) thereof" from the parenthetical immediately following the words "materially participated".

14. Paragraph (f)(5)(ii) is amended by adding the following phrase immediately after the word "when": "the performance of the services described in paragraph (f)(5)(i)(C) of this section is complete, and".

15. Paragraph (f)(5)(iii)(C) is amended by removing the parenthetical phrase and adding the following in its place: "(but only if, as of the time the taxpayer acquires an interest in the property, a substantial portion of the property is not leased)".

16. Paragraph (f)(5)(iv), *Example*, is revised to read as follows:

(f) * * *

(5) * * *

(iv) * * *

Example. (i) A, a calendar year individual, is a partner in calendar year partnership P, which develops commercial real estate. In 1988, P acquires an interest in undeveloped land, and arranges for the financing and construction of an office building on the land. Construction is completed in February 1990, and substantially all of the building is held out for rent and is in a state of readiness for rental beginning on March 1, 1990.

(ii) P holds the building for rent for the remainder of 1990 and all of 1991, and sells the building on January 15, 1992, pursuant to a contract entered into on January 15, 1991. P did not hold the building (or any other buildings) for sale to customers in the ordinary course of P's trade or business (see paragraph (c)(2)(v) of this section). A's distributive share of P's taxable losses from the rental of the building is $50,000 for 1990 and $30,000 for 1991. All of A's losses from the rental of the building are disallowed under §1.469-1T((a)-(1)(i). A's distributive share of the gain recognized by P on the sale of the building is $150,000. A has no other gross income or deductions from the activity of renting the building.

(iii) For purposes of paragraph (f)(5)(i)(C) of this section, in 1988, 1989, and 1990, the real estate development activity that A holds through P involves the performance of services for the purpose of enhancing the value of the building. In 1992, the building is sold, and the date on which the use of the building in the rental activity commenced (March 1, 1990) was less than 12 months before the date on which a binding contract for such sale was entered into (January 15, 1991). Accordingly, if A materially participated in the real estate development activity in 1988, 1989, or 1990 (without regard to whether A materially participated in the activity in more than one of those years), an amount of A's gross rental activity income for 1992 from the building equal to A's net rental activity income for 1992 from such building ($150,000 − $80,000 of previously disallowed deductions = $70,000) is treated under this paragraph (f)(5) as gross income that is not from a passive activity.

17. Paragraph (f)(6) is amended by removing the phrase "used in a rental activity for such year" and by removing the phrase ", but without regard to paragraph (e) thereof" from the parenthetical immediately following the words "materially participates".

18. Paragraph (f)(9)(iii) is revised to read as follows:

(f) * * *

(9) * * *

(iii) The gross rental activity income for a taxable year from an item of property is any passive activity gross income (determined without regard to paragraph (f)(2) through (6) of this section) that—

(A) Is income for such year from the rental or disposition of such item of property; and

(B) In the case of income from the disposition of such item of property, is income from an activity that involved the rental of such item of property during the 12-month period ending on the date of the disposition (see paragraph (c)(2)(ii) of this section); and

* * * * *

19. Paragraph (f)(9)(iv)(B) is amended by removing the phrase "the use of such item of property in the rental activity" and adding in its place the words "such income".

20. Paragraph (f)(10) is revised to read as follows:

(f) * * *

(10) *Coordination with section 163-(d).* Gross income that is treated as not from a passive activity under paragraph (f)(3), (4), or (7) of this section shall be treated as income described in section 469(e)(1)(A) and paragraph (c)(3)(i) of this section except in determining whether—

(i) Any property is treated for purposes of section 469(e)(1)(A)(ii)(I) and paragraph (c)(3)(i)(C) of this section as property that produces income of a type described in paragraph (c)(3)(i)(A) of this section;

(ii) Any property is treated for purposes of section 469(e)(1)(A)(ii)(II) and paragraph (c)(3)(i)(D) of this section as property held for investment;

(iii) An expense (other than interest expense) is treated for purposes of section 469(e)(1)(A)(i)(II) and paragraph (d)(4) of this section as clearly and directly allocable to portfolio income (within the meaning of paragraph (c)(3)-(i) of this section); and

(iv) Interest expense is allocated under §1.163-8T to an investment expenditure (within the meaning of §1.163-8T(b)(3)) or to a passive activity expenditure (within the meaning of §1.163-8T(b)(4)).

* * * * *

Par. 5. Section 1.469-3T is amended as follows:

1. Paragraph (e) is revised.

2. Paragraph (f) is redesignated as paragraph (g), and a new paragraph (f) is added.

3. The revised provisions read as follows:

§1.469-3T Passive activity credit (temporary).

* * * * *

(e) *Coordination with section 38(b).* Any credit described in section 38(b)(1) through (5) is taken into account in computing the current year business credit for the first taxable year in which such credit is subject to section 469 and is not disallowed by section 469 and the regulations thereunder.

(f) *Coordination with section 47.* In the case of any cessation described in section 47(a)(1), (3), or (5) or any change in use described in section 47(a)-(2) or (4), the credits allocable to the taxpayer's activities under §1.469-1T(f)(4) shall be adjusted by reason of such cessation (or change in use).

* * * * *

Par. 6. The text of §1.469-4T is added to read as follows:

§1.469-4T Definition of activity (temporary).

(a) *Overview*—(1) *Purpose and effect of overview.* This paragraph (a) contains a general description of the rules contained in this section and is intended solely as an aid to readers. The provisions of this paragraph (a) are not a substitute for the more detailed rules contained in the remainder of this section and cannot be relied upon in cases in which those rules qualify the general description contained in this paragraph (a).

(2) *Scope and structure of §1.469-4T.* This section provides rules under which a taxpayer's business and rental operations are treated as one or more activities for purposes of section 469 and the regulations thereunder. (See paragraph (b)-(2)(ii) of this section for the definition of business and rental operations.) In general, these rules are divided into three groups:

(i) Rules that identify the business and rental operations that constitute an undertaking (the undertaking rules).

(ii) Rules that identify the undertaking or undertakings that constitute an activity (the activity rules).

(iii) Rules that apply only under certain special circumstances (the special rules).

(3) *Undertaking rules*—(i) *In general.* The undertaking is generally the smallest unit that can constitute an activity. (See paragraph (b)(1) of this section for the general rule and paragraph (k)(2)(iii) of this section for a special rule that permits taxpayers to treat a single rental real estate undertaking as multiple activities.) An undertaking may include diverse business and rental operations.

(ii) *Basic undertaking rule.* The basic undertaking rule identifies the business and rental operations that constitute an undertaking by reference to their location and ownership. Under this rule, business and rental operations that are conducted at the same location and are owned by the same person are generally treated as part of the same undertaking. Conversely, business and rental operations generally constitute separate undertakings to the extent that they are conducted at different locations or are not owned by the same person. (See paragraph (c)(2)(i) of this section.)

(iii) *Circumstances in which location is disregarded.* In some circumstances, the undertaking in which business and rental operations are included does not depend on the location at which the operations are conducted. Operations that are not conducted at any fixed place of business or that are conducted at the customer's place of business are treated as part of the undertaking with which the operations are most closely associated (see paragraph (c)(2)(iii)(C) of this section). In addition, operations that are conducted at a location but do not relate to the production of property at that location or to the transaction of business with customers at that location are treated, in effect, as part of the undertaking or undertakings that the operations support (see paragraph (c)(2)(ii) of this section).

(iv) *Rental undertakings.* The basic undertaking rule is also modified if the undertaking determined under that rule includes both rental and nonrental operations. In such cases, the rental operations and the nonrental operations generally must be treated as separate undertakings (see paragraph (d)(1) of this section). This rule does not apply if more than 80 percent of the income of the undertaking determined under the basic rule is attributable to one class of operations (*i.e.*, rental or nonrental) or if the rental operations would not be treated as part of a rental activity because of the exceptions contained in §1.469-1T(e)(3)(ii) (see paragraph (d)(2) of this section). In applying the rental undertaking rules, short-term rentals of real property (*e.g.*, hotel-room rentals) are generally treated as nonrental operations (see paragraph (d)(3)(ii) of this section).

(v) *Oil and gas wells.* Another exception to the basic undertaking rule treats oil and gas wells that are subject to the working-interest exception in §1.469-1T((e)(4) as separate undertakings (see paragraph (e) of this section).

(4) *Activity rules*—(i) *In general.* The basic activity rule treats each undertaking in which a taxpayer owns an interest as a separate activity of the taxpayer (see paragraph (b)(1) of this section). In the case of trade or business undertakings, professional service undertakings, and rental real estate undertakings, additional rules may either require or permit the aggregation of two or more undertakings into a single activity.

(ii) *Aggregation of trade or business undertakings*—(A) *Trade or business undertakings.* Trade or business undertakings include all nonrental undertakings other than oil and gas undertakings described in paragraph (a)(3)(v) of this section and professional service undertakings described in paragraph (a)(4)(iii) of this section (see paragraph (f)(1)(ii) of this section).

(B) *Similar, commonly-controlled undertakings treated as a single activity.* An aggregation rule treats trade or business undertakings that are both similar and controlled by the same interests as part of the same activity. This rule is, however, generally inapplicable to small interests held by passive investors in such undertakings, except to the extent such interests are held through the same passthrough entity. (See paragraph (f)(2) of this section.) Undertakings are similar for purposes of this rule if more than half (by value) of their operations are in the same line of business (as defined in a revenue procedure issued pursuant to paragraph (f)(4)(iv) of this section) or if the undertakings are vertically integrated (see paragraph (f)(4)(iii) of this section). All the facts and circumstances are taken into account in determining whether undertakings are controlled by the same interests for purposes of the aggregation rule (see paragraph (j)(1) of this section). If, however, each member of a group of five or fewer persons owns a substantial interest in each of the undertakings, the undertakings may be rebuttably presumed to be controlled by the same interests (see paragraph (j)(2) and (3) of this section).

(C) *Integrated businesses treated as a single activity.* Trade or business undertakings (including undertakings that have been aggregated because of their similarity and common control) are subject to a second aggregation rule. Under this rule undertakings that constitute an integrated business and are controlled by the same interests must be treated as part of the same activity. (See paragraph (g) of this section.)

(iii) *Aggregation of professional service undertakings.* Professional service undertakings are nonrental undertakings that predominantly involve the provision of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting (see paragraph (h)(1)(ii) of this section). In general, professional service undertakings that are either similar, related, or controlled by the same interests must be treated as part of the same activity (see paragraph (h)(2) of this section). The rules for determining whether trade or business undertakings are controlled by the same interests also apply with respect to professional service undertakings. Professional service undertakings are similar, however, if more than 20 percent (by value) of their operations are in the same field, and two professional service undertakings are related if one of the undertakings derives more than 20 percent of its gross income from persons who are customers of the other undertaking (see paragraph (h)(3) of this section).

(iv) *Rules for rental real estate*—(A) *Taxpayers permitted to determine rental real estate activities.* The rules for aggregating rental real estate undertakings are generally elective. They permit taxpayers to treat any combination of rental real estate undertakings as a single activity. Taxpayers may also divide their rental real estate undertakings and then treat portions of the undertakings as separate activities or recombine the portions into activities that include parts of different undertakings. (See paragraph (k)(2)(i) and (iii) of this section.)

(B) *Limitations on fragmentation and aggregation of rental real estate.* Taxpayers may not fragment their rental real estate in a manner that is inconsistent with their treatment of such property in prior taxable years or with the treatment of such property by the passthrough entity through which it is held (see paragraph (k)(2)(ii) and (3) of this section). There are no comparable limitations on the aggregation of rental real estate into a single activity. If, however, the income or gain from a rental real estate undertaking is subject to recharacterization under §1.469-2T(f)(3) (relating to the rental of nondepreciable property), a coordination rule provides that the undertaking must be treated as a separate activity (see paragraph (k)(6) of this section).

(v) *Election to treat nonrental undertakings as separate activities.* Another elective rule permits taxpayers to treat a nonrental undertaking as a separate activity even if the undertaking would be treated as part of a larger activity under the aggregation rules applicable to the undertaking (see paragraph (o)(2) of this section). This elective rule is limited by consistency requirements similar to those that apply to rental real estate operations (see paragraph (o)(3) and (4) of this section). Moreover, in cases in which a taxpayer elects to treat a nonrental undertaking as a separate activity, the taxpayer's level of participation (*i.e.*, material, significant, or otherwise) in the separate activity is the same as the taxpayer's level of participation in the larger activity in which the undertaking would be included but for the election (see paragraph (o)(6) of this section).

(5) *Special rules*—(i) *Consolidated groups and publicly traded partnerships.* Special rules apply to the business and rental operations of consolidated groups of corporations and publicly traded partnerships. Under these rules, a consolidated group is treated as one taxpayer in determining its activities and those of its members (see paragraph (m) of this sec-

tion), and business and rental operations owned through a publicly traded partnership cannot be aggregated with operations that are not owned through the partnership (see paragraph (n) of this section).

(ii) *Transitional rule.* A special rule applies for taxable years ending before August 10, 1989. In those years, taxpayers may organize business and rental operations into activities under any reasonable method (see paragraph (p)(1) of this section). A taxpayer will also be permitted to use any reasonable method to allocate disallowed deductions and credits among activities for the first taxable year in which the taxpayer's activities are determined under the general rules of §1.469-4T (see paragraph (p)(3) of this section).

(b) *General rule and definitions of general application*—(1) *General rule.* Except as otherwise provided in this section, each undertaking in which a taxpayer owns an interest shall be treated as a separate activity of the taxpayer. See paragraphs (f), (g), and (h) of this section for rules requiring certain nonrental undertakings to be treated as part of the same activity and paragraph (k) of this section for rules identifying the rental real estate undertakings (or portions thereof) that are included in an activity.

(2) *Definitions of general application.* The following definitions set forth the meaning of certain terms for purposes of this section:

(i) *Passthrough entity.* The term "passthrough entity" means a partnership, S corporation, estate, or trust.

(ii) *Business and rental operations*—(A) *In general.* Except as provided in paragraph (b)(2)(ii)(B) of this section, the term "business and rental operations" means all endeavors that are engaged in for profit or the production of income and satisfy one or more of the following conditions for the taxable year:

(*1*) Such endeavors involve the conduct of a trade or business (within the meaning of section 162) or are conducted in anticipation of such endeavors becoming a trade or business;

(*2*) Such endeavors involve making tangible property available for use by customers; or

(*3*) Research or experimental expenditures paid or incurred with respect to such endeavors are deductible under section 174 (or would be deductible if the taxpayer adopted the method described in section 174(a)).

(B) *Operations conducted through nonpassthrough entities.* For purposes of applying section 469 and the regulations thereunder, a taxpayer's activities do not include operations that the taxpayer conducts through one or more entities (other than passthrough entities). The following example illustrates the operation of this paragraph (b)(2)(ii)(B):

Example. (i) A, an individual, owns stock of X, a closely held corporation (within the meaning of §1.469-1T(g)(2)(ii)) that is directly engaged in the conduct of a real estate development business. A participates in X's real estate development business, but does not own any interest in the business other than through ownership of the stock of X.

(ii) X is subject to section 469 (see §1.469-1T-((b)(5)) and does not hold the real estate development business through another entity. Accordingly, for purposes of section 469 and the regulations thereunder, the operations of X's real estate development business are treated as part of X's activities.

(iii) A is also subject to section 469 (see §1.469-1T(b)(1)), but A's only interest in the real estate development business is held through X. X is a C corporation and therefore is not a passthrough entity. Thus, for purposes of section 469 and the regulations thereunder, A's activities do not include the operations of X's real estate development business. Accordingly, A's participation in X's business is not participation in an activity of A, and is not taken into account in determining whether A materially participates (within the meaning of §1.469-5T) or significantly participates (within the meaning of §1.469-5T(c)(2)) in any activity. (See, however, §1.469-1T(g)(3) for rules under which a shareholder's participation is taken into account for purposes of determining whether a corporation materially or significantly participates in an activity.)

(c) *Undertaking*—(1) *In general.* Except as otherwise provided in paragraphs (d), (e), and (k)(2)(iii) of this section, business and rental operations that constitute a separate source of income production shall be treated as a single undertaking that is separate from other undertakings.

(2) *Operations treated as a separate source of income production*—(i) *In general.* Except as otherwise provided in this paragraph (c)(2), business and rental operations shall be treated for purposes of this paragraph (c) as a separate source of income production if and only if—

(A) Such operations are conducted at the same location (within the meaning of paragraph (c)(2)(iii) of this section) and are owned by the same person (within the meaning of paragraph (c)(2)(v) of this section); and

(B) Income-producing operations (within the meaning of paragraph (c)(2)(iv) of this section) owned by such person are conducted at such location.

(ii) *Treatment of support operations*—(A) *In general.* For purposes of section 469 and the regulations thereunder—

(*1*) The support operations conducted at a location shall not be treated as part of an undertaking under paragraph (c)(2)(i) of this section; and

(*2*) The income and expenses that are attributable to such operations and are reasonably allocable to an undertaking conducted at a different location shall be taken into account in determining the income or loss from the activity or activities that include such undertaking.

(B) *Support operations.* For purposes of this paragraph (c)(2), the business and rental operations conducted at a location are treated as support operations to the extent that—

(*1*) Such operations and an undertaking that is conducted at a different location are owned by the same person (within the meaning of paragraph (c)(2)(v) of this section);

(*2*) Such operations involve the provision of property or services to such undertaking; and

(*3*) Such operations are not income-producing operations (within the meaning of paragraph (c)(2)(iv) of this section).

(iii) *Location.* For purposes of this paragraph (c)(2)—

(A) The term "location" means, with respect to any business and rental operations, a fixed place of business at which such operations are regularly conducted;

(B) Business and rental operations are conducted at the same location if they are conducted in the same physical structure or within close proximity of one another;

(C) Business and rental operations that are not conducted at a fixed place of business or that are conducted on the customer's premises shall be treated as operations that are conducted at the location (other than the customer's premises) with which they are most closely associated;

(D) All the facts and circumstances (including, in particular, the factors listed in paragraph (c)(3) of this section) are taken into account in determining the location with which business and rental operations are most closely associated; and

(E) Oil and gas operations that are conducted for the development of a common reservoir are conducted within close proximity of one another.

(iv) *Income-producing operations.* For purposes of this paragraph (c)(2), the term "income-producing operations" means business and rental operations that are conducted at a location and relate to (or are conducted in reasonable anticipation of)—

(A) The production of property at such location;

(B) The sale of property to customers at such location;

(C) The performance of services for customers at such location;

(D) Transactions in which customers take physical possession at such location of property that is made available for their use; or

(E) Any other transactions that involve the presence of customers at such location.

(v) *Ownership by the same person.* For purposes of this paragraph (c)(2), business and rental operations are owned by the same person if and only if one person (within the meaning of section 7701(a)(1)) is the direct owner of such operations.

(3) *Facts and circumstances determinations.* In determining whether a location is the location with which business and rental operations are most closely associated for purposes of paragraph (c)(2)(iii)(D) of this section, the following relationships between operations that are conducted at such location and other operations are generally the most significant:

(i) The extent to which other persons conduct similar operations at one location;

(ii) Whether such operations are treated as a unit in the primary accounting records reflecting the results of such operations;

(iii) The extent to which other persons treat similar operations as a unit in the primary accounting records reflecting the results of such similar operations;

(iv) The extent to which such operations involve products or services that are commonly provided together;

(v) The extent to which such operations serve the same customers;

(vi) The extent to which the same personnel, facilities, or equipment are used to conduct such operations;

(vii) The extent to which such operations are conducted in coordination with or reliance upon each other;

(viii) The extent to which the conduct of any such operations is incidental to the conduct of the remainder of such operations;

(ix) The extent to which such operations depend on each other for their economic success; and

(x) Whether such operations are conducted under the same trade name.

(4) *Examples.* The following examples illustrate the application of this paragraph (c). In each example that does not state otherwise, the taxpayer is an individual and the facts, analysis, and conclusion relate to a single taxable year.

Example (1). The taxpayer is the sole owner of a department store and a restaurant and conducts both businesses in the same building. Thus, the department store and restaurant operations are conducted at the same location (within the meaning of paragraph (c)(2)(iii) of this section) and are owned by the same person (*i.e.*, the taxpayer is the direct owner of the operations). In addition, the taxpayer conducts income-producing operations (within the meaning of paragraph (c)(2)(iv) of this section) at the location (*i.e.*, property is sold to customers and services are performed for customers on the premises of the department store). Accordingly, the department store and restaurant operations are treated as a separate source of income production (see paragraph (c)(2) of this section) and as a single undertaking that is separate from other undertakings (see paragraph (c)(1) of this section).

Example (2). (i) The facts are the same as in example (1), except that the taxpayer is also the sole owner of an automotive center that services automobiles and sells tires, batteries, motor oil, and accessories. The taxpayer operates the automotive center in a separate structure in the shopping mall in which the department store is located. Although the automotive center operations and the department store and restaurant operations are not conducted in the same physical structure, they are conducted within close proximity (within the meaning of paragraph (c)(2)(iii)(B) of this section) of one another. Thus, the department store, restaurant, and automotive center operations are conducted at the same location (within the meaning of paragraph (c)(2)(iii) of this section).

(ii) As in example (1), the operations conducted at the same location are owned by the same person, and the taxpayer conducts income-producing operations (within the meaning of paragraph (c)(2)(iv) of this section) at the location. Accordingly, the department store, restaurant, and automotive center operations are treated as a separate source of income production (see paragraph (c)(2) of this section) and as a single undertaking that is separate from other undertakings (see paragraph (c)(1) of this section).

Example (3). (i) The facts are the same as in example (2), except that the automotive center is located several blocks from the shopping mall. As in example (1), the department store and restaurant operations are treated as a single undertaking that is separate from other undertakings. Because, however, the automotive center operations are not conducted within close proximity (within the meaning of paragraph (c)(2)(iii)(B) of this section) of the department store and restaurant operations, all of the taxpayer's operations are not conducted at the same location (within the meaning of paragraph (c)(2)(iii) of this section).

(ii) All of the automotive center operations are conducted at the same location (within the meaning of paragraph (c)(2)(iii) of this section) and are owned by the same person (*i.e.*, the taxpayer is the direct owner of the operations). In addition, the taxpayer conducts income-producing operations (within the meaning of paragraph (c)(2)(iv) of this section) at the location (*i.e.*, property is sold to customers and services are performed for customers on the premises of the automotive center). Accordingly, the automotive center operations are also treated as a separate source of income production (see paragraph (c)(2) of this section) and as a single undertaking that is separate from other undertakings (see paragraph (c)(1) of this section). See, however, paragraph (g) of this section for rules under which certain trade or business activities are treated as a single activity.

Example (4). The taxpayer is the sole owner of a building and rents residential, office, and retail space in the building to various tenants. The taxpayer manages these rental operations from an office located in the building. The rental operations are conducted at the same location (within the meaning of paragraph (c)(2)(iii) of this section) and are owned by the same person (*i.e.*, the taxpayer is the direct owner of the operations). In addition, the taxpayer conducts income-producing operations (within the meaning of paragraph (c)(2)(iv) of this section) at the location (*i.e.*, customers take physical possession in the building of property made available for their use). Accordingly, the rental operations are treated as a separate source of income production (see paragraph (c)(2) of this section) and as a single undertaking that is separate from other undertakings (see paragraph (c)(1) of this section). See paragraph (d) of this section for rules for determining whether this undertaking is a rental undertaking and paragraph (k) of this section for rules for identifying rental real estate activities.

Example (5). (i) The facts are the same as in example (4), except that the taxpayer also uses the rental office in the building ("Building #1") to manage rental operations in another building ("Building #2") that the taxpayer owns. The rental operations conducted in Building #2 are treated as a separate source of income production under paragraph (c)(2) of this section and as a single undertaking that is separate from other undertakings (the "Building #2 undertaking") under paragraph (c)(1) of this section.

(ii) The operations conducted at the rental office in Building #1 and the Building #2 undertaking are owned by the same person (*i.e.*, the taxpayer is the direct owner of the operations). In addition, the operations conducted at the rental office with respect to the Building #2 undertaking relate to transactions in which customers take physical possession at another location of property that is made available for their use (*i.e.*, the operations are not income-producing operations (within the meaning of paragraph (c)(2)(iv) of this section)). Thus, to the extent the operations conducted at the rental office involve the management of the Building #2 undertaking, they are support operations (within the meaning of paragraph (c)(2)(ii)(B) of this section) with respect to the Building #2 undertaking.

(iii) Paragraph (c)(2)(ii)(A)(*1*) of this section provides that support operations are not treated as part of an undertaking under paragraph (c)(2)(i) of this section. Therefore, the support operations conducted at the rental office are not treated as part of the undertaking that consists of the rental operations conducted in Building #1 (the "Building #1 undertaking"). Paragraph (c)(2)(ii)(A)(*2*) of this section provides that the income and expenses that are attributable to support operations and are reasonably allocable to an undertaking conducted at a different location shall be taken into account in determining the income or loss from the activity that includes such undertaking. Accordingly, the income and expenses of the rental office that are reasonably allocable to the Building #2 undertaking are taken into account in determining the income or loss from the activity or activities that include the Building #2 undertaking. See paragraph (k) of this section for rules for identifying rental real estate activities.

(iv) Rental office operations that involve the management of rental operations conducted in

Building #1 are not support operations (within the meaning of paragraph (c)(2)(ii)(B) of this section) because they relate to an undertaking that is conducted at the same location (the "Building #1 undertaking"). Thus, the rules for support operations in paragraph (c)(2)(ii)(A) of this section do not apply to such operations, and they are treated as part of the Building #1 undertaking.

Example (6). (i) The taxpayer conducts business and rental operations at eleven different locations (within the meaning of paragraph (c)(2)(iii) of this section). At ten of the locations the taxpayer owns grocery stores, and at the eleventh location the taxpayer owns a warehouse that receives goods and supplies them to the taxpayer's stores. The operations of each store are conducted at the same location (within the meaning of paragraph (c)(2)(iii) of this section) and are owned by the same person (*i.e.*, the taxpayer is the direct owner of the operations). In addition, the taxpayer conducts income-producing operations (within the meaning of paragraph (c)(2)(iv) of this section) at each location (*i.e.*, property is sold to customers on the store premises, and customers take physical possession on the store premises of property made available for their use). Accordingly, the operations of each of the ten grocery stores are treated as a separate source of income production (see paragraph (c)(2) of this section), and each store is treated as a single undertaking (a "grocery store undertaking") that is separate from other undertakings (see paragraph (c)(1) of this section). The operations conducted at the warehouse, however, do not include any income-producing operations (within the meaning of paragraph (c)(2)(iv) of this section). Accordingly, the warehouse operations do not satisfy the requirements of paragraph (c)(2)(i) of this section and are not treated as a separate undertaking under paragraph (c)(1) of this section.

(ii) The warehouse operations and the grocery store undertakings are owned by the same person (*i.e.*, the taxpayer is the direct owner of the operations), the operations conducted at the warehouse involve the provision of property to the grocery store undertakings, and the warehouse operations are not income-producing operations (within the meaning of paragraph (c)(2)(iv) of this section). Thus, the warehouse operations are support operations (within the meaning of paragraph (c)(2)(ii)(B) of this section) with respect to the grocery store undertakings. Paragraph (c)(2)(ii)(A)(*2*) of this section provides that the income and expenses that are attributable to support operations and are reasonably allocable to an undertaking conducted at a different location shall be taken into account in determining the income or loss from the activity or activities that include such undertaking. Accordingly, the income and expenses of the warehouse operations that are reasonably allocable to a grocery store undertaking are taken into account in determining the income or loss from the activity or activities that include such undertaking. See paragraph (f) of this section for rules under which certain similar, commonly-controlled undertakings are treated as a single activity.

Example (7). (i) The facts are the same as in example (6), except that the warehouse operations also include the sale of goods to grocery stores that the taxpayer does not own ("other grocery stores"). Because of these sales, the taxpayer conducts income-producing operations (within the meaning of paragraph (c)(2)(iv) of this section) at the warehouse. The warehouse operations are conducted at the same location (within the meaning of paragraph (c)(2)(iii) of this section) and are owned by the same person (*i.e.*, the taxpayer is the direct owner of the operations). Accordingly, prior to the application of the rules for support operations in paragraph (c)(2)(ii) of this section, the warehouse operations are treated as a separate source of income production (see paragraph (c)(2) of this section) and as a single undertaking (the "separate warehouse undertaking") that is separate from other undertakings (see paragraph (c)(1) of this section).

(ii) As in example (6), the warehouse operations that involve supplying goods to the taxpayer's grocery store undertakings are support operations with respect to those undertakings. Therefore, those operations are not treated as part of the separate warehouse undertaking (see paragraph (c)(2)(ii)(A)-(*1*) of this section), and the income and expenses of such operations are taken into account, as in example (6), in determining the income or loss from the activity or activities that include the taxpayer's grocery store undertakings.

Example (8). (i) A partnership is formed to acquire real property and construct a building on the property. The partnership hires brokers to locate a suitable parcel of land, lawyers to negotiate zoning variances, easements, and building permits, and architects and engineers to design the improvements. After the architects and engineers have designed the improvements and other preliminaries have been completed, the partnership hires a general contractor who hires subcontractors and oversees construction. During the construction process and after construction has been completed, the partnership leases out space in the building. The partnership then operates the building as a rental property. The operations of acquiring the real property, negotiating contracts, overseeing the designing and construction of the improvements, leasing up the building, and operating the building are conducted at an office (the "management office") that is not at the same location (within the meaning of paragraph (c)(2)(iii) of this section) as the building.

(ii) The operations conducted at the building site (*e.g.*, excavating the land, pouring the concrete for the foundation, erecting the frame of the building, completing the exterior of the building, and building out the interior of the building) are conducted at the same location (within the meaning of paragraph (c)(2)(iii) of this section) and are owned by the same person (*i.e.*, the partnership is the direct owner of the operations). In addition, the partnership conducts income-producing operations (within the meaning of paragraph (c)(2)(iv) of this section) at the location (*i.e.*, during the construction period property (the building) is produced at the building site, and during the rental period customers take physical possession in the building of property made available for their use). Accordingly, the operations conducted at the building site are treated as a separate source of income production (see paragraph (c)(2) of this section) and as a single undertaking that is separate from other undertakings (see paragraph (c)(1) of this section).

(iii) The operations conducted at the management office and the undertaking conducted at the building site are owned by the same person (*i.e.*, the partnership is the direct owner of the operations). In addition, the operations conducted at the management office relate to transactions in which customers take physical possession at another location of property that is made available for their use (*i.e.*, the operations are not income-producing operations (within the meaning of paragraph (c)(2)-(iv) of this section)). Thus, to the extent the operations conducted at the management office involve the provision of services to the undertaking conducted at the building site, they are support operations (within the meaning of paragraph (c)(2)(ii)(B) of this section) with respect to such undertaking.

(iv) Paragraph (c)(2)(ii)(A)(*2*) of this section provides that the income and expenses of support operations that are reasonably allocable to an undertaking conducted at a different location shall be taken into account in determining the income or loss from the activity that includes such undertaking. Accordingly, the income and expenses of the management office that are reasonably allocable to the undertaking conducted at the building site are taken into account in determining the income or loss from the activity or activities that include such undertaking.

(v) Until the building is first held out for rent and is in a state of readiness for rental, the undertaking conducted at the building site is a trade or business undertaking (within the meaning of paragraph (f)(1)(ii) of this section). See paragraph (d) of this section for rules for determining whether the undertaking is a rental undertaking for periods after the building is first held out for rent and is in a state of readiness for rental and paragraph (k) of this section for rules for identifying rental real estate activities.

Example (9). The taxpayer owns 15 oil wells pursuant to a single working interest (within the meaning of §1.469-1T(e)(4)(iv)). All of the wells are drilled and operated for the development of a common reservoir. Thus, all of the wells are at the same location (see paragraph (c)(2)(iii)(E) of this section). All of the wells are owned by the same person (*i.e.*, the taxpayer is the direct owner of the operations), and the taxpayer conducts income-producing operations (within the meaning of paragraph (c)(2)(iv) of this section) at the location (*i.e.*, oil wells are drilled in reasonable anticipation of producing oil at the location). Accordingly, the operations of the wells are treated as a separate source of income production (see paragraph (c)(2) of this section) and as a single undertaking that is separate from other undertakings (see paragraph (c)(1) of this section). See paragraph (e) of this section for rules under which certain oil and gas operations are treated as multiple undertakings even if they would be part of the same undertaking under the rules of this paragraph (c).

Example (10). (i) Partnership X owns an automobile dealership and partnership Y owns an automobile repair shop. The dealership and repair shop operations are conducted in the same physical structure. Individuals A, B, and C are the only partners in partnerships X and Y, and each of the partners owns a one-third interest in both partnerships.

(ii) The dealership operations and the repair-shop operations are conducted at the same location (within the meaning of paragraph (c)(2)(iii) of this section), but are owned by different persons (*i.e.*, X is the direct owner of the dealership operations, and Y is the direct owner of the repair-shop operations). Moreover, indirect ownership of the operations is not taken into account under paragraph (c)-(2)(v) of this section. Thus, it is irrelevant that the two partnerships are owned by the same persons in identical proportions. Accordingly, the dealership and repair-shop operations are not treated as part of the same source of income production (see paragraph (c)(2) of this section) or as a single undertaking that is separate from other undertakings (see paragraph (c)(1) of this section). See, however, paragraph (g) of this section for rules under which certain trade or business activities are treated as a single activity.

Example (11). (i) The taxpayer owns and operates a delivery service. The business consists of a central office, retail establishments, and messengers who transport packages from one place to another. Customers may bring their packages to a retail establishment for delivery elsewhere or, by calling the central office, may have packages picked up at their homes or offices. The central office dispatches messengers and coordinates all pickups and deliveries. Customers may pay for deliveries when they drop off or pick up packages at a retail establishment, or the central office will bill the customer for services rendered. In addition, many packages are routed through the central office.

(ii) The operations conducted at the central office are conducted at the same location (within the meaning of paragraph (c)(2)(iii) of this section) and are owned by the same person (*i.e.*, the taxpayer is the direct owner of the operations). The operations actually conducted at the central office, however, do not include any income-producing operations (within the meaning of paragraph (c)(2)(iv) of this section).

(iii) Under paragraph (c)(2)(iii)(C) and (D) of this section, business and rental operations that are not conducted at a fixed place of business or that are conducted on the customer's premises are treated as operations that are conducted at the location (other than the customer's premises) with which they are most closely associated, and all the facts and circumstances are taken into account in determining the location with which business and rental operations are most closely associated. The facts and circumstances in this case (including the facts that the central office dispatches messengers, coordinates all pickups and deliveries, and is the transshipment point for many packages) establish that the operations of delivering packages from one location to another are most closely associated with the central office. Thus, the delivery operations are treated as operations that are conducted at the central office, and the deliveries are treated as income-producing operations (*i.e.*, the performance of services for customers) that the taxpayer conducts at the central office. Accordingly, the operations conducted at the central office are treated as a separate source of income production (see paragraph (c)(2) of this section) and as a single undertaking that is separate from other undertakings (see paragraph (c)(1) of this section).

(iv) The operations conducted at each retail establishment are conducted at the same location (within the meaning of paragraph (c)(2)(iii) of this section) and are owned by the same person (*i.e.*, the taxpayer is the direct owner of the operations). At each retail establishment, the taxpayer's operations include transactions that involve the presence of customers at the establishment. Thus, the taxpayer conducts income-producing operations (within the meaning of paragraph (c)(2)(iv)(E) of this section) at the retail establishments. Accordingly, the operations of each retail establishment are treated as a separate source of income production (see paragraph (c)(2) of this section) and as a single undertaking that is separate from other undertakings (see paragraph (c)(1) of this section). See, however, paragraph (f) of this section for rules under which certain similar, commonly-controlled undertakings are treated as a single activity.

Example (12). (i) The taxpayer is the sole owner of a saw mill and a lumber yard. The taxpayer's business operations consist of converting timber into lumber and other wood products and selling the resulting products. The timber is processed at the saw mill, and the resulting products are transported to the lumber yard where they are sold. The saw mill and the lumber yard are at different locations (within the meaning of paragraph (c)(2)(iii) of this section). The transportation operations are managed at the saw mill.

(ii) The operations conducted at the saw mill are conducted at the same location (within the meaning of paragraph (c)(2)(iii) of this section) and are owned by the same person (*i.e.*, the taxpayer is the direct owner of the operations). In addition, the taxpayer conducts income-producing operations (within the meaning of paragraph (c)(2)(iv) of this section) at the location (*i.e.*, lumber is produced at the mill). Similarly, the selling operations at the lumber yard are conducted at the same location (within the meaning of paragraph (c)(2)(iii) of this section) and are owned by the same person (*i.e.*, the taxpayer is the direct owner of the operations). In addition, the taxpayer conducts income-producing operations (within the meaning of paragraph (c)(2)(iv) of this section) at the location (*i.e.*, lumber is sold to customers at the lumber yard). Thus, the milling operations and the selling operations are treated as separate sources of income production (see paragraph (c)(2) of this section) and as separate undertakings (see paragraph (c)(1) of this section).

(iii) The operations conducted at the mill involve the provision of property to the lumber-yard undertaking. Nonetheless, the milling operations are income-producing operations because they relate to the production of property at the mill, and an undertaking's income-producing operations are not treated as support operations (see paragraph (c)(2)(ii)(B)(*3*) of this section). Accordingly, the milling operations are not support operations with respect to the lumber-yard undertaking. See, however, paragraph (f) of this section for rules under which certain vertically-integrated undertakings are treated as part of the same activity.

(iv) The operations of transporting finished products from the saw mill to the lumber yard are not conducted at a fixed location. Under paragraph (c)(2)(iii)(C) and (D) of this section, business and rental operations that are not conducted at a fixed place of business or that are conducted on the customer's premises are treated as operations that are conducted at the location (other than the customer's premises) with which they are most closely associated, and all the facts and circumstances are taken into account in determining the location with which business and rental operations are most closely associated. The facts and circumstances in this case (including the fact that the transportation operations are managed at the saw mill) establish that the transportation operations are most closely associated with the saw mill. Thus, the transportation operations are treated as operations that are conducted at the mill and as part of the undertaking that consists of the milling operations.

(d) *Rental undertaking*—(1) *In general.* This paragraph (d) applies to operations that are treated, under paragraph (c) of this section and before the application of paragraph (d)(1)(i) of this section, as a single undertaking that is separate from other undertakings (a "paragraph (c) undertaking"). For purposes of this section—

(i) A paragraph (c) undertaking's rental operations and its operations other than rental operations shall be treated, except as otherwise provided in paragraph (d)(2) of this section, as two separate undertakings;

(ii) The income and expenses that are reasonably allocable to an undertaking (determined after the application of paragraph (d)(1)(i) of this section) shall be taken into account in determining the income or loss from the activity or activities that include such undertaking; and

(iii) An undertaking (determined after the application of paragraph (d)(1)(i) of this section) shall be treated as a rental undertaking if and only if such undertaking, considered as a separate activity, would constitute a rental activity (within the meaning of §1.469-1T(e)(3)).

(2) *Exceptions.* Paragraph (d)(1)(i) of this section shall not apply to a paragraph (c) undertaking for any taxable year in which—

(i) The rental operations of the paragraph (c) undertaking, considered as a separate activity, would not constitute a rental activity (within the meaning of §1.469-1T(e)(3));

(ii) Less than 20 percent of the gross income of the paragraph (c) undertaking is attributable to rental operations; or

(iii) Less than 20 percent of the gross income of the paragraph (c) undertaking is attributable to operations other than rental operations.

(3) *Rental operations.* For purposes of this paragraph (d), a paragraph (c) undertaking's rental operations are determined under the following rules:

(i) *General rule.* Except as otherwise provided in paragraph (d)(3)(ii) or (iii) of this section, a paragraph (c) undertaking's rental operations are all of the undertaking's business and rental operations that involve making tangible property available for use by customers and the provision of property and services in connection therewith.

(ii) *Real property provided for short-term use.* A paragraph (c) undertaking's operations that involve making short-term real property available for use by customers and the provision of property and services in connection therewith shall not be treated as rental operations if such operations, considered as a separate activity, would not constitute a rental activity. An item of property is treated as short-term real property for this purpose if and only if such item is real property that the paragraph (c) undertaking makes available for use by customers and the average period of customer use (within the meaning of §1.469-1T(e)(3)(iii)) for all of the paragraph (c) undertaking's real property of the same type as such item is 30 days or less.

(iii) *Property made available to licensees.* A paragraph (c) undertaking's operations that involve making tangible property available during defined business hours for nonexclusive use by various customers shall not be treated as rental operations. (See §1.469-1T(e)(3)-(ii)(E).)

(4) *Examples.* The following examples illustrate the application of this paragraph (d). In each example that does not state otherwise, the taxpayer is an individual and the facts, analysis, and conclusions relate to a single taxable year.

Example (1). (i) The taxpayer owns a building in which the taxpayer rents office space to tenants and operates a parking garage that is used by tenants and other persons. (Assume that, under paragraph (c)(1) of this section, the operations conducted in the building are treated as a single paragraph (c) undertaking.) The taxpayer's tenants typically occupy an office for at least one year, and the services provided to tenants are those customarily provided in office buildings. Some persons (including tenants) rent spaces in the parking garage on a monthly or annual basis. In general, however, spaces are rented on an hourly or daily basis, and the average period for which all customers (including tenants) use the parking garage is less than 24 hours. The paragraph (c) undertaking derives 75 percent of its gross income from office-space rentals and 25 percent of its gross income from the parking garage. The operations conducted in the building are not incidental to any other activity of the taxpayer (within the meaning of §1.469-1T(e)-(3)(vi)).

(ii) The parking spaces are real property and the average period of customer use (within the meaning of §1.469-1T(e)(3)(iii)) for the parking spaces is 30 days or less. Thus, the parking spaces are short-term real properties (within the meaning of paragraph (d)(3)(ii) of this section). (For this purpose, individual parking spaces that are rented on a monthly or annual basis are, nevertheless, short-term real properties because all the parking spaces are property of the same type, and the average rental period taking all parking spaces into account is 30 days or less.) In addition, the parking-garage operations involve making short-term real properties available for use by customers and the provision of property and services in connection therewith.

(iii) Paragraph (d)(3)(i) and (ii) of this section provides, in effect, that a paragraph (c) undertaking's operations that involve making short-term real properties available for use by customers and the provision of property and services in connection therewith are treated as rental operations if and only if the operations, considered as a separate activity, would constitute a rental activity (within the meaning of §1.469-1T(e)(3)). In this case, the parking-garage operations, if considered as a separate activity, would not constitute a rental activity because the average period of customer use for the parking spaces is seven days or less (see §1.469-1T(e)(3)(ii)(A)). Accordingly, the parking-garage operations are not treated as rental operations.

(iv) The paragraph (c) undertaking's remaining operations involve the provision of tangible property (the office spaces) for use by customers and the provision of property and services in connection therewith. The average period of customer use for the office spaces exceeds 30 days. Thus, the office spaces are not short-term real properties, and the undertaking's operations involving the rental of office spaces are rental operations.

(v) Paragraph (d)(1)(i) of this section provides, with certain exceptions, that a paragraph (c) undertaking's rental operations and its operations other than rental operations are treated as two separate undertakings. In this case, at least 20 percent of the paragraph (c) undertaking's gross income is attributable to rental operations (the office-space operations) and at least 20 percent is attributable to operations other than rental operations (the parking-garage operations). Thus, the exceptions in paragraph (d)(2)(ii) and (iii) of this section do not apply. In addition, the average period of customer use for the office spaces exceeds 30 days, extraordinary personal services (within the meaning of §1.469-1T(e)(3)(v)) are not provided, and the rental of the office spaces is not treated as incidental to a nonrental activity under §1.469-1T(e)(3)(vi) (relating to incidental rentals that are not treated as a rental activity). Thus, the rental operations, if considered as a separate activity, would constitute a rental activity, and the exception in paragraph (d)-(2)(i) of this section does not apply. Accordingly, the rental operations and the parking-garage operations are treated as two separate undertakings (the "office-space undertaking" and the "parking-garage undertaking").

(vi) Paragraph (d)(1)(iii) of this section provides that an undertaking (determined after the application of paragraph (d)(1)(i) of this section) is treated as a rental undertaking if and only if the undertaking, considered as a separate activity, would constitute a rental activity. In this case, the office-space undertaking, if considered as a separate activity, would constitute a rental activity (see (v) above), and the parking-garage undertaking, if considered as a separate activity, would not constitute a rental activity (see (iii) above). Accordingly, the office-space undertaking is treated as a rental undertaking, and the parking-garage undertaking is not.

Example (2). (i) The taxpayer owns a building in which the taxpayer rents apartments to tenants and operates a restaurant. (Assume that, under paragraph (c)(1) of this section, the operations conducted in the building are treated as a single paragraph (c) undertaking.) The taxpayer's tenants typically occupy an apartment for at least one year, and the services provided to tenants are those customarily provided in residential apartment buildings. The paragraph (c) undertaking derives 85 percent of its gross income from apartment rentals and 15 percent of its gross income from the restaurant. The operations conducted in the building are not incidental to any other activity of the taxpayer (within the meaning of §1.469-1T(e)(3)(vi)).

(ii) The operations with respect to apartments (the "apartment operations") involve the provision of tangible property (the apartments) for use by customers and the provision of property and services in connection therewith. In addition, the apartments are not short-term real properties (within the meaning of paragraph (d)(3)(ii) of this section) because the average period of customer use (within the meaning of §1.469-1T(e)(3)(iii)) for the apartments exceeds 30 days. Accordingly, the apartment operations are rental operations (within the meaning of paragraph (d)(3) of this section). The restaurant operations do not involve the provision of tangible property for use by customers or the provision of property or services in connection therewith. Thus, the restaurant operations are not rental operations.

(iii) Paragraph (d)(1)(i) of this section provides, with certain exceptions, that a paragraph (c) undertaking's rental operations and its operations other than rental operations are treated as two separate undertakings. In this case, however, the exception in paragraph (d)(2)(iii) of this section applies because less than 20 percent of the paragraph (c) undertaking's gross income is attributable to operations other than rental operations (the restaurant operations). Accordingly, the rental operations and the restaurant operations are not treated as two separate undertakings under paragraph (d)(1)(i) of this section.

(iv) Paragraph (d)(1)(iii) of this section provides that an undertaking (determined after the application of paragraph (d)(1)(i) of this section) is treated as a rental undertaking if and only if the undertaking, considered as a separate activity, would constitute a rental activity. In this case, the undertaking (determined after the application of paragraph (d)(1)(i) of this section) includes both the apartment operations and the restaurant operations, and the gross income of this undertaking represents amounts paid principally for the use of tangible property (the apartments). Moreover, the average period of customer use for the apartments exceeds 30 days, extraordinary personal services (within the meaning of §1.469-1T(e)(3)(v)) are not provided, and the rental of the apartments is not treated as incidental to a nonrental activity under §1.469-1T-(e)(3)(vi) (relating to incidental rentals that are not treated as a rental activity). Thus, the undertaking, if considered as a separate activity, would constitute a rental activity. Accordingly, the undertaking is treated as a rental undertaking.

Example (3). (i) The taxpayer owns a building in which the taxpayer rents hotel rooms, meeting rooms, and parking spaces to customers, rents space to various retailers, and operates a restaurant and health club. (Assume that, under paragraph (c)-(1) of this section, the operations conducted in the building are treated as a single paragraph (c) undertaking.) Although some customers occupy hotel rooms for extended periods (including some customers who reside in the hotel), customers use hotel rooms for an average period of two days and meeting rooms for an average period of one day. The services provided to persons using the hotel rooms and meeting rooms are those customarily provided in hotels (including wake-up calls, valet services, and delivery of food and beverages to rooms). Some customers rent spaces in the parking garage on a monthly or annual basis. In general, however, parking spaces are rented on an hourly or daily basis, and the average period for which customers use the parking garage is less than 24 hours. Retail tenants typically occupy their space for at least one year, and the services provided to retail tenants are those customarily provided in commercial buildings. The paragraph (c) undertaking derives 45 percent of its gross income from renting hotel rooms, meeting rooms, and parking spaces, 35 percent of its gross income from renting retail space, and 20 percent of its gross income from the restaurant and health club. The operations conducted in the building are not incidental to any other activity of the taxpayer (within the meaning of §1.469-1T(e)(3)(vi)).

(ii) The parking spaces, hotel rooms, and meeting rooms are real property of three different types, but the average period of customer use (within the meaning of §1.469-1T(e)(3)(iii)) for property of each type is 30 days or less. Thus, the parking spaces, hotel rooms, and meeting rooms are short-term real properties. (For this purpose, individual parking spaces or hotel rooms that are rented for extended periods are, nevertheless, short-term real properties if the average rental period for all parking spaces is 30 days or less and the average rental period for all hotel rooms is 30 days or less.) In addition, the parking garage operations, the operations with respect to hotel rooms (the "hotel-room operations"), and the operations with respect to meeting rooms (the "meeting-room operations") involve making short-term real properties available for use by customers and the provision of property and services in connection therewith.

(iii) Paragraph (d)(3)(i) and (ii) of this section provides, in effect, that a paragraph (c) undertaking's operations that involve making short-term real properties available for use by customers and the provision of property and services in connection therewith are treated as rental operations if and only if the operations, considered as a separate activity, would constitute a rental activity (within the meaning of §1.469-1T(e)(3)). In this case, the parking-garage, hotel-room and meeting-room operations, if considered as separate activities, would not constitute rental activities because the average period of customer use for parking spaces, hotel rooms, and meeting rooms does not exceed seven days (see §1.469-1T(e)(3)(ii)(A)). Accordingly, the parking-garage, hotel-room, and meeting-room operations are not treated as rental operations.

(iv) The operations with respect to retail space in the building (the "retail-space operations") involve the provision of tangible property (the retail spaces) for use by customers and the provision of property and services in connection therewith. In addition, the retail spaces are not short-term real properties (within the meaning of paragraph (d)(3)(ii) of this section) because the average period of customer use (within the meaning of §1.469-1T(e)(3)(iii)) for the retail spaces exceeds 30 days. Accordingly, the retail-space operations are rental operations.

(v) The health-club operations involve making tangible property available for use by customers, but the property is customarily made available during defined business hours for nonexclusive use by various customers. Accordingly, the health-club operations are not rental operations (see paragraph (d)(3)(iii) of this section). The restaurant operations do not involve the provision of tangible property for use by customers or the provision of property or services in connection therewith. Accordingly, the restaurant operations also are not rental operations.

(vi) Paragraph (d)(1)(i) of this section provides, with certain exceptions, that a paragraph (c) undertaking's rental operations and its operations other than rental operations are treated as two separate undertakings. In this case, at least 20 percent of the paragraph (c) undertaking's gross income is attributable to rental operations (35 percent of the paragraph (c) undertaking's gross income is from the retail-space operations) and at least 20 percent is attributable to operations other than rental operations (45 percent from the hotel-room, meeting-room and parking-garage operations and 20 percent from the restaurant and health-club operations). Thus, the exceptions in paragraph (d)(2)(ii) and (iii) of this section do not apply. In addition, the average period of customer use for the retail space exceeds 30 days, extraordinary personal services (within the meaning of §1.469-1T(e)(3)(v)) are not provided, and the rental of the retail space is not treated as incidental to a nonrental activity under §1.469-1T(e)(3)(vi) (relating to incidental rentals that are not treated as a rental activity). Thus, the retail-space operations, if considered as a separate activity, would constitute a rental activity, and the exception in paragraph (d)(2)(i) of this section does not apply. Accordingly, the retail-space operations are treated as an undertaking (the "retail-space undertaking") and all the other operations conducted in the building (*i.e.*, renting hotel and meeting rooms and parking spaces and operating the restaurant and health club) are treated as a separate undertaking (the "hotel undertaking").

(vii) Paragraph (d)(1)(iii) of this section provides that an undertaking (determined after the application of paragraph (d)(1)(i) of this section) is treated as a rental undertaking if and only if the undertaking, considered as a separate activity, would constitute a rental activity. In this case, the retail-space undertaking, if considered as a separate activity, would constitute a rental activity (see (iv) above). Accordingly, the retail-space undertaking is treated as a rental undertaking. The hotel undertaking, if considered as a separate activity, would not constitute a rental activity because all tangible property provided for the use of customers in the hotel undertaking is either property for which the average period of customer use is seven days or less (see §1.469-1T(e)(3)(ii)(A)) or property customarily made available during defined business hours for nonexclusive use by various customers (see §1.469-1T(e)(3)(ii)(E)). Accordingly, the hotel undertaking is not treated as a rental undertaking.

Example (4). (i) A law partnership owns a ten-story building. The partnership uses eight floors of the building in its law practice and leases two floors to one or more tenants. (Assume that, under paragraph (c)(1) of this section, the operations conducted in the building are treated as a single paragraph (c) undertaking.) Tenants typically occupy space on the two rented floors for at least one year, and the services provided to tenants are those customarily provided in office buildings. The paragraph (c) undertaking derives 90 percent of its gross income from rendering legal services and 10 percent of its gross income from renting space. The operations conducted in the building are not incidental to any other activity of the taxpayer (within the meaning of §1.469-1T(e)(3)(vi)).

(ii) The operations with respect to the office space leased to tenants (the "office-space operations") involve the provision of tangible property (the office space) for use by customers and the provision of property and services in connection therewith. In addition, the office spaces are not short-term real properties (within the meaning of paragraph (d)(3)(ii) of this section) because the average period of customer use (within the meaning of §1.469-1T(e)(3)(iii)) for the office space exceeds 30 days. Accordingly, the office-space operations are rental operations (within the meaning of paragraph (d)(3) of this section).

(iii) The operations that involve the performance of legal services (the "law-practice operations") do not involve the provision of tangible property for use by customers or the provision of property or services in connection therewith. Accordingly, the law-practice operations are not rental operations.

(iv) Paragraph (d)(1)(i) of this section provides, with certain exceptions, that a paragraph (c) undertaking's rental operations and its operations other than rental operations are treated as two separate undertakings. In this case, however, the exception in paragraph (d)(2)(ii) of this section applies because less than 20 percent of the paragraph (c) undertaking's gross income is attributable to rental operations (the office-space operations). Accordingly, the law-practice operations and the office-space operations are not treated as two separate undertakings under paragraph (d)(1)(i) of this section.

(v) Paragraph (d)(1)(iii) of this section provides that an undertaking (determined after the application of paragraph (d)(1)(i) of this section) is treated as a rental undertaking only if the undertaking, considered as a separate activity, would constitute a rental activity. In this case, the undertaking (determined after the application of paragraph (d)(1)(i) of this section) includes both the law-practice operations and the office-space operations, and the gross income of this undertaking does not represent amounts paid principally for the use of tangible property. Thus, the undertaking, if considered as a separate activity, would not constitute a rental activity. Accordingly, the undertaking is not treated as a rental undertaking.

Example (5). (i) The facts are the same as in example (4), except that the building is owned by a separate partnership (the "real estate partnership") which leases eight floors of the building to the law partnership for use in its law practice and two floors to one or more other tenants. The law partnership and the real estate partnership are owned by the same individuals in identical proportions.

(ii) The operations conducted in the building are owned by two different persons (*i.e.*, the law partnership and the real estate partnership). (See paragraph (c)(2)(v) of this section.) Thus, the operations conducted in the building are not treated as a single undertaking under paragraph (c)(1) of this section. Instead, each partnership's share of such operations is treated as a separate paragraph (c) undertaking (the "law-practice undertaking" and the "office-space undertaking").

(iii) Paragraph (d)(1)(iii) of this section provides that an undertaking (determined after the application of paragraph (d)(1)(i) of this section) is treated as a rental undertaking if and only if the undertaking, considered as a separate activity, would constitute a rental activity. In this case, the office-space undertaking, if considered as a separate activity, would constitute a rental activity because all of the undertaking's gross income (including rents paid by the law partnership) represents amounts paid principally for the use of tangible property (the office space), the average period of customer use for the office space exceeds 30 days, extraordinary personal services (within the meaning of §1.469-1T(e)(3)(v)) are not provided, and the rental of the office space is not treated as incidental to a nonrental activity under §1.469-1T(e)(3)(vi) (relating to incidental rentals that are not treated as a rental activity). Accordingly, the office-space undertaking is treated as a rental undertaking. See, however, §1.469-2T(f)(6) (relating to certain rentals of property to a trade or business activity in which the taxpayer materially participates).

(iv) The law-practice undertaking, if considered as a separate activity, would not constitute a rental activity because none of the undertaking's gross income represents amounts paid principally for the use of tangible property. Accordingly, the law-practice undertaking is not treated as a rental undertaking.

Example (6). (i) The taxpayer owns a building in which the taxpayer operates a nursing home and a medical clinic. (Assume that, under paragraph (c)(1) of this section, the operations conducted in the building are treated as a single paragraph (c) undertaking.) The nursing-home operations consist of renting apartments in the nursing home to elderly and handicapped persons and providing medical care, meals, and social activities. (Assume that these services are extraordinary personal services (within the meaning of §1.469-1T(e)(3)(v)).) The medical clinic provides medical care to nursing-home residents and other individuals. Nursing-home residents typically occupy an apartment for at least one year. The paragraph (c) undertaking derives 55 percent of its gross income from nursing-home operations (including the provision of medical services to nursing-home residents) and 45 percent of its gross income from medical-clinic operations. The operations conducted in the building are not incidental to any other activity of the taxpayer (within the meaning of §1.469-1T(e)(3)(vi)).

(ii) The paragraph (c) undertaking's nursing-home operations involve the provision of tangible property (the apartments) for use by customers and the provision of property and services in connection therewith. In addition, the apartments are not short-term real properties (within the meaning of paragraph (d)(3)(ii) of this section) because the average period of customer use (within the meaning of §1.469-1T(e)(3)(iii)) for the apartments exceeds 30 days. Accordingly, the nursing-home operations are rental operations (within the meaning of paragraph (d)(3) of this section). The medical-clinic operations do not involve the provision of tangible property for use by customers or the provision of property or services in connection therewith. Thus, the medical-clinic operations are not rental operations.

(iii) Paragraph (d)(1)(i) of this section provides, with certain exceptions, that a paragraph (c) undertaking's rental operations and its operations other than rental operations are treated as two separate undertakings. In this case, however, the nursing-home operations, if considered as a separate activity, would not constitute a rental activity because extraordinary personal services are provided in connection with making nursing-home apartments available for use by customers (see §1.469-1T(e)(3)(ii)(C)). Thus, the exception in paragraph (d)(2)(i) of this section applies, and the nursing-home operations and the medical-clinic operations are not treated as two separate undertakings under paragraph (d)(1)(i) of this section.

(iv) Paragraph (d)(1)(iii) of this section provides that an undertaking (determined after the application of paragraph (d)(1)(i) of this section) is treated as a rental undertaking only if the undertaking, considered as a separate activity, would constitute a rental activity. In this case, the nursing-home operations, if considered as a separate activity, would not constitute a rental activity (see (iii) above). Thus, an undertaking that includes no rental operations other than the nursing-home operations would not, if considered as a separate activity, constitute a rental activity. Accordingly, the undertaking is not treated as a rental undertaking.

Example (7). (i) The taxpayer rents and sells videocassettes. (Assume that, under paragraph (c)(1) of this section, the videocassette operations are treated as a single paragraph (c) undertaking.) Renters of videocassettes typically keep the videocassettes for one or two days, and do not receive any other property or services in connection with videocassette rentals. The paragraph (c) undertaking derives 70 percent of its gross income from renting videocassettes and 30 percent of its gross income from selling videocassettes. The videocassette operations are not incidental to any other activity of the taxpayer (within the meaning of §1.469-1T(e)(3)(vi)).

(ii) The rental of videocassettes involves the provision of tangible property (the videocassettes) for use by customers. In addition, the special rules for short-term real properties contained in paragraph (d)(3)(ii) of this section do not apply in this case because the videocassettes are not real property. Thus, the operations that involve videocassette rentals are rental operations (within the meaning of paragraph (d)(3) of this section). The sale of videocassettes does not involve the provision of tangible property for use by customers or the provision of property or services in connection therewith. Thus, the operations that involve videocassette sales are not rental operations.

(iii) Paragraph (d)(1)(i) of this section provides, with certain exceptions, that a paragraph (c) undertaking's rental operations and its operations other than rental operations are treated as two separate undertakings. In this case, however, the rental operations, if considered as a separate activity, would not constitute a rental activity because the average period of customer use for rented videocassettes does not exceed seven days (see §1.469-1T(e)(3)(ii)(A)). Accordingly, the exception in paragraph (d)(2)(i) of this section applies, and the videocassette-rental operations and videocassette-sales operations are not treated as two separate undertakings under paragraph (d)(1)(i) of this section.

(iv) Paragraph (d)(1)(iii) of this section provides that an undertaking (determined after the application of paragraph (d)(1)(i) of this section) is treated as a rental undertaking only if the undertaking, considered as a separate activity, would constitute a rental activity. In this case, the videocassette-rental operations, if considered as a separate activity, would not constitute a rental activity (see (iii) above). Thus, an undertaking that includes no rental operations other than the videocassette-rental operations would not, if considered as a separate activity, constitute a rental activity. Accordingly, the undertaking is not treated as a rental undertaking.

Example (8). (i) The taxpayer owns a building in which the taxpayer sells, leases, and services automobiles. (Assume that, under paragraph (c)(1) of this section, the operations conducted in the building are treated as a single paragraph (c) undertaking.) The minimum lease term for any leased automobile is 31 days, and the services provided to lessees (including periodic oil changes, lubrication, and routine services and repairs) are those customarily provided in long-term automobile leases. The paragraph (c) undertaking derives 75 percent of its gross income from selling automobiles, 15 percent of its gross income from servicing automobiles other than leased automobiles, and 10 percent of its gross income from leasing automobiles. The taxpayer's automobile operations are not incidental to any other activity of the taxpayer (within the meaning of §1.469-1T(e)(3)(vi)).

(ii) The paragraph (c) undertaking's automobile-leasing operations involve the provision of tangible property (the automobiles) for use by customers and the provision of services in connection therewith. In addition, the special rules for short-term real properties contained in paragraph (d)(3)(ii) of this section do not apply in this case because the automobiles are not real property. Accordingly, the automobile-leasing operations are rental operations (within the meaning of paragraph (d)(3) of this section). The paragraph (c) undertaking's automobile-sales operations and servicing operations for automobiles other than leased automobiles (the "selling-and-servicing operations") do not involve the provision of tangible property for use by customers or the provision of property or services in connection therewith. Thus, the selling-and-servicing operations are not rental operations.

(iii) Paragraph (d)(1)(i) of this section provides, with certain exceptions, that a paragraph (c) undertaking's rental operations and its operations other than rental operations are treated as two separate undertakings. In this case, however, the exception in paragraph (d)(2)(ii) of this section applies because less than 20 percent of the paragraph (c) undertaking's gross income is attributable to rental operations (the "automobile-leasing operations"). Accordingly, the rental operations and the selling-and-servicing operations are not treated as two separate undertakings under paragraph (d)(1)(i) of this section.

(iv) Paragraph (d)(1)(iii) of this section provides that an undertaking (determined after the application of paragraph (d)(1)(i) of this section) is treated as a rental undertaking only if the undertaking, considered as a separate activity, would constitute a rental activity. In this case, the undertaking (determined after the application of paragraph (d)(1)(i) of this section) includes both the selling-and-servicing operations and the automobile-leasing operations, and the gross income of the undertaking does not represent amounts paid principally for the use of tangible property. Thus, the undertaking, if considered as a separate activity, would not constitute a rental activity. Accordingly, the undertaking is not treated as a rental undertaking.

Example (9). (i) The facts are the same as in example (8), except that the paragraph (c) undertaking derives 60 percent of its gross income from selling automobiles, 15 percent of its gross income from servicing automobiles other than leased automobiles, and 25 percent of its gross income from leasing automobiles.

(ii) Paragraph (d)(1)(i) of this section provides, with certain exceptions, that a paragraph (c) undertaking's rental operations and its operations other than rental operations are treated as two separate undertakings. In this case, more than 20 percent of the paragraph (c) undertaking's gross income is attributable to rental operations (the automobile-leasing operations), and more than 20 percent is attributable to operations other than rental operations (the selling-and-servicing operations). Thus, the exceptions in paragraph (d)(2)(ii) and (iii) of this section do not apply. In addition, the average period of customer use for leased automobiles exceeds 30 days, extraordinary personal services (within the meaning of §1.469-1T(e)(3)(v)) are not provided, and the leasing of the automobiles is not treated as incidental to a nonrental activity under §1.469-1T(e)(3)(vi) (relating to incidental rentals that are not treated as a rental activity). Thus, the leasing operations, if considered as a separate activity, would constitute a rental activity, and the exception in paragraph (d)(2)(i) of this section does not apply. Accordingly, the rental operations and the selling-and-servicing operations are treated as two separate undertakings (the "automobile-leasing undertaking" and the "automobile selling-and-servicing undertaking").

(iii) Paragraph (d)(1)(iii) of this section provides that an undertaking (determined after the application of paragraph (d)(1)(i) of this section) is treated as a rental undertaking if and only if the undertaking, considered as a separate activity, would constitute a rental activity. In this case, the automobile-leasing undertaking would, if considered as a separate activity, constitute a rental activity, and the automobile selling-and-servicing undertaking would not, if considered as a separate activity, constitute a rental activity (see example (8) and (ii) above). Accordingly, the automobile-leasing undertaking is treated as a rental undertaking, and the automobile selling-and-servicing undertaking is not.

(e) *Special rules for certain oil and gas operations*—(1) *Wells treated as nonpassive under §1.469-1T(e)(4)(i).* An oil or gas well shall be treated as an undertaking that is separate from other undertakings in determining the activities of a taxpayer for a taxable year if the following conditions are satisfied:

(i) The well is drilled or operated pursuant to a working interest (within the meaning of §1.469-1T(e)(4)(iv)) and at any time during such taxable year the taxpayer holds such working interest either—

(A) Directly; or

(B) Through an entity that does not limit the liability of the taxpayer with respect to the drilling or operation of such well pursuant to such working interest; and

(ii) The taxpayer would not be treated as materially participating (within the meaning of §1.469-5T) for the taxable year in the activity in which such well would be included if the taxpayer's activities were determined without regard to this paragraph (e).

(2) *Business and rental operations that constitute an undertaking*. In any case in which an oil or gas well is treated under this paragraph (e) as an undertaking that is separate from other undertakings, the business and rental operations that constitute such undertaking are the business and rental operations that are attributable to such well.

(3) *Examples*. The following examples illustrate the application of this paragraph (e). In each example, the taxpayer is an individual whose taxable year is the calendar year.

Example (1). During 1989, A directly owns an undivided interest in a working interest (within the meaning of §1.469-1T(e)(4)(iv)) in two oil wells. A does not participate in the activity in which the wells would be included if A's activities were determined without regard to this paragraph (e). Under paragraph (e)(1) of this section, each well is treated as a separate undertaking in determining A's activities for 1989 because A holds the working interest directly and would not be treated as materially participating for 1989 in the activity in which the wells would be included if A's activities were determined without regard to this paragraph (e). The aggregation rules in paragraph (f) of this section do not apply to these undertakings (see paragraph (f)(1)(ii)(B) of this section). Thus, each of the undertakings is treated as a separate activity under paragraph (b)(1) of this section. The result is the same even if A has net income from one or both wells for 1989 and even if the wells would otherwise be treated as part of the same undertaking under paragraph (c) of this section. The result would also be the same if A held the working interest through an entity, such as a general partnership, that does not limit A's liability with respect to the drilling or operation of the wells pursuant to the working interest.

Example (2). (i) During 1989, B is a general partner in a partnership that owns a working interest (within the meaning of §1.469-1T(e)(4)(iv)) in an oil well. B does not own any interest in the well other than through the partnership. At the end of 1989, however, B's partnership interest is converted into a limited partnership interest, and during 1990 B holds the working interest only as a limited partner. B does not participate in the activity in which the well would be included if B's activities were determined without regard to this paragraph (e).

(ii) Under paragraph (e)(1) of this section, the well is treated as a separate undertaking in determining B's activities for 1989 because B holds the working interest during 1989 through an entity that does not limit B's liability with respect to the drilling or operation of the well pursuant to the working interest, and B would not be treated as materially participating for 1989 in the activity in which the well would be included if B's activities were determined without regard to this paragraph (e). Throughout 1990, however, B's liability with respect to the drilling and operation of the well is limited by the entity through which B holds the working interest (*i.e.*, the limited partnership). Accordingly, paragraph (e)(1) of this section does not apply to the well in 1990, and the well may be included under paragraph (c) of this section in an undertaking that includes other operations.

Example (3). The facts are the same as in example (2), except that B's partnership interest is converted into a limited partnership interest at the end of November 1989. An oil or gas well may be treated as a separate undertaking under paragraph (e)(1) of this section if at any time during the taxable year the taxpayer holds a working interest in the well directly or through an entity that does not limit the taxpayer's liability with respect to the drilling or operation of the well pursuant to the working interest (see §1.469-1T(e)(4)(i)). Thus, although B's liability with respect to the drilling and operation of the well is limited during December 1989, the result in both 1989 and 1990 is the same as in example (2). In 1989, however, disqualified deductions and a ratable portion of the gross income from the well may be treated under §1.469-1T(e)(4)(ii) as passive activity deductions and passive activity gross income, respectively.

(f) *Certain trade or business undertakings treated as part of the same activity*—(1) *Applicability*—(i) *In general*. This paragraph (f) applies to a taxpayer's interests in trade or business undertakings (within the meaning of paragraph (f)(1)(ii) of this section).

(ii) *Trade or business undertaking*. For purposes of this paragraph (f), the term "trade or business undertaking" means any undertaking in which a taxpayer has an interest, other than—

(A) A rental undertaking (within the meaning of paragraph (d) of this section);

(B) An oil or gas well treated as an undertaking that is separate from other undertakings under paragraph (e) of this section; or

(C) A professional service undertaking (within the meaning of paragraph (h) of this section).

(2) *Treatment as part of the same activity*. A taxpayer's interests in two or more trade or business undertakings that are similar (within the meaning of paragraph (f)(4) of this section) and controlled by the same interests (within the meaning of paragraph (j) of this section) shall be treated as part of the same activity of the taxpayer for any taxable year in which the taxpayer—

(i) Owns interests in each such undertaking through the same passthrough entity;

(ii) Owns a direct or substantial indirect interest (within the meaning of paragraph (f)(3) of this section) in each such undertaking; or

(iii) Materially or significantly participates (within the meaning of §1.469-5T) in the activity that would result if such undertakings were treated as part of the same activity.

(3) *Substantial indirect interest*—(i) *In general*. For purposes of this paragraph (f), a taxpayer owns a substantial indirect interest in an undertaking for a taxable year if at any time during such taxable year the taxpayer's ownership percentage (determined in accordance with paragraph (j)(3) of this section) in a passthrough entity that directly owns such undertaking exceeds ten percent.

(ii) *Coordination rule*. A taxpayer shall be treated for purposes of this paragraph (f) as owning a substantial indirect interest in each of two or more undertakings for any taxable year in which—

(A) Such undertakings are treated as part of the same activity of the taxpayer under paragraph (f)(2)(i) of this section; and

(B) The taxpayer owns a substantial indirect interest (within the meaning of paragraph (f)(3)(i) of this section) in any such undertaking.

(4) *Similar undertakings*—(i) *In general*. Except as provided in paragraph (f)(4)(iii) of this section, two undertakings are similar for purposes of this paragraph (f) if and only if—

(A) There are predominant operations in each such undertaking; and

(B) The predominant operations of both undertakings are in the same line of business.

(ii) *Predominant operations*. For purposes of paragraph (f)(4)(i)(A) of this section, there are predominant operations in an undertaking if more than 50 percent of the undertaking's gross income is attributable to operations in a single line of business.

(iii) *Vertically-integrated undertakings*. If an undertaking (the "supplier undertaking") provides property or services to other undertakings (the "recipient undertakings"), the following rules apply for purposes of this paragraph (f):

(A) *Supplier undertaking similar to recipient undertaking*. If the supplier undertaking predominantly involves the provision of property and services to a recipient undertaking that is controlled by the same interests (within the meaning of paragraph (j) of this section), the supplier undertaking shall be treated as similar to the recipient undertaking. For purposes of applying the preceding sentence—

(*1*) If a supplier undertaking and two or more recipient undertakings that are similar (within the meaning of paragraph (f)(4)(i) of this section) are controlled by the same interests, such recipient undertakings shall be treated as a single undertaking; and

(*2*) A supplier undertaking predominantly involves the provision of property and services to a recipient undertaking for any taxable year in which such recipient undertaking obtains more than 50 percent (by value) of all property and services provided by the supplier undertaking.

(B) *Recipient undertaking similar to supplier undertaking*. If the supplier undertaking is the predominant provider of property and services to a recipient undertaking that is controlled by the same interests (within the meaning of paragraph (j) of this section), the recipient undertaking shall be treated, except as otherwise provided in paragraph (f)(4)(iii)(C) of this section, as similar to the supplier undertaking. For purposes of the preceding sentence, a supplier undertaking is the predominant provider of property and services to a recipient undertaking for any taxable year in which the supplier undertaking provides more than 50 percent (by value) of all property and services obtained by the recipient undertaking.

(C) *Coordination rules*. (*1*) Paragraph (f)(4)(iii)(B) of this section does not apply if, under paragraph (f)(4)(iii)(A) of this section—

(*i*) The supplier undertaking is treated as an undertaking that is similar to any recipient undertaking;

(*ii*) The recipient undertaking is treated as a supplier undertaking that is similar to another recipient undertaking; or

(*iii*) Another supplier undertaking is treated as an undertaking that is similar to the recipient undertaking.

(*2*) If paragraph (f)(4)(iii)(A) of this section applies to a supplier undertaking, the supplier undertaking shall be treated as similar to undertakings that are similar to the recipient undertaking and shall not otherwise be treated as similar to undertakings to which the supplier undertaking would be similar without regard to paragraph (f)(4)(iii) of this section.

(*3*) If paragraph (f)(4)(iii)(B) of this section applies to a recipient undertaking, the recipient undertaking shall be treated as similar to undertakings that are similar to the supplier undertaking and shall not otherwise be treated as similar to undertakings to which the recipient undertaking would be similar without regard to paragraph (f)(4)(iii) of this section.

(iv) *Lines of business*. The Commissioner shall establish, by revenue procedure, lines of business for purposes of this paragraph (f)(4). Business and rental operations that are not included in the lines of business established by the Commissioner shall nonetheless be included in a line of business for purposes of this paragraph (f)(4). Such operations shall be included in a single line of business or in multiple lines of business on a basis that reasonably reflects—

(A) Similarities and differences in the property or services provided pursuant to such operations and in the markets to which such property or services are offered; and

(B) The treatment within the lines of business established by the Commissioner of operations that are comparable in their similarities and differences.

(5) *Examples*. The following examples illustrate the application of this paragraph (f). In each example that does not state otherwise, the taxpayer is an individual and the facts, analysis, and conclusions relate to a single taxable year.

Example (1). (i) The taxpayer is a partner in partnerships A, B, C, and D and owns a five-percent interest in each partnership. Each partnership owns a single undertaking (undertakings A, B, C, and D), and the undertakings are trade or business undertakings (within the meaning of paragraph (f)(1)(ii) of this section) that are controlled by the same interests (within the meaning of paragraph (j) of this section). In addition, undertakings A, B, and D are similar (within the meaning of paragraph (f)(4) of this section). The taxpayer is not related to any of the other partners, and does not participate in any of the undertakings.

(ii) In general, each undertaking in which a taxpayer owns an interest is treated as a single activity that is separate from other activities of the taxpayer (see paragraph (b)(1) of this section). This paragraph (f) provides aggregation rules for trade or business undertakings that are similar and controlled by the same interests. These aggregation rules do not apply, however, unless the taxpayer owns interests in the undertakings through the same passthrough entity, owns direct or substantial indirect interests in the undertakings, or materially or significantly participates in the undertakings. In this case, the taxpayer does not satisfy any of these conditions, and the aggregation rules in this paragraph (f) do not apply. Accordingly, except as otherwise provided in paragraph (g) of this section (relating to an aggregation rule for integrated businesses), undertakings A, B, C, and D are treated as separate activities of the taxpayer under paragraph (b)(1) of this section.

Example (2). (i) The facts are the same as in example (1), except that the taxpayer owns a 25-percent interest in partnership A, a 15-percent interest in partnership B, and a 40-percent interest in partnership C.

(ii) Paragraph (f)(2)(ii) of this section provides that trade or business undertakings that are similar and controlled by the same interests are treated as part of the same activity of the taxpayer if the taxpayer owns a direct or substantial indirect interest in each such undertaking. In this case, the taxpayer owns more than ten percent of partnerships A, B, and C, and these partnerships directly own undertakings A, B, and C. Thus, the taxpayer owns a substantial indirect interest in undertakings A, B, and C (see paragraph (f)(3)(i) of this section). Of these undertakings, only undertakings A and B are both similar and controlled by the same interests. Accordingly, the taxpayer's interests in undertakings A and B are treated as part of the same activity. As in example (1), the aggregation rules in this paragraph (f) do not apply to undertakings C and D, and except as otherwise provided in paragraph (g) of this section, undertakings C and D are treated as separate activities.

Example (3). (i) The facts are the same as in example (1), except that the taxpayer participates (within the meaning of §1.469-5T(f)) for 60 hours in undertaking A and for 60 hours in undertaking B.

(ii) Paragraph (f)(2)(iii) of this section provides that trade or business undertakings that are similar and controlled by the same interests are treated as part of the same activity of the taxpayer if the taxpayer materially or significantly participates (within the meaning of §1.469-5T) in the activity that would result from the treatment of similar, commonly-controlled undertakings as part of the same activity. In this case, the activity that would result from treating the similar, commonly-controlled undertakings as part of the same activity consists of undertakings A, B, and D, and the taxpayer participates for 120 hours in the activity that results from this treatment. Accordingly, undertakings A, B, and D are treated as part of the same activity because the taxpayer significantly participates (within the meaning of §1.469-5T(c)(2)) in the activity that results from this treatment. The result is the same whether the taxpayer participates in one, two, or all three of the similar, commonly-controlled undertakings, so long as the taxpayer's aggregate participation in undertakings A, B, and D exceeds 100 hours. As in example (1), the aggregation rules in this paragraph (f) do not apply to undertaking C, and except as otherwise provided in paragraph (g) of this section, undertaking C is treated as a separate activity.

Example (4). (i) The taxpayer owns a 5-percent interest in partnership A. Partnership A owns interests in partnerships B and C, each of which owns a single undertaking (undertakings B and C). In addition, the taxpayer is a partner in partnerships C and D and directly owns a 15-percent interest in each partnership. Partnership D also owns a single undertaking (undertaking D). Undertakings B, C, and D are trade or business undertakings (within the meaning of paragraph (f)(1)(ii) of this section) that are similar (within the meaning of paragraph (f)(4) of this section) and controlled by the same interests (within the meaning of paragraph (j) of this section). The taxpayer does not participate in undertaking B, C, or D.

(ii) Paragraph (f)(2)(i) of this section provides that trade or business undertakings that are similar and controlled by the same interests are treated as part of the same activity of the taxpayer if the taxpayer owns interests in the undertakings through the same passthrough entity. In this case, the taxpayer owns interests in undertakings B and C through partnership A. Thus, the taxpayer's interests in undertakings B and C are treated as part of the same activity.

(iii) Paragraph (f)(2)(ii) of this section provides that trade or business undertakings that are similar and controlled by the same interests are treated as part of the same activity of the taxpayer if the taxpayer owns a direct or substantial indirect interest in each such undertaking. In this case, the taxpayer owns more than ten percent of partnerships C and D, and these partnerships directly own undertakings C and D. Thus, the taxpayer owns a substantial indirect interest in undertakings C and D (see paragraph (f)(3)(i) of this section).

(iv) The coordination rule in paragraph (f)(3)(ii) of this section applies to undertakings B and C because they are treated as part of the same activity under paragraph (f)(2)(i) of this section, and the taxpayer owns a substantial indirect interest in undertaking C. Under the coordination rule, the taxpayer is treated as owning a substantial indirect interest in undertaking B as well as undertaking C. Accordingly, the taxpayer's interests in undertakings B, C, and D are treated as part of the same activity.

Example (5). (i) Undertakings A, B, C, and D are trade or business undertakings (within the meaning of paragraph (f)(1)(ii) of this section), each of which involves the operation of a department store, restaurants, and movie theaters. The following table shows, for each undertaking, the percentages of gross income attributable to the various operations of the undertaking.

	Department store	*Restaurants*	*Movie Theaters*
Undertaking A	70%	20%	10%
Undertaking B	60%	20%	20%
Undertaking C	35%	35%	30%
Undertaking D	35%	10%	55%

(ii) Paragraph (f)(4)(i) of this section provides that two undertakings are similar for purposes of this paragraph (f) if and only if there are predominant operations in each undertaking and the predominant operations of the two undertakings are in the same line of business. (Assume that the applicable revenue procedure provides that "general merchandise stores," "eating and drinking places," and "motion picture services" are three separate lines of business.)

(iii) Undertaking A and undertaking B each derives more than 50 percent of its gross income from department-store operations, which are in the general-merchandise-store line of business. Thus, there are predominant operations in undertaking A and undertaking B, and the predominant operations of the two undertakings are in the same line of business. Accordingly, undertakings A and B are similar.

(iv) Undertaking C does not derive more than 50 percent of its gross income from operations in any single line of business. Thus, there are no predominant operations in undertaking C, and undertaking C is not similar to any of the other undertakings.

(v) Undertaking D derives more than 50 percent of its gross income from movie-theater operations, which are in the motion-picture-services line of business. Thus, there are predominant operations in undertaking D. The predominant operations of undertaking D, however, are not in the same line of business as those of undertakings A and B. Accordingly, undertaking D is not similar to undertakings A and B.

Example (6). (i) Undertakings A and B are trade or business undertakings (within the meaning of paragraph (f)(1)(ii) of this section) that derive all of their gross income from the sale of automobiles. Undertakings C and D derive all of their gross income from the rental of automobiles. Undertaking C is not a rental undertaking (within the meaning of paragraph (d)(1)(iii) of this section) because the average period of customer use (within the meaning of §1.469-1T(e)(3)(iii)) for its automobiles does not exceed seven days (see §1.469-1T(e)(3)(ii)(A)). Undertaking D, on the other hand, leases automobiles for periods of one year or more and is a rental undertaking.

(ii) Paragraph (f)(4)(i) of this section provides that two undertakings are similar for purposes of this paragraph (f) if and only if there are predominant operations in each undertaking and the predominant operations of the two undertakings are in the same line of business. (Assume that the applicable revenue procedure provides that (a) "automotive dealers and service stations" (automotive retail) and (b) "auto repair, services (including rentals), and parking" (automotive services) are two separate lines of business.)

(iii) Undertakings A and B both derive more than 50 percent of their gross income from operations in the automotive-retail line of business (the automobile-sales operations). Similarly, undertakings C and D both derive more than 50 percent of their gross income from operations in the automotive-services line of business (the automobile-rental operations). Thus, there are predominant operations in each undertaking, the predominant operations of undertakings A and B are in the same line of business, and the predominant operations of undertakings C and D are in the same line of business. Accordingly, undertakings A and B are similar, undertakings C and D are similar, and undertakings A and B are not similar to undertakings C and D.

(iv) Paragraph (f)(1) of this section provides that this paragraph (f) applies only to trade or business undertakings and that a rental undertaking is not a trade or business undertaking. Accordingly, this paragraph (f) does not apply to undertaking D, and undertakings C and D, although similar, are not treated, under this paragraph (f), as part of the same activity.

Example (7). (i) Undertakings A, B, and C are trade or business undertakings (within the meaning of paragraph (f)(1)(ii) of this section) that involve real estate operations. Undertaking A derives all of its gross income from the development of real property, undertaking B derives all of its gross income from the management of real property and the performance of services as a leasing agent with respect to real property, and undertaking C derives all of its gross income from buying, selling, or arranging purchases and sales of real property. Undertaking D derives all of its gross income from the rental of residential apartments and is a rental undertaking (within the meaning of paragraph (d)(1)(iii) of this section).

(ii) Paragraph (f)(4)(i) of this section provides that two undertakings are similar for purposes of this paragraph (f) if there are predominant operations in each undertaking and the predominant operations of the two undertakings are in the same line of business. (Assume that the applicable revenue procedure provides that real estate development and services (including the development and management of real property, dealing in real property, and the performance of services as a leasing agent with respect to real property) is a single line of business (the "real-estate" line of business).)

(iii) Undertakings A, B, and C all derive more than 50 percent of their gross income from operations in the realestate line of business. Thus, there are predominant operations in undertakings A, B, and C, and the predominant operations of the three undertakings are in the same line of business. Accordingly, undertakings A, B, and C are similar.

(iv) Undertaking D also derives more than 50 percent of its gross income from operations in the real-estate line of business. Thus, there are predominant operations in undertaking D, and the predominant operations of undertaking D are in the same line of business as those of undertakings A, B, and C. Paragraph (f)(1) of this section provides, however, that this paragraph (f) applies only to trade or business undertakings and that a rental undertaking is not a trade or business undertaking. Accordingly, this paragraph (f) does not apply to undertaking D, and undertaking D, although similar to undertakings A, B, and C, is not treated, under this paragraph (f), as part an activity that includes undertaking A, B, or C.

Example (8). (i) Undertakings A and B are trade or business undertakings (within the meaning of paragraph (f)(1)(ii) of this section), both of which involve the provision of moving services. Undertaking A derives its gross income principally from local moves, and undertaking B derives its gross income principally from long-distance moves.

(ii) Paragraph (f)(4)(i) of this section provides that two undertakings are similar for purposes of this paragraph (f) if there are predominant operations in each undertaking and the predominant operations of the two undertakings are in the same line of business. Under paragraph (f)(4)(iv) of this section, operations that are not in the lines of business established by the applicable revenue procedure are nonetheless included in a line of business. In addition, such operations are included in a single line of business or in multiple lines of business on a basis that reasonably reflects (a) similarities and differences in the property or services provided pursuant to such operations and in the markets to which such property or services are offered, and (b) the treatment within the lines of business established by the Commissioner of operations that are comparable in their similarities and differences. (Assume that the provision of moving services is not in any line of business established by the Commissioner and that within the lines of business established by the Commissioner services that differ only in the distance over which they are performed (*e.g.*, local and long-distance telephone services) are generally treated as part of the same line of business.)

(iii) Undertakings A and B provide the same types of services to similar customers, and the only significant difference in the services provided is the distance over which they are performed. Thus, treating local and long-distance moving services as a single line of business (the "moving-services" line of business) reasonably reflects the treatment within the lines of business established by the Commissioner of operations that are comparable in their similarities and differences.

(iv) Each undertaking derives more than 50 percent of its gross income from operations in the moving-services line of business. Thus, there are predominant operations in each undertaking, and the predominant operations of the two undertakings are in the same line of business. Accordingly, undertakings A and B are similar.

Example (9). (i) Undertakings A, B, C, D, and E are trade or business undertakings (within the meaning of paragraph (f)(1)(ii) of this section) and are controlled by the same interests (within the meaning of paragraph (j) of this section). Undertakings A, B, and C derive all of their gross income from retail sales of dairy products, and undertakings D and E derive all of their gross income from the processing of dairy products. Undertakings D and E sell less than ten percent of their dairy products to undertakings A, B, and C, and sell the remainder to unrelated undertakings. Undertakings A, B, and C purchase less than ten percent of their inventory from undertakings D and E and purchase the remainder from unrelated undertakings.

(ii) Paragraph (f)(4)(i) of this section provides that, except as provided in paragraph (f)(4)(iii) of this section, undertakings are similar for purposes of this paragraph (f) if and only if there are predominant operations in each undertaking and the predominant operations of the undertakings are in the same line of business. (Assume that the applicable revenue procedure provides that (a) "food stores" and (b) "manufacturing—food and kindred products" are two separate lines of business.)

(iii) Undertakings A, B, and C all derive more than 50 percent of their gross income from operations in the food-store line of business (the dairy-sales operations). Thus, there are predominant operations in undertakings A, B, and C, and the predominant operations of the three undertakings are in the same line of business. Accordingly, undertakings A, B, and C are similar.

(iv) Undertakings D and E both derive more than 50 percent of their gross income from operations in the food-manufacturing line of business (the dairy-processing operations). Thus, there are predominant operations in undertakings D and E, and the predominant operations of the two undertakings are in the same line of business. Accordingly, undertakings D and E are similar. The predominant operations of undertakings D and E are not in the same line of business as those of undertakings A, B, and C. Accordingly, undertakings D and E are not similar to undertakings A, B, and C.

(v) Paragraph (f)(4)(iii) of this section provides rules under which certain undertakings whose operations are not in the same line of business nevertheless are similar to one another if one of the undertakings (the "supplier undertaking") provides property or services to the other undertaking (the "recipient undertaking"), and the undertakings are controlled by the same interests. These rules apply, however, only if the supplier undertaking predominantly involves the provision of property and services to the recipient undertaking (see paragraph (f)(4)(iii)(A) of this section), or the supplier undertaking is the predominant provider of property and services to the recipient undertaking (see paragraph (f)(4)(iii)(B) of this section). In this case, undertakings D and E are supplier undertakings, and undertakings A, B, and C are recipient undertakings. Undertakings D and E, however, sell less than ten percent of their dairy products to undertakings A, B, and C and thus do not predominantly involve the provision of property and services to recipient undertakings. Similarly, undertakings D and E are not the predominant providers of property and services to undertakings A, B, and C. Thus, the rules for vertically-integrated undertakings in paragraph (f)(4)(iii) of this section do not apply in this case.

Example (10). (i) The facts are the same as in example (9), except that undertaking D sells 75 percent of its dairy products to undertakings A, B, and C.

(ii) Paragraph (f)(4)(iii)(A) of this section applies if a supplier undertaking predominantly involves the provision of property to a recipient undertaking that is controlled by the same interests. Paragraph (f)(4)(iii)(A)(*2*) of this section provides that a supplier undertaking predominantly involves the provision of property to a recipient undertaking if the supplier undertaking provides more than 50 percent of its property to such recipient undertaking. In addition, paragraph (f)(4)(iii)(A)(*1*) of this section provides that if a supplier undertaking and two or more similar recipient undertakings are controlled by the same interests, the recipient undertakings are treated as a single undertaking for purposes of applying paragraph (f)(4)(iii)(A) of this section. Undertakings D and E both provide dairy products to undertakings A, B, and C. Thus, for purposes of paragraph (f)(4)(iii) of this section, undertakings D and E are supplier undertakings and undertakings A, B, and C are recipient undertakings. Undertaking D predominantly involves the provision of property to undertakings A, B, and C. Moreover, undertakings A, B, and C are treated as a single undertaking under paragraph (f)(4)(iii)(A)(*1*) of this section because undertakings A, B, and C are similar to one another under paragraph (f)(4)(i) of this section, and undertakings A, B, C, and D are controlled by the same interests. Accordingly, paragraph (f)(4)(iii)(A) of this section applies to undertakings A, B, C, and D.

(iii) If paragraph (f)(4)(iii)(A) of this section applies to supplier and recipient undertakings, the supplier undertaking is treated under paragraph (f)(4)(iii)(A) and (C)(*2*) of this section as an undertaking that is similar to the recipient undertakings and to undertakings to which the recipient undertakings are similar. Accordingly, undertaking D is similar, for purposes of this paragraph (f), to undertakings A, B, and C.

(iv) Undertaking E does not predominantly involve the provision of property to undertakings A, B, and C, or to any other related undertakings. Thus, paragraph (f)(4)(iii)(A) of this section does not apply to undertaking E, and undertaking E is not similar to undertakings A, B, and C. Moreover, undertakings D and E are not similar because, under paragraph (f)(4)(iii)(C)(*2*) of this section, undertaking D is not similar to any undertaking that is not similar to undertakings A, B, and C.

Example (11). (i) The facts are the same as in example (10), except that 75 percent of undertaking D's dairy products are sold to undertakings A and B, and none are sold to undertaking C.

(ii) In this case, undertaking D is a supplier undertaking only with respect to undertakings A and B. Accordingly, paragraph (f)(4)(iii)(A) applies only to undertakings A, B, and D. As in example (10), undertaking D is similar to undertakings A and B, and is not similar to undertaking E. In addition, if paragraph (f)(4)(iii)(A) of this section applies to supplier and recipient undertakings, the supplier undertaking is treated under paragraph (f)(4)(iii)(C)(*2*) of this section as an undertaking that is similar to the recipient undertakings and undertakings to which the recipient undertakings are similar. Accordingly, even though undertaking D does not provide any property or services to undertaking C, undertaking D is similar to undertaking C because undertaking C is similar to undertakings A and B.

Example (12). (i) The facts are the same as in example (9), except that undertakings A and B purchase 80 percent of their inventory from undertaking D.

(ii) Paragraph (f)(4)(iii)(B) of this section applies, except as provided in paragraph (f)(4)(iii)(C) of this section, if a supplier undertaking is the predominant provider of property to a recipient undertaking that is controlled by the same interests. Undertakings D and E both provide dairy products to undertakings A, B, and C. Thus, for purposes of paragraph (f)(4)(iii) of this section, undertakings D and E are supplier undertakings, and undertakings A, B, and C are recipient undertakings. In addition, undertaking D is the predominant provider of property and services to undertakings A and B, and undertakings A, B, and D are controlled by the same interests. Thus, except as provided in paragraph (f)(4)(iii)(C) of this section, paragraph (f)(4)(iii)(B) of this section applies to undertakings A, B, and D.

(iii) The coordination rules in paragraph (f)(4)(iii)(C)(*1*) of this section provide that paragraph (f)(4)(iii)(B) of this section does not apply in certain cases to which paragraph (f)(4)(iii)(A) of this section applies. These coordination rules would apply if undertaking D or E (or any other undertaking that is controlled by the interests that control undertakings A, B, and C) predominantly involved the provision of property and services to undertakings A, B, and C. The coordination rules in paragraph (f)(4)(iii)(C)(*1*) of this section would also apply if undertaking A, B, or D predominantly involved the provision of property or services to a recipient undertaking that is controlled by the same interests. Assume that these coordination rules do not apply in this case.

(iv) If paragraph (f)(4)(iii)(B) of this section applies to supplier and recipient undertakings, the recipient undertakings are treated under paragraph (f)(4)(iii)(B) and (C)(*3*) of this section as undertakings that are similar to the supplier undertaking and to undertakings to which the supplier undertaking is similar. Accordingly, undertakings A and B are similar, for purposes of this paragraph (f), to undertaking D and, because undertakings D and E are similar, to undertaking E.

(v) The principal providers of property and services to undertaking C are unrelated undertakings. Thus, paragraph (f)(4)(iii)(B) of this section does not apply to undertaking C, and undertaking C is not similar to undertakings D and E. Moreover, undertaking C is not similar to undertakings A and B because, under paragraph (f)(4)(iii)(C)(*3*) of this section, undertakings A and B are not similar to any undertaking that is not similar to undertaking D.

Example (13). (i) Undertakings A through Z are trade or business undertakings (within the meaning of paragraph (f)(1)(ii) of this section) and are controlled by the same interests (within the meaning of paragraph (j) of this section). Undertaking A derives all of its gross income from the manufacture and sale of men's and women's clothing, undertaking B derives all of its gross income from sales of men's and women's clothing to retail stores, and undertakings C through Z derive all of their gross income from retail sales of men's and women's clothing. Undertaking A sells clothing exclusively to undertaking B. Undertaking B sells 75 percent of its clothing to undertakings C through Z, and sells the remainder to unrelated retail stores. Undertaking B purchases 80 percent of its inventory from undertaking A, and undertakings C through Z purchase 60 to 90 percent of their inventory from undertaking B.

(ii) Paragraph (f)(4)(iii)(A) of this section applies if a supplier undertaking predominantly involves the provision of property to a recipient undertaking that is controlled by the same interests. In addition, paragraph (f)(4)(iii)(A)(*1*) of this section provides that if a supplier undertaking and two or more similar recipient undertakings are controlled by the same interests, the recipient undertakings are treated as a single undertaking for this purpose. Undertaking B provides men's and women's clothing to undertakings C through Z. Thus, for purposes of paragraph (f)(4)(iii) of this section, undertaking B is a supplier undertaking and undertakings C through Z are recipient undertakings. In addition, undertaking B predominantly involves the provision of property to undertakings C through Z, and undertakings C through Z are treated as a single undertaking for purposes of paragraph (f)(4)(iii)(A) of this section. Accordingly, paragraph (f)(4)(iii)(A) of this section applies to undertakings B and C through Z.

(iii) If paragraph (f)(4)(iii)(A) of this section applies to supplier and recipient undertakings, the supplier undertaking is treated under paragraph (f)-

(4)(iii)(A) of this section as an undertaking that is similar to the recipient undertakings. Accordingly, undertaking B is similar, for purposes of this paragraph (f), to undertakings C through Z.

(iv) Undertaking A provides men's and women's clothing to undertaking B. Thus, for purposes of paragraph (f)(4)(iii) of this section, undertaking A is a supplier undertaking and undertaking B is a recipient undertaking. In addition, undertaking A predominantly involves the provision of property to undertaking B, and undertakings A and B are controlled by the same interests. Accordingly, paragraph (f)(4)(iii)(A) of this section applies to undertakings A and B, and undertaking A is similar to undertaking B.

(v) If paragraph (f)(4)(iii)(A) of this section applies to supplier and recipient undertakings, the supplier undertaking is treated under paragraph (f)(4)(iii)(C)(*2*) of this section as an undertaking that is similar to undertakings to which the recipient undertakings are similar. Accordingly, undertaking A is also similar, for purposes of this paragraph (f), to undertakings C through Z.

(vi) The coordination rule in paragraph (f)(4)(iii)(C)(*1*)(*i*) of this section provides that paragraph (f)(4)(iii)(B) of this section does not apply if, as described above, the supplier undertaking predominantly involves the provision of property to recipient undertakings and is treated under paragraph (f)(4)(iii)(A) of this section as an undertaking that is similar to such recipient undertakings. Accordingly, paragraph (f)(4)(iii)(B) of this section does not apply to undertakings B through Z, even though undertaking B is the predominant provider of property and services to undertakings C through Z, and undertakings B through Z are controlled by the same interests. For the same reason, paragraph (f)(4)(iii)(B) of this section does not apply to undertakings A and B. (Paragraph (f)(4)(iii)(B) of this section is also inapplicable to undertakings A and B because the coordination rule in paragraph (f)(4)(iii)(C)(*1*)(*ii*) of this section applies if the recipient undertaking (undertaking B) is itself a supplier undertaking that is treated under paragraph (f)(4)(iii)(A) of this section as an undertaking that is similar to its recipient undertakings (undertakings C through Z).)

(g) *Integrated businesses*—(1) *Applicability*—(i) *In general.* This paragraph (g) applies to a taxpayer's interests in trade or business activities (within the meaning of paragraph (g)(1)(ii) of this section).

(ii) *Trade or business activity.* For purposes of this paragraph (g), the term "trade or business activity" means any activity (determined without regard to this paragraph (g)) that consists of interests in one or more trade or business undertakings (within the meaning of paragraph (f)(1)(ii) of this section).

(2) *Treatment as a single activity.* A taxpayer's interests in two or more trade or business activities shall be treated as a single activity if and only if—

(i) The operations of such trade or business activities constitute a single integrated business; and

(ii) Such activities are controlled by the same interests (within the meaning of paragraph (j) of this section).

(3) *Facts and circumstances test.* In determining whether the operations of two or more trade or business activities constitute a single integrated business for purposes of this paragraph (g), all the facts and circumstances are taken into account, and the following factors are generally the most significant:

(i) Whether such operations are conducted at the same location;

(ii) The extent to which other persons conduct similar operations at one location;

(iii) Whether such operations are treated as a unit in the primary accounting records reflecting the results of such operations;

(iv) The extent to which other persons treat similar operations as a unit in the primary accounting records reflecting the results of such similar operations;

(v) Whether such operations are owned by the same person (within the meaning of paragraph (c)(2)(v) of this section);

(vi) The extent to which such operations involve products or services that are commonly provided together;

(vii) The extent to which such operations serve the same customers;

(viii) The extent to which the same personnel, facilities, or equipment are used to conduct such operations;

(ix) The extent to which such operations are conducted in coordination with or reliance upon each other;

(x) The extent to which the conduct of any such operations is incidental to the conduct of the remainder of such operations;

(xi) The extent to which such operations depend on each other for their economic success; and

(xii) Whether such operations are conducted under the same trade name.

(4) *Examples.* The following examples illustrate the application of this paragraph (g). The facts, analysis, and conclusion in each example relate to a single taxable year, and the trade or business activities described in each example are controlled by the same interests (within the meaning of paragraph (j) of this section).

Example (1). (i) The taxpayer owns a number of department stores and auto-supply stores. Some of the taxpayer's department stores include auto-supply departments. In other cases, the taxpayer operates a department store and an auto-supply store at the same location (within the meaning of paragraph (c)(2)(iii) of this section), or at different locations from which the same group of customers can be served. In cases in which a department store and an auto-supply store are operated at the same location, the department-store operations are the predominant operations (within the meaning of paragraph (f)(4)(ii) of this section), and the undertaking that includes the stores is treated as a department-store undertaking for purposes of paragraph (f) of this section. Under paragraph (f) of this section, the department-store undertakings are all treated as part of the same activity of the taxpayer (the "department-store activity"). Similarly, the auto-supply undertakings (*i.e.*, the auto-supply stores that are not operated at a department-store location) are all treated as part of the same activity (the "auto-supply activity"). (Assume that department-store undertakings and auto-supply undertakings are not similar and are not treated as part of the same activity under paragraph (f) of this section.)

(ii) The department stores and auto-supply stores use a common trade name and coordinate their marketing activities (*e.g.*, the stores advertise in the same catalog and the same newspaper supplements, honor the same credit cards (including credit cards issued by the department stores), and jointly conduct sales and other promotional activities). Although sales personnel generally work only in a particular store or in a particular department within a store, other employees (*e.g.*, cashiers, janitorial and maintenance workers, and clerical staff) may work in or perform services for various stores, including both department and auto-supply stores. In addition, the management of store operations is organized on a geographical basis, and managers above the level of the individual store generally supervise operations in both types of store. A central office provides payroll, financial, and other support services to all stores and establishes pricing and other business policies. Most inventory for both types of stores is acquired through a central purchasing department and inventory for all stores in an area is stored in a common warehouse.

(iii) Based on the foregoing facts and circumstances, the operations of the department-store activity and the auto-supply activity constitute an integrated business. Paragraph (g)(3) of this section provides that the factors relevant to this determination include the conduct of department-store and auto-supply operations at the same location, the location of department and auto-supply stores at sites where the same group of customers can be served, the treatment of all such operations as a unit in the taxpayer's financial statements, the taxpayer's ownership and the common management of all such operations, the use of the same personnel, facilities, and equipment to conduct and support the operations, the use of a common trade name, and the coordination (as evidenced by the coordinated marketing activities) of department-store and auto-supply operations.

(iv) Paragraph (g)(2) of this section provides that a taxpayer's interests in two or more trade or business activities (within the meaning of paragraph (g)(1)(ii) of this section) are treated as a single activity of the taxpayer if the operations of such activities constitute an integrated business and the activities are controlled by the same interests. The department-store activity and the auto-supply activity consist of trade or business undertakings and, thus, are trade or business activities. In addition, the activities are controlled by the same interests (the taxpayer), and the operations of the activities constitute an integrated business. Accordingly, the department-store activity and the auto-supply activity are treated as a single activity of the taxpayer.

Example (2). (i) The taxpayer owns a number of stores that sell stereo equipment and a repair shop that services stereo equipment. Under paragraph (f) of this section, the stores are all treated as part of the same activity of the taxpayer (the "store activity"). The repair shop does not sell stereo equipment, does not predominantly involve the provision of services to the taxpayer's stores, and is treated as a separate activity (the "repair-shop activity"). (Assume that stereo-sales undertakings and stereo-repair undertakings are not similar and are not treated as part of the same activity under paragraph (f) of this section.)

(ii) The stores sell stereo equipment produced by manufacturers for which the stores are an authorized distributor. The repair shop's operations principally involve the servicing of stereo equipment produced by the same manufacturers. These operations include repairs on equipment under warranty for which reimbursement is received from the manufacturer and reconditioning of equipment taken as trade-ins by the taxpayer's stores. The majority of the operations, however, involve repairs that are performed for customers and are not covered by a warranty. The taxpayer's distribution agreements with manufacturers generally require the taxpayer to repair and service equipment produced by the manufacturer both during and after the warranty period. In some cases, the distribution agreements require that the taxpayer's repair facility meet the manufacturer's standards and provide for periodic inspections to ensure that these standards are met.

(iii) The stores and the repair shop use a common trade name. Sales personnel generally work only in a particular store and stereo technicians work only in the repair shop. The stores and the repair shop are, however, managed from a central office, which supervises both store and repair-shop operations, provides payroll, financial, and other support services to the stores and the repair shop, and establishes pricing and other business policies. In addition, inventory for the stores and supplies for the repair shop are acquired through a central purchasing department and are stored in a single warehouse.

(iv) Based on the foregoing facts and circumstances, the operations of the store activity and the repair-shop activity constitute an integrated business. Paragraph (g)(3) of this section provides that the factors relevant to this determination include the treatment of all such operations as a unit in the taxpayer's financial statements, the taxpayer's ownership and the common management of all such operations, the use of the same personnel and facilities to support the operations, the use of a common trade name, the extent to which the same customers patronize both the stores and the repair shop, the similarity of the products (*i.e.*, stereo equipment) involved in both store and repair-shop operations, and the extent to which the provision of repair services contributes to the taxpayer's ability to obtain the stereo equipment sold in store operations.

(v) Paragraph (g)(2) of this section provides that a taxpayer's interests in two or more trade or business activities (within the meaning of paragraph (g)(1)(ii) of this section) are treated as a single activity of the taxpayer if the operations of such activities constitute an integrated business and the activities are controlled by the same interests. The store activity and the repair-shop activity consist of trade or business undertakings and thus are trade or business activities. In addition, the activities are controlled by the same interests (the taxpayer), and the operations of the activities constitute an integrated business. Accordingly, the store activity and the repair-shop activity are treated as a single activity of the taxpayer.

Example (3). (i) The taxpayer owns interests in three partnerships. One partnership owns a television station, the second owns a professional sports franchise, and the third owns a motion-picture production company. The operations of the partnerships are treated as three separate undertakings. Although other persons own interests in the partnerships, all three undertakings are controlled (within the meaning of paragraph (j) of this section) by the taxpayer. The operations of the partnerships are treated as three separate activities (the "television activity," the "sports activity," and the "motion-picture activity"). (Assume that the undertakings are not similar and are not treated as part of the same activity under paragraph (f) of this section.)

(ii) Each partnership prepares financial statements that reflect only the results of that partnership's operations, and each of the activities is conducted under its own trade name. The taxpayer participates extensively in the management of each partnership and makes the major business decisions for all three partnerships. Each partnership, however, employs separate management and other personnel who conduct its operations on a day-to-day basis. The taxpayer generally arranges the partnerships' financing and often obtains loans for two, or all three, partnerships from the same source. Although the assets of one partnership are not used as security for loans to another partnership, the taxpayer's interest in a partnership may secure loans to the other partnerships. The television station broadcasts the sports franchise's games, and the motion-picture production company occasionally prepares programming for the television station. In addition, support staff of one partnership may, during periods of peak activity or in the case of emergency, be made available to another partnership on a temporary basis. There are no other significant transactions between the partnerships. Moreover, all transactions between the partnerships involve essentially the same terms as would be provided in transactions between unrelated persons.

(iii) Based on the foregoing facts and circumstances, the television activity, the sports activity, and the motion-picture activity constitute three separate businesses. Paragraph (g)(3) of this section provides that the factors relevant to this determination include the treatment of the activities as separate units in the partnerships' financial statements, the use of a different trade name for each activity, the separate day-to-day management of the activities, and the limited extent to which the activities contribute to or depend on each other (as evidenced by the small number of significant transactions between the partnerships and the arm's length nature of those transactions). The taxpayer's participation in management and financing are taken into account in this determination, as are the transactions between the partnerships, but these factors do not of themselves support a determination that the activities constitute an integrated business.

(iv) Paragraph (g)(2) of this section provides that a taxpayer's interests in two or more trade or business activities (within the meaning of paragraph (g)(1)(ii) of this section) are treated as a single activity of the taxpayer only if the operations of such activities constitute an integrated business and the activities are controlled by the same interests. In this case, the taxpayer's activities do not constitute an integrated business, and the aggregation rule in paragraph (g)(2) of this section does not apply. Accordingly, the television activity, the sports activity, and the motion-picture activity are treated as three separate activities of the taxpayer.

(h) *Certain professional service undertakings treated as a single activity*—(1) *Applicability*—(i) *In general.* This paragraph (h) applies to a taxpayer's interests in professional service undertakings (within the meaning of paragraph (h)(1)(ii) of this section).

(ii) *Professional service undertaking.* For purposes of this paragraph (h), an undertaking is treated as a professional service undertaking for any taxable year in which the undertaking derives more than 50 percent of its gross income from the provision of services that are treated, for purposes of section 448(d)(2)(A) and the regulations thereunder, as services performed in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting.

(2) *Treatment as a single activity*—(i) *Undertakings controlled by the same interests.* A taxpayer's interests in two or more professional service undertakings that are controlled by the same interests (within the meaning of paragraph (j) of this section) shall be treated as part of the same activity of the taxpayer.

(ii) *Undertakings involving significant similar or significant related services.* A taxpayer's interests in two or more professional service undertakings that involve the provision of significant similar services or significant related services shall be treated as part of the same activity of the taxpayer.

(iii) *Coordination rule.* (A) Except as provided in paragraph (h)(2)(iii)(B) of this section, a taxpayer's interests in two or more undertakings (the "original undertakings") that are treated as part of the same activity of the taxpayer under the provisions of paragraph (h)(2)(i) or (ii) of this section shall be treated as interests in a single professional service undertaking (the "aggregated undertaking") for purposes of reapplying such provisions.

(B) If any original undertaking included in an aggregated undertaking and any other undertaking that is not included in such aggregated undertaking involve the provision of significant similar or related services, the aggregated undertaking and such other undertaking shall be treated as undertakings that involve the provision of significant similar or related services for purposes of reapplying the provisions of paragraph (h)(2)(ii) of this section.

(3) *Significant similar or significant related services.* For purposes of this paragraph (h)—

(i) Services (other than consulting services) in any field described in paragraph (h)(1)(ii) of this section are similar to all other services in the same field;

(ii) All the facts and circumstances are taken into account in determining whether consulting services are similar;

(iii) Two professional service undertakings involve the provision of significant similar services if and only if—

(A) Each such undertaking provides significant professional services; and

(B) Significant professional services provided by one such undertaking are similar to significant professional services provided by the other such undertaking;

(iv) Services are significant professional services if and only if such services are in a field described in paragraph (h)(1)(ii) of this section and more than 20 percent of the undertaking's gross income is attributable to services in such field (or, in the case of consulting services, to similar services in such field); and

(v) Two professional service undertakings involve the provision of significant related services if and only if more than 20 percent of the gross income of one such undertaking is derived from customers that are also customers of the other such undertaking.

(4) *Examples.* The following examples illustrate the application of this paragraph (h). In each example that does not state otherwise, the taxpayer is an individual, and the facts, analysis, and conclusions relate to a single taxable year.

Example (1). (i) The taxpayer is a partner in a law partnership that has offices in various cities. Some of the partnership's offices provide a full range of legal services. Other offices, however, specialize in a particular area or areas of the law (*e.g.*, litigation, tax law, corporate law, *etc.*). In either case, substantially all of the office's gross income is derived from the provision of legal services. Under paragraph (c)(1) of this section, each of the law partnership's offices is treated as a single undertaking that is separate from other undertakings (a "law-office undertaking").

(ii) Each law-office undertaking derives more than 50 percent of its gross income from the provision of services in the field of law. Thus, each such undertaking is treated as a professional service undertaking (within the meaning of paragraph (h)(1)(ii) of this section).

(iii) Each law-office undertaking derives more than 20 percent of its gross income from services in the field of law. Thus, each such undertaking involves significant professional services (within the meaning of paragraph (h)(3)(iv) of this section) in the field of law. In addition, all services in the field of law are treated as similar services under paragraph (h)(3)(i) of this section. Thus, the law-office undertakings involve the provision of significant similar services (within the meaning of paragraph (h)(3)(iii) of this section).

(iv) Paragraph (h)(2)(ii) of this section provides that a taxpayer's interests in professional service undertakings that involve the provision of significant similar services are treated as part of the same activity of the taxpayer. Accordingly, the taxpayer's interests in the law-office undertakings are treated as part of the same activity of the taxpayer under paragraph (h)(2)(ii) of this section even if the undertakings are not controlled by the same interests (within the meaning of paragraph (j) of this section).

Example (2). (i) The taxpayer is a partner in medical partnerships A and B. Both partnerships derive all of their gross income from the provision of medical services, but partnership A specializes in internal medicine and partnership B operates a radiology laboratory. Under paragraph (c)(1) of this section, the medical-service business of each partnership is treated as a single undertaking that is separate from other undertakings (a "medical-service undertaking"). Partnerships A and B are not controlled by the same interests (within the meaning of paragraph (j) of this section).

(ii) Each partnership's medical-service undertaking derives more than 50 percent of its gross income from the provision of services in the field of health. Thus, each partnership's medical-service undertaking is treated as a professional service undertaking (within the meaning of paragraph (h)(1)(ii) of this section).

(iii) Each partnership's medical-service undertaking derives more than 20 percent of its gross income from services in the field of health. Thus, each such undertaking involves significant professional services (within the meaning of paragraph (h)(3)(iv) of this section) in the field of health. In addition, all services in the field of health are treated as similar services under paragraph (h)(3)(i) of this section. Thus, the medicalservice undertakings of partnerships A and B involve the provision of significant similar services (within the meaning of paragraph (h)(3)(iii) of this section).

(iv) Paragraph (h)(2)(ii) of this section provides that a taxpayer's interests in professional service undertakings that involve the provision of significant similar services are treated as part of the same activity of the taxpayer. Accordingly, the taxpayer's interests in the medical-service undertakings of partnerships A and B are treated as part of the same activity of the taxpayer under paragraph (h)(2)(ii) of this section even though the undertakings are not controlled by the same interests.

Example (3). (i) The facts are the same as in example (2), except that the taxpayer withdraws from partnership A in 1989 and becomes a partner in partnership B in 1990. In addition, the taxpayer was a full-time participant in the operations of partnership A from 1970 through 1989, but does not participate in the operations of partnership B.

(ii) Paragraph (h)(2)(ii) of this section provides that a taxpayer's interests in professional service undertakings that involve the provision of significant similar services are treated as part of the same activity of the taxpayer. This rule is not limited to cases in which the taxpayer holds such interests simultaneously. Thus, as in example (2), the taxpayer's interests in the medical-service undertakings of partnerships A and B are treated as part of the same activity of the taxpayer.

(iii) The activity that includes the taxpayer's interests in the medical-service undertakings of partnerships A and B is a personal service activity (within the meaning of §1.469-5T(d)) because it involves the performance of personal services in the field of health. In addition, the taxpayer materially participated in the activity for three or more taxable years preceding 1990 (see §1.469-5T(j)(1)). Thus, even if the taxpayer does not work in the activity after 1989, the taxpayer is treated, under §1.469-5T(a)(6), as materially participating in the activity for 1990 and subsequent taxable years.

Example (4). (i) The taxpayer is a partner in an accounting partnership that has offices in various cities (partnership A) and in a management-consulting partnership that has a single office (partnership B). Each of partnership A's offices derives substantially all of its gross income from services in the field of accounting, and partnership B derives substantially all of its gross income from services in the field of consulting. Under paragraph (c)(1) of this section, partnership B's consulting business is treated as a single undertaking that is separate from other undertakings (the "consulting undertaking") and each of partnership A's offices is similarly treated (the "accounting undertakings"). The accounting undertakings are controlled by the same interests, but partnerships A and B are not controlled by the same interests (within the meaning of paragraph (j) of this section). Partnership B's consulting business derives 50 percent of its gross income from customers of partnership A's accounting undertakings, but does not derive more than 20 percent of its gross income from the customers of any single accounting undertaking.

(ii) Each accounting undertaking derives more than 50 percent of its gross income from the provision of services in the field of accounting, and the consulting undertaking derives more than 50 percent of its gross income from the provision of services in the field of consulting. Thus, each accounting undertaking is treated as a professional service undertaking (within the meaning of paragraph (h)(1)(ii) of this section), and the consulting undertaking is also treated as a professional service undertaking.

(iii) Each accounting undertaking derives more than 20 percent of its gross income from services in the field of accounting. Thus, each such undertaking involves significant professional services (within the meaning of paragraph (h)(3)(iv) of this section) in the field of accounting. In addition, all services in the field of accounting are treated as similar services under paragraph (h)(3)(i) of this section. Thus, the accounting undertakings involve the provision of significant similar services (within the meaning of paragraph (h)(3)(iii) of this section).

(iv) Paragraph (h)(2)(i) and (ii) of this section provides that a taxpayer's interests in professional service undertakings that are controlled by the same interests or that involve the provision of significant similar services are treated as part of the same activity of the taxpayer. The accounting undertakings are controlled by the same interests (see (i) above) and involve the provision of significant similar services (see (iii) above). Accordingly, the taxpayer's interests in the accounting undertakings are treated as part of the same activity under paragraph (h)(2)(i) and (ii) of this section.

(v) The consulting undertaking derives more than 20 percent of its gross income from services in the field of consulting. If, based on all the facts and circumstances, these services are determined to be similar consulting services under paragraph (h)(3)(ii) of this section, the consulting undertaking involves significant professional services (within the meaning of paragraph (h)(3)(iv) of this section). In this case, however, the consulting undertaking and the accounting undertakings do not involve the provision of significant similar services (within the meaning of paragraph (h)(3)(iii) of this section) because consulting services and accounting services are not treated as similar services under paragraph (h)(3)(i) of this section.

(vi) The consulting undertaking does not derive more than 20 percent of its gross income from the customers of any single accounting undertaking of partnership A. If, however, partnership A's accounting undertakings are aggregated, the consulting undertaking derives more than 20 percent of its gross income from customers of the aggregated undertakings. Paragraph (h)(3)(v) of this section provides that two professional service undertakings involve the provision of significant related services if more than 20 percent of the gross income of one undertaking is derived from customers of the other undertaking. For purposes of applying this rule, partnership A's accounting undertakings are treated as a single undertaking under paragraph (h)(2)(iii) of this section because the accounting undertakings are treated as part of the same activity under paragraph (h)(2)(i) and (ii) of this section. Thus, the consulting undertaking and the accounting undertakings involve the provision of significant related services.

(vii) Paragraph (h)(2)(ii) of this section provides that a taxpayer's interests in professional service undertakings that involve the provision of significant related services are treated as part of the same activity of the taxpayer. Accordingly, the taxpayer's interests in the consulting undertaking and the accounting undertakings are treated as part of the same activity of the taxpayer under paragraph (h)(2)(ii) of this section.

Example (5). (i) The facts are the same as in example (4), except that partnership B's consulting business derives only 15 percent of its gross income from customers of partnership A's accounting undertakings.

(ii) As in example (4), the taxpayer's interests in the accounting undertakings are treated as part of the same activity under paragraph (h)(2)(i) and (ii) of this section and are treated under paragraph (h)(2)(iii) of this section as a single undertaking for purposes of reapplying those provisions. In this case, however, the consulting undertaking does not derive more than 20 percent of its gross income from the customers of partnership A's accounting undertakings. Thus, the consulting undertaking and the accounting undertakings do not involve the provision of significant related services. Accordingly, the accounting undertakings and the consulting undertaking are not treated as part of the same activity under paragraph (h)(2)(i) or (ii) of this section because they are not controlled by the same interests and do not involve the provision of significant similar or related services.

Example (6). (i) The taxpayer is a partner in partnerships A, B, and C. Partnership A derives substantially all of its gross income from the provision of engineering services, partnership B derives substantially all of its gross income from the provision of architectural services, and partnership C derives 40 percent of its gross income from the provision of engineering services and the remainder from the provision of architectural services. Under paragraph (c)(1) of this section, each partnership's service business is treated as a single undertaking that is separate from other undertakings. Partnerships A, B, and C are not controlled by the same interests (within the meaning of paragraph (j) of this section).

(ii) Each partnership's undertaking derives more than 50 percent of its gross income from the provision of services in the fields of architecture and engineering. Thus, each such undertaking is treated as a professional service undertaking (within the meaning of paragraph (h)(1)(ii) of this section).

(iii) Partnership A's undertaking ("undertaking A") derives more than 20 percent of its gross income from services in the field of engineering, partnership B's undertaking ("undertaking B") derives more than 20 percent of its gross income from services in the field of architecture, and partnership C's undertaking ("undertaking C") derives more than 20 percent of its gross income from services in the field of engineering and more than 20 percent of its gross income from services in the field of architecture. Thus, undertaking A involves significant services in the field of engineering, undertaking B involves significant services in the field of architecture, and undertaking C involves significant services in both fields. Under paragraph (h)(3)(i) of this section, all services within each field are treated as similar services, but engineering services and architectural services are not treated as similar services. Thus, undertakings A and C, and undertakings B and C, involve the provision of significant similar services (within the meaning of paragraph (h)(3)(iii) of this section).

(iv) Paragraph (h)(2)(ii) of this section provides that a taxpayer's interests in professional service undertakings that involve the provision of significant similar services are treated as part of the same activity of the taxpayer. Accordingly, the taxpayer's interests in undertakings A and C are treated as part of the same activity of the taxpayer.

(v) Under paragraph (h)(2)(iii)(A) of this section, undertakings A and C are also treated as a single undertaking for purposes of determining whether undertaking B involves the provision of significant similar services. Paragraph (h)(2)(iii)(B) of this section in effect provides that treating undertakings A and C as a single undertaking does not affect the conclusion that the architectural services provided by undertakings B and C are significant similar services. Thus, undertaking B and the single undertaking in which undertakings A and C are included under paragraph (h)(3)(iii) of this section involve the provision of significant similar services, and the taxpayer's interests in undertakings A, B, and C are treated as part of the same activity of the taxpayer under paragraph (h)(2)(ii) of this section.

(i) [Reserved.]

(j) *Control by the same interests and ownership percentage*—(1) *In general.* Except as otherwise provided in paragraph (j)(2) of this section, all the facts and circumstances are taken into account in determining, for purposes of this section, whether undertakings are controlled by the same interests. For this purpose, control includes any kind of control, direct or indirect, whether legally enforceable, and however exercisable or exercised. It is the reality of control that is determinative, and not its form or mode of exercise.

(2) *Presumption*—(i) *In general.* Undertakings are rebuttably presumed to be controlled by the same interests if such undertakings are part of the same common-ownership group.

(ii) *Common-ownership group.* Except as provided in paragraph (j)(2)(iii) of this section, two or more undertakings of a taxpayer are part of the same common-ownership group for purposes of this paragraph (j)(2) if and only if the sum of the common-ownership percentages of any five or fewer persons (within the meaning of section 7701(a)(1), but not including passthrough entities) with respect to such undertakings exceeds 50 percent. For this purpose, the common-ownership percentage of a person with respect to such undertakings is the person's smallest ownership percentage (determined in accordance with paragraph (j)(3) of this section) in any such undertaking.

(iii) *Special aggregation rule.* If, without regard to this paragraph (j)(2)(iii), an undertaking of a taxpayer is part of two or more common-ownership groups, any undertakings of the taxpayer that are part of any such common-ownership group shall be treated for purposes of this paragraph (j)(2) as part of a single common-ownership group in determining the activities of such taxpayer.

(3) *Ownership percentage*—(i) *In general.* For purposes of this section, a person's ownership percentage in an undertaking or in a passthrough entity shall include any interest in such undertaking or passthrough entity that the person holds directly and the person's share of any interest in such undertaking or passthrough entity that is held through one or more passthrough entities.

(ii) *Passthrough entities.* The following rules apply for purposes of applying paragraph (j)(3)(i) of this section:

(A) A partner's interest in a partnership and share of any interest in a passthrough entity or undertaking held through a partnership shall be determined on the basis of the greater of such partner's percentage interest in the capital (by value) of such partnership or such partner's largest distributive share of any item of income or gain (disregarding guaranteed payments under section 707(c)) of such partnership.

(B) A shareholder's interest in an S corporation and share of any interest in a passthrough entity or undertaking held through an S corporation shall be determined on the basis of such shareholder's stock ownership.

(C) A beneficiary's interest in a trust or estate and share of any interest in a passthrough entity or undertaking held through a trust or estate shall not be taken into account.

(iii) *Attribution rules*—(A) *In general.* Except as otherwise provided in paragraph (j)(3)(iii)(B) of this section, a person's ownership percentage in a passthrough entity or in an undertaking shall be determined by treating such person as the owner of any interest that a person related to such person owns (determined without regard to this paragraph (j)(3)(iii)) in such passthrough entity or in such undertaking.

(B) *Determination of common-ownership percentage*. The common-ownership percentage of five or fewer persons with respect to two or more undertakings shall be determined, in any case in which, after the application of paragraph (j)(3)(iii)(A) of this section, two or more such persons own the same interest in any such undertaking (the "related-party owners") by treating as the only owner of such interest (or portion thereof) the related-party owner whose ownership of such interest (or a portion thereof) would result in the highest common-ownership percentage.

(C) *Related person*. A person is related to another person for purposes of this paragraph (j)(3)(iii) if the relationship of such persons is described in section 267(b) or 707(b)(1).

(4) *Special rule for trade or business activities*. In determining whether two or more trade or business activities are controlled by the same interests for purposes of paragraph (g) of this section, each such activity shall be treated as a separate undertaking in applying this paragraph (j).

(5) *Examples*. The following examples illustrate the application of this paragraph (j):

Example (1). (i) Partnership X is the sole owner of an undertaking (undertaking X), and partnership Y is the sole owner of another undertaking (undertaking Y). Individuals A, B, C, D, and E are the only partners in partnerships X and Y, and the partnership agreements of both X and Y provide that no action may be taken or decision made on behalf of the partnership without the unanimous consent of the partners. Moreover, each partner actually participates in, and agrees to, all major decisions that affect the operations of either partnership. The ownership percentages (within the meaning of paragraph (j)(3) of this section) of A, B, C, D, and E in each partnership (and in the undertaking owned by the partnership) are as follows:

	Partnership/Undertaking	
Partner	*X*	*Y*
A	15%	5%
B	10%	60%
C	10%	20%
D	77%	12%
E	8%	20%
	120%	117%

(The sum of the ownership percentages exceeds 100 percent for both X and Y because, under paragraph (j)(3)(ii)(A) of this section, each partner's ownership percentage is determined on the basis of the greater of the partner's percentage interest in the capital of the partnership or the partner's largest distributive share of any item of income or gain of the partnership.)

(ii) Paragraph (j)(2)(ii) of this section provides that a person's common-ownership percentage with respect to any two or more undertakings is the person's smallest ownership percentage in any such undertaking. Thus, the common-ownership percentages of A, B, C, D, and E with respect to undertakings X and Y are as follows:

Partner	*Common-ownership percentage*
A	5%
B	10%
C	10%
D	12%
E	8%
	45%

(iii) Paragraph (j)(2)(i) of this section provides that undertakings are rebuttably presumed to be controlled by the same interests if the undertakings are part of the same common-ownership group. In general, undertakings are part of a common-ownership group only if the sum of the common-ownership percentages of any five or fewer persons with respect to such undertakings exceeds 50 percent. In this case, the sum of the partners' common-ownership percentages with respect to undertakings X and Y is only 45 percent. Thus, undertakings X and Y are not part of the same common-ownership group.

(iv) If the presumption in paragraph (j)(2)(i) of this section does not apply, all the facts and circumstances are taken into account in determining whether undertakings are controlled by the same interests (see paragraph (j)(1) of this section). In this case, all actions and decisions in both undertakings require the unanimous consent of the same persons and each of those persons actually participates in, and agrees to, all major decisions. Accordingly, undertakings X and Y are controlled by the same interests (*i.e.*, A, B, C, D, and E).

Example (2). (i) Partnerships W, X, Y, and Z are each the sole owner of an undertaking (undertakings W, X, Y, and Z). Individuals A, B, and C are partners in each of the four partnerships, and the remaining interests in each partnership are owned by a number of unrelated individuals, none of whom owns more than a one-percent interest in any of the partnerships. The ownership percentages (within the meaning of paragraph (j)(3) of this section) of A, B, and C in each partnership (and in the undertaking owned by the partnership) are as follows:

	Partner		
Partnership/ Undertaking	*A*	*B*	*C*
W	23%	21%	40%
X	19%	30%	22%
Y	25%	25%	20%
Z	8%	4%	2%

(ii) Paragraph (j)(2)(ii) of this section provides that a person's common-ownership percentage with respect to any two or more undertakings is the person's smallest ownership percentage in any such undertaking. Thus, the common-ownership percentages of A, B, and C in undertakings W, X, Y, and Z are as follows:

Partner	*Common ownership percentage*
A	8%
B	4%
C	2%
	14%

(iii) The sum of the common-ownership percentages of A, B, and C with respect to undertakings W, X, Y, and Z is 14 percent, and no other person owns more than a one-percent interest in any of the undertakings. Thus, the sum of the common-ownership percentages of any five or fewer persons with respect to all four undertakings cannot exceed 50 percent. Accordingly, undertakings W, X, Y, and Z are not part of the same common-ownership group (see paragraph (j)(2)(ii) of this section) and are not rebuttably presumed to be controlled by the same interests (see paragraph (j)(2)(i) of this section).

(iv) The common-ownership percentages of A, B, and C in undertakings W, X, and Y are as follows:

Partner	*Common ownership percentage*
A	19%
B	21%
C	20%
	60%

(v) The sum of the common-ownership percentages of A, B, and C, taking into account only undertakings W, X, and Y, is 60 percent. Because the sum of the common-ownership percentages exceeds 50 percent, undertakings W, X, and Y are part of the same common-ownership group (see paragraph (j)(2)(ii) of this section) and are rebuttably presumed to be controlled by the same interests (see paragraph (j)(2)(i) of this section).

Example (3). (i) Corporation X, an S corporation, is the sole owner of an undertaking (undertaking X), and corporation Y, another S corporation, is the sole owner of another undertaking (undertaking Y). Individuals A, B, and C are shareholders in corporations X and Y. Both A and B are related (within the meaning of paragraph (j)(3)(iii)(C) of this section) to C, but not to each other. A, B, and C are not related to any other person that owns an interest in either corporation X or corporation Y. The ownership percentages (determined without regard to the attribution rules of paragraph (j)(3)(iii) of this section) of A, B, and C in each corporation (and in the undertaking owned by the corporation) are as follows:

	Corporation/Undertaking	
Shareholder	*X*	*Y*
A	20%	—
B	—	20%
C	5%	5%

(ii) In general, a person's ownership percentage is determined by treating the person as the owner of interests that are actually owned by related persons (see paragraph (j)(3)(iii)(A) of this section). If A, B, and C are treated as owning interests that are actually owned by related persons, their ownership percentages are as follows:

	Corporation/Undertaking	
Shareholder	*X*	*Y*
A	25%	5%
B	5%	25%
C	25%	25%

(iii) Paragraph (j)(3)(iii)(B) of this section provides that, in determining the sum of the common-ownership percentages of any five or fewer persons with respect to any undertakings, each interest in such undertakings is counted only once. If two or more persons are treated as owners of the same interest under paragraph (j)(3)(iii)(A) of this section, the person whose ownership would result in the highest sum is treated as the only owner of the interest. In this case, C's common-ownership percentage with respect to undertakings X and Y, determined by treating C as the owner of the interests actually owned by A and B, is 25 percent. If, however, A and B are treated as the owners of the interests actually owned by C, each has a common-ownership percentage of only five percent. Thus, in determining the sum of common-ownership percentages with respect to undertakings X and Y, C is treated as the owner of the interests actually owned by A and B because this treatment results in the highest sum of common-ownership percentages with respect to such undertakings.

Example (4). (i) The ownership percentages of individuals A, B, and C in undertakings X, Y, and Z are as follows:

	Undertaking		
Individual	*X*	*Y*	*Z*
A	30%	30%	30%
B	30%	30%	—
C	—	30%	30%

No other person owns an interest in more than one of the undertakings.

(ii) Paragraph (j)(2)(ii) of this section provides that a person's common ownership percentage with respect to any two or more undertakings is the person's smallest ownership percentage in any such undertaking. Thus, A's common-ownership percentage with respect to undertakings X, Y, and Z is 30 percent, and the common-ownership percentages of B and C (and all other persons owning interests in such undertakings) with respect to such undertakings is zero. Accordingly, the sum of the common ownership percentages with respect to undertakings X, Y, and Z is only 30 percent, and undertakings X, Y, and Z are not treated as part of the same common-ownership group under paragraph (j)(2)(ii) of this section.

(iii) B's common-ownership percentage with respect to undertakings X and Y is 30 percent, and the sum of A's and B's common-ownership percentages with respect to such undertakings is 60 percent. Thus, undertakings X and Y are treated as part of the same common-ownership group under paragraph (j)(2)(ii) of this section. Similarly, C's common-ownership percentage with respect to undertakings Y and Z is 30 percent, and the sum of A's and C's common-ownership percentages with respect to such undertakings is 60 percent. Thus, undertakings Y and Z are also treated as part of the same common-ownership group under paragraph (j)(2)(ii) of this section.

(iv) Paragraph (j)(2)(iii) of this section requires the aggregation of common-ownership groups that include the same undertaking. In this case, undertaking Y is treated as part of the common-ownership group XY and as part of the common-ownership group YZ. Accordingly, undertakings X, Y, and Z are treated as part of a single common-ownership group and are rebuttably presumed to be controlled by the same interests (see paragraph (j)(2)(i) of this section) even though B does not own an interest in undertaking Z and C does not own an interest in undertaking X. The fact that B and C are not common owners with respect to undertakings X and Z is taken into account, however, in determining whether this presumption is rebutted.

(k) *Identification of rental real estate activities*—(1) *Applicability*—(i) *In general*. Except as otherwise provided in paragraph (k)(6) of this section, this paragraph (k) applies to a taxpayer's interests in rental real estate undertakings (within the meaning of paragraph (k)(1)(ii) of this section).

(ii) *Rental real estate undertaking*. For purposes of this paragraph (k), a rental real estate undertaking is a rental undertaking (within the meaning of paragraph (d) of this section) in which at least 85 percent of the unadjusted basis (within the meaning of §1.469-2T(f)(3)) of the property made available for use by customers is real property. For this purpose the term "real property" means any tangible property other than tangible personal property (within the meaning of §1.48-1 (c)).

(2) *Identification of activities*—(i) *Multiple undertakings treated as a single activity or multiple activities by taxpayer*. Except as otherwise provided in this paragraph (k), a taxpayer may treat two or more rental real estate undertakings (determined after the application of paragraph (k)(2)(ii) and (iii) of this section) as a single activity or may treat such undertakings as separate activities.

(ii) *Multiple undertakings treated as a single activity by passthrough entity*. A taxpayer must treat two or more rental real estate undertakings as a single rental real estate undertaking for a taxable year if any passthrough entity through which the taxpayer holds such undertakings treats such undertakings as a single activity on the applicable return of the passthrough entity for the taxable year of the taxpayer.

(iii) *Single undertaking treated as multiple undertakings*. Notwithstanding that a taxpayer's interest in leased property would, but for the application of this paragraph (k)(2)(iii), be treated as used in a single rental real estate undertaking, the taxpayer may, except as otherwise provided in paragraph (k)(3) of this section, treat a portion of the leased property (including a ratable portion of any common areas or facilities) as a rental real estate undertaking that is separate from the undertaking or undertakings in which the remaining portion of the property is treated as used. This paragraph (k)(2)(iii) shall apply for a taxable year if and only if—

(A) Such portion of the leased property can be separately conveyed under applicable State and local law (taking into account the limitations, if any, imposed by any special rules or procedures, such as condominium conversion laws, restricting the separate conveyance of parts of the same structure); and

(B) The taxpayer holds such leased property directly or through one or more passthrough entities, each of which treats such portion of the leased property as a separate activity on the applicable return of the passthrough entity for the taxable year of the taxpayer.

(3) *Treatment in succeeding taxable years*. All rental real estate undertakings or portions of such undertakings that are treated, under this paragraph (k), as part of the same activity for a taxable year ending after August 9, 1989, must be treated as part of the same activity in each succeeding taxable year.

(4) *Applicable return of passthrough entity*. For purposes of this paragraph (k), the applicable return of a passthrough entity for a taxable year of a taxpayer is the return reporting the passthrough entity's income, gain, loss, deductions, and credits taken into account by the taxpayer for such taxable year.

(5) *Evidence of treatment required*. For purposes of this paragraph (k), a person (including a passthrough entity) does not treat a rental real estate undertaking as multiple undertakings for a taxable year or, except as otherwise provided in paragraph (k)(2)(ii) or (3) of this section, treat multiple rental real estate undertakings as a single undertaking for a taxable year unless such treatment is reflected on a schedule attached to the person's return for the taxable year.

(6) *Coordination rule for rental of nondepreciable property*. This paragraph (k) shall not apply to a rental real estate undertaking if less than 30 percent of the unadjusted basis (within the meaning of §1.469-2T(f)(3)) of property used or held for use by customers in such undertaking during the taxable year is subject to the allowance for depreciation under section 167.

(7) *Coordination rule for rental of dwelling unit*. For any taxable year in which section 280A(c)(5) applies to a taxpayer's use of a dwelling unit—

(i) Paragraph (k)(2) and (3) of this section shall not apply to the taxpayer's interest in such dwelling unit; and

(ii) The taxpayer's interest in such dwelling unit shall be treated as a separate activity of the taxpayer.

(8) *Examples*. The following examples illustrate the application of this paragraph (k). In each example, the taxpayer is an individual whose taxable year is the calendar year.

Example (1). (i) In 1989, the taxpayer directly owns five condominium units (units A, B, C, D, and E) in three different buildings. Units A, B, and C are in one of the buildings and constitute a single rental real estate undertaking (within the meaning of paragraph (k)(1)(ii) of this section). Units D and E are in the other two buildings, and each of these units constitutes a separate rental real estate undertaking. Each of the units can be separately conveyed under applicable State and local law.

(ii) Paragraph (k)(2)(iii) of this section permits a taxpayer to treat a portion of the property included in a rental real estate undertaking as a separate rental real estate undertaking if the property can be separately conveyed under applicable State and local law and the taxpayer owns the property directly. Thus, the taxpayer can treat units A, B, and C as three separate undertakings. Alternatively, the taxpayer could treat two of those units (*e.g.*, units A and C) as an undertaking and the remaining unit as a separate undertaking, or could treat units A, B, and C as a single undertaking.

(iii) Paragraph (k)(2)(i) of this section permits a taxpayer to treat two or more rental real estate undertakings as a single activity, or to treat such undertakings as separate activities. Thus, the taxpayer, by combining undertakings, can treat all five units as a single activity. Alternatively, the taxpayer could treat each undertaking as a separate activity, or could combine some, but not all, undertakings. Thus, for example, the taxpayer could treat units A, B, C, and D as an activity and unit E as a separate activity.

(iv) For purposes of paragraph (k)(2)(i) of this section, a taxpayer's rental real estate undertakings are determined after the application of paragraph (k)(2)(iii) of this section. Thus, the taxpayer, by treating units as separate undertakings under paragraph (k)(2)(iii) of this section and combining them with other units under paragraph (k)(2)(i) of this section, can treat any combination of units as a single activity. For example, the taxpayer could treat units A and B as a separate rental real estate undertaking, and then treat units A, B, and D as a single activity. In that case, the taxpayer could treat units C and E either as a single activity or as two separate activities.

Example (2). (i) The facts are the same as in example (1). In addition, the taxpayer treats all five units as a single activity for 1989 and sells unit E in 1990. (See paragraph (k)(5) of this section for a rule providing that the units are treated as a single activity only if such treatment is reflected on a schedule attached to the taxpayer's return.)

(ii) Under paragraph (k)(3) of this section, rental real estate undertakings that are treated as part of the same activity for a taxable year must be treated as part of the same activity in each succeeding year. In this case, all five units were treated as part of the same activity for 1989 and must therefore be treated as part of the same activity for 1990. Accordingly, the taxpayer's sale of unit E in 1990 cannot be treated as a disposition of the taxpayer's entire interest in an activity for purposes of section 469(g) and the rules to be contained in §1.469-6T (relating to the treatment of losses upon certain dispositions of passive and former passive activities).

Example (3). (i) The facts are the same as in example (1), except that the taxpayer is a partner in a partnership that is the direct owner of the five condominium units. In its return for its taxable year ending on November 30, 1989, the partnership treats the five units as a single activity. (See paragraph (k)(5) of this section for a rule providing that the units are treated as a single activity only if such treatment is reflected on a schedule attached to the partnership's return.) The partnership sells unit E on November 1, 1990.

(ii) Paragraph (k)(2)(ii) of this section provides that a taxpayer who holds rental real estate undertakings through a passthrough entity must treat those undertakings as a single rental real estate undertaking if they are treated as a single activity on the applicable return of the passthrough entity. Under paragraph (k)(4) of this section, the applicable return of the partnership for the taxpayer's 1989 taxable year is the partnership's return for its taxable year ending on November 30, 1989. Accordingly, the taxpayer must treat the five condominium units as a single rental real estate undertaking (and thus as part of the same activity) for 1989 because they are treated as a single activity on the partnership's return for its taxable year ending in 1989.

(iii) Under paragraph (k)(3) of this section, the taxpayer must continue treating the condominium units as part of the same activity for taxable years after 1989. Accordingly, as in example (2), the five condominium units are treated as part of the same activity for 1990, and the sale of unit E in 1990 cannot be treated as a disposition of the taxpayer's interest in an activity for purposes of section 469 (g) and the rules to be contained in §1.469-6T.

Example (4). (i) The taxpayer owns a shopping center and a vacant lot that are separate rental real estate undertakings (within the meaning of paragraph (k)(1)(ii) of this section). The taxpayer rents space in the shopping center to various tenants and rents the vacant lot to a parking lot operator. Most of the unadjusted basis of the property used in the shopping-center undertaking (taking into account the land on which the shopping center is built) is subject to the allowance for depreciation, but no depreciable property is used in the parking-lot undertaking.

(ii) This paragraph (k) provides rules for identifying rental real estate activities (including the rule in paragraph (k)(2)(i) of this section that permits a taxpayer to treat two or more rental real estate undertakings as a single activity). Paragraph (k)(6) of this section provides, however, that these rules do not apply to a rental real estate undertaking if less than 30 percent of the unadjusted basis of the property used in the undertaking is subject to the allowance for depreciation. Thus, the taxpayer may not combine the parking-lot undertaking, which includes no depreciable property, with the shopping-center undertaking or any other rental real estate undertaking under paragraph (k)(2)(i) of this section. Accordingly, the parking lot undertaking is treated as a separate activity under paragraph (b)(1) of this section.

Example (5). (i) The facts are the same as in example (4), except that the shopping center and the vacant lot are at the same location (within the meaning of paragraph (c)(2)(iii) of this section) and are part of the same rental real estate undertaking (within the meaning of paragraph (k)(1)(ii) of this section). Taking into account the property used in the shopping center operations (including the land on which the shopping center is built) and the vacant lot, 50 percent of the unadjusted basis of the property used in the undertaking is subject to the allowance for depreciation.

(ii) In this case, the vacant lot is used in a rental real estate undertaking in which depreciable property is also used. Moreover, the exception in paragraph (k)(6) of this section does not apply to the undertaking consisting of the shopping center and the parking lot because at least 30 percent of unadjusted basis of the property used in the undertaking is subject to the allowance for depreciation. Accordingly, the taxpayer may combine the undertaking with other rental real estate undertakings and treat the combined undertakings as a single activity under paragraph (k)(2)(i) of this section.

(l) [Reserved.]

(m) *Consolidated groups*—(1) *In general.* The activities of a consolidated group (within the meaning of §1.469-1T(h)(2)(ii)) and of each member of such group shall be determined under this section as if the consolidated group were one taxpayer.

(2) *Examples.* The following examples illustrate the application of this paragraph (m). In each example, the facts, analysis, and conclusions relate to a single taxable year.

Example (1). (i) Corporations M, N, and O are the members of a consolidated group (within the meaning of §1.469-1T(h)(2)(ii)). Under §1.469-1T(h)(4)(i)(A) and (ii), the consolidated group and its members are treated as closely held corporations (within the meaning of §1.469-1T(g)(2)(ii)). Each member of the consolidated group owns a two-percent interest in partnership X and a two-percent interest in partnership Y, and owns interests in a number of trade or business undertakings (within the meaning of paragraph (f)(1)(ii) of this section) through the partnerships. Each of these undertakings is directly owned by partnership X or Y, and all the undertakings of partnerships X and Y are controlled by the same interests (within the meaning of paragraph (j) of this section) and are similar (within the meaning of paragraph (f)(4) of this section). The employees of the consolidated group and the shareholders of its common parent do not participate in the undertakings that the member corporations own through the partnerships.

(ii) Paragraph (f)(2)(i) of this section provides that trade or business undertakings that are similar and controlled by the same interests are treated as part of the same activity of the taxpayer if the taxpayer owns interests in the undertakings through the same passthrough entity. In this case, the member corporations own interests in similar, commonly-controlled undertakings through both partnerships, and such interests are treated under this paragraph (m) as interests owned by one taxpayer (the consolidated group). Accordingly, the member corporations' interests in the undertakings owned through partnership X are treated as part of the same activity of the consolidated group, and their interests in the undertakings owned through partnership Y are treated similarly.

Example (2). (i) The facts are the same as in example (1), except that each member of the consolidated group owns a five-percent interest in partnership X and a five-percent interest in partnership Y.

(ii) Paragraph (f)(2)(ii) of this section provides that trade or business undertakings that are similar and controlled by the same interests are treated as part of the same activity of the taxpayer if the taxpayer owns a direct or substantial indirect interest in each such undertaking. In this case, the member corporations own, in the aggregate, a 15-percent interest in partnership X and a 15-percent interest in partnership Y, and such interests are treated under this paragraph (m) as interests owned by one taxpayer (the consolidated group). Thus, the consolidated group owns a substantial indirect interest in the similar, commonly-controlled undertakings owned by partnerships X and Y (see paragraph (f)(3)(i) of this section). Accordingly, the member corporations' interests in the undertakings owned through partnerships X and Y are treated as part of the same activity of the consolidated group.

(n) *Publicly traded partnerships.* The rules of this section shall apply to a taxpayer's interest in business and rental operations held through a publicly traded partnership (within the meaning of section 469(k)(2)) as if the taxpayer had no interest in any other business and rental operations. The following example illustrates the application of this paragraph (n):

Example. (i) The taxpayer, an individual, owns a 20-percent interest in partnership X and a 15-percent interest in partnership Y. Partnership X directly owns a hotel ("hotel 1") and a commercial office building ("building 1"). Partnership Y directly owns two hotels ("hotels 2 and 3") and two commercial office buildings ("buildings 2 and 3"). Each of the three hotels is a separate trade or business undertaking (within the meaning of paragraph (f)(1)(ii) of this section), and each of the three office buildings is a separate rental real estate undertaking (within the meaning of paragraph (k)(1)(ii) of this section). The three hotel undertakings are similar (within the meaning of paragraph (f)(4) of this section) and are controlled by the same interests (within the meaning of paragraph (j) of this section). Partnership X is not a publicly traded partnership (within the meaning of section 469(k)(2)). Partnership Y, however, is a publicly traded partnership and is not treated as a corporation under section 7704.

(ii) This paragraph (n) provides that the rules of this section apply to a taxpayer's interest in business and rental operations held through a publicly traded partnership as if the taxpayer had no interest in any other business and rental operations. Thus, undertakings owned through partnership Y may be treated as part of the same activity under the rules of this section, but an undertaking owned through partnership Y and an undertaking that is not owned through partnership Y may not be treated as part of the same activity.

(iii) Paragraph (f)(2)(i) of this section provides that a taxpayer's interests in two or more trade or business undertakings that are similar and controlled by the same interests are treated as part of the same activity if the taxpayer owns interests in each undertaking through the same passthrough entity. Partnership Y's hotel undertakings (*i.e.*, hotels 2 and 3) are similar and are controlled by the same interests. In addition, the taxpayer owns interests in both undertakings through the same partnership. Accordingly, the taxpayer's interests in partnership Y's hotel undertakings are treated as part of the same activity.

(iv) The hotel undertaking owned through partnership X (*i.e.*, hotel 1) and the hotel undertakings owned through partnership Y are similar and controlled by the same interests, and the taxpayer owns a substantial indirect interest in each of the undertakings (see paragraph (f)(3)(i) of this section). Thus, the three undertakings would ordinarily be treated as part of the same activity under paragraph (f)(2)(ii) of this section. Under this paragraph (n), however, undertakings that are owned through a publicly traded partnership cannot be treated as part of the same activity as any undertaking not owned through that partnership. Accordingly, the hotel undertaking that the taxpayer owns through partnership X and the hotel undertakings that the taxpayer owns through partnership Y are treated as two separate activities.

(v) Paragraph (k)(2)(i) of this section provides that, with certain exceptions, a taxpayer may treat two or more rental real estate undertakings as a single activity or as separate activities. Thus, the taxpayer's interests in the rental real estate undertakings owned through partnership Y (*i.e.*, buildings 2 and 3) may be treated as a single activity or as separate activities. Under this paragraph (n), however, undertakings that are owned through a publicly traded partnership cannot be treated as part of the same activity as any undertaking not owned through that partnership. Accordingly, the taxpayer's interest in the rental real estate undertaking owned through partnership X (building 1) cannot be treated as part of an activity that includes any rental real estate undertaking owned through partnership Y

(o) *Elective treatment of undertakings as separate activities*—(1) *Applicability*. This paragraph applies to a taxpayer's interest in any undertaking (other than a rental real estate undertaking (within the meaning of paragraph (k)(1)(ii) of this section)) that would otherwise be treated under this section as part of an activity that includes the taxpayer's interest in any other undertaking.

(2) *Undertakings treated as separate activities*. Except as otherwise provided in this paragraph (o), a person (including a passthrough entity) shall treat an undertaking to which this paragraph (o) applies as an activity separate from the remainder of the activity in which such undertaking would otherwise be included for a taxable year if and only if, for such taxable year or any preceding taxable year, such person made an election with respect to such undertaking under this paragraph (o).

(3) *Multiple undertakings treated as a single activity by passthrough entity*. A person (including a passthrough entity) must treat interests in two or more undertakings as part of the same activity for a taxable year if any passthrough entity through which the person holds such undertakings treats such undertakings as part of the same activity on the applicable return of the passthrough entity for the taxable year of such person.

(4) *Multiple undertakings treated as a single activity for a preceding taxable year*. If a person (including a passthrough entity) treats undertakings as part of the same activity on such person's return for a taxable year ending after August 9, 1989, such person may not treat such undertakings as part of different activities under this paragraph (o) for any subsequent taxable year.

(5) *Applicable return of passthrough entity*. For purposes of this paragraph (o), the applicable return of a passthrough entity for a taxable year of a taxpayer is the return reporting the passthrough entity's income, gain, loss, deductions, and credits taken into account by the taxpayer for such taxable year.

(6) *Participation*. The following rules apply to multiple activities (the "separate activities") that would be treated as a single activity (the "original activity") if the taxpayer's activities were determined without regard to this paragraph (o):

(i) The taxpayer shall be treated as materially participating (within the meaning of §1.469-5T) for the taxable year in the separate activities if and only if the taxpayer would, but for the application of this paragraph (o), be treated as materially participating for the taxable year in the original activity.

(ii) The taxpayer shall be treated as significantly participating (within the meaning of §1.469-5T(c)(2)) for the taxable year in the separate activities if and only if the taxpayer would, but for the application of this paragraph (o), be treated as significantly participating for the taxable year in the original activity.

(7) *Election*—(i) *In general*. A person makes an election with respect to an undertaking under this paragraph (o) by attaching the written statement described in paragraph (o)(7)(ii) of this section to such person's return for the taxable year for which the election is made (see paragraph (o)(2) of this section).

(ii) *Written statement*. The written statement required by paragraph (o)(7)(i) of this section must—

(A) State the name, address, and taxpayer identification number of the person making the election;

(B) Contain a declaration that an election is being made under §1.469-4T(o);

(C) Identify the undertaking with respect to which such election is being made; and

(D) Identify the remainder of the activity in which such undertaking would otherwise be included.

(8) *Examples*. The following examples illustrate the application of this paragraph (o):

Example (1). (i) During 1989, the taxpayer, an individual whose taxable year is the calendar year, acquires and is the direct owner of ten grocery stores. The operations of each grocery store are treated under paragraph (c)(1) of this section as a single undertaking that is separate from other undertakings (a "grocery-store undertaking"), and the taxpayer's interests in the grocery-store undertakings would be treated as part of the same activity of the taxpayer under paragraph (f)(2) of this section.

(ii) Paragraph (o)(2) of this section provides that, with certain exceptions, undertakings that would be treated as part of the same activity under other rules in this section may, at the election of the taxpayer, be treated as separate activities. Thus, the taxpayer may elect to treat each grocery-store undertaking as a separate activity for 1989. Alternatively, the taxpayer may combine grocery-store undertakings in any manner and treat each combination of undertakings (and each uncombined undertaking) as a separate activity for 1989. In either case, the election must be made by attaching the written statement described in paragraph (o)(7)(ii) of this section to the taxpayer's 1989 return.

Example (2). (i) The facts are the same as in example (1). In addition, the taxpayer, in 1989, elects to treat each grocery-store undertaking as a separate activity and participates for 15 hours in each of the grocery-store undertakings.

(ii) The taxpayer's interest in each grocery-store undertaking is treated, under paragraph (o)(2) of this section, as a separate activity of the taxpayer for 1989 (a "grocery-store activity"). In 1989, however, the taxpayer participates for more than 100 hours in the activity in which the undertakings would be included (but for the election to treat the grocery-store undertakings as separate activities) and would be treated under §1.469-5T(c)(2) as significantly participating in such activity. Accordingly, the taxpayer is treated under paragraph (o)-(6)(ii) of this section as significantly participating in each of the grocery-store activities for 1989.

Example (3). (i) The facts are the same as in example (1). In addition, the taxpayer, in 1989, elects to treat each grocery-store undertaking as a separate activity. The taxpayer does not participate in any of the grocery-store undertakings in 1989 or 1990, and sells one of the grocery stores in 1990.

(ii) As in example (2), the taxpayer's interest in each grocery-store undertaking is treated, under paragraph (o)(2) of this section, as a separate activity of the taxpayer for 1989. Because the taxpayer elected to treat the undertakings as separate activities for a preceding taxable year (1989), each grocery-store undertaking is also treated, under paragraph (o)(2) of this section, as a separate activity of the taxpayer for 1990. In addition, each of the taxpayer's grocery-store activities is a passive activity for 1989 and 1990 because the taxpayer does not participate in any of the grocery store undertakings for 1989 and 1990. Accordingly, the taxpayer's sale of the grocery store will generally be treated as a disposition of the taxpayer's entire interest in a passive activity for purposes of section 469(g) and the rules to be contained in §1.469-6T (relating to the treatment of losses upon certain dispositions of passive and former passive activities).

Example (4). (i) The facts are the same as in example (3), except that the taxpayer elects to treat the grocery-store undertakings as two separate activities. One of the activities includes three grocery-store undertakings, and the store sold in 1990 is part of this activity. The other activity includes the seven remaining grocery-store undertakings.

(ii) Paragraph (o)(4) of this section provides that a person who treats undertakings as part of the same activity for a taxable year ending after August 9, 1989, may not elect to treat those undertakings as separate activities for a subsequent taxable year. The grocery store sold in 1990 was treated for 1989 as part of an activity that includes two other grocery stores. Thus, those three stores must be treated as part of the same activity for 1990. Accordingly, the taxpayer's sale of the grocery store cannot be treated as a disposition of the taxpayer's entire interest in a passive activity for purposes of section 469(g) and the rules to be contained in §1.469-6T.

Example (5). (i) The facts are the same as in example (1), except that the taxpayer is a partner in a partnership that acquires and is the direct owner of the ten grocery stores. The taxable year of the partnership ends on November 30, and the partnership acquires the grocery stores in its taxable year ending on November 30, 1989. In its return for that taxable year, the partnership treats the grocery-store undertakings as a single activity.

(ii) Paragraph (o)(3) of this section provides that a person who holds undertakings through a passthrough entity may not elect to treat those undertakings as separate activities if they are treated as part of the same activity on the applicable return of the passthrough entity. Under paragraph (o)(5) of this section, the applicable return of the partnership for the taxpayer's 1989 taxable year is the partnership's return for its taxable year ending on November 30, 1989. Accordingly, the taxpayer must treat the grocery-store undertakings as a single activity for 1989 because those undertakings are treated as a single activity on the partnership's return for its taxable year ending in 1989.

(iii) Under paragraph (o)(4) of this section, the taxpayer must continue treating the grocery-store undertakings as part of the same activity for taxable years after 1989. This rule applies even if the partnership subsequently distributes its interest in the grocery stores to the taxpayer, and the taxpayer becomes the direct owner of the grocery-store undertakings.

(p) *Special rule for taxable years ending before August 10, 1989*—(1) *In general.* For purposes of applying section 469 and the regulations thereunder for a taxable year ending before August 10, 1989, a taxpayer's business and rental operations may be organized into activities under the rules of paragraphs (b) through (n) of this section or under any other reasonable method. For example, for such taxable years a taxpayer may treat each of the taxpayer's undertakings as a separate activity, or a taxpayer may treat undertakings that involve the provision of similar goods or services as a single activity.

(2) *Unreasonable methods.* A method of organizing business and rental operations into activities is not reasonable if such method—

(i) Treats rental operations (within the meaning of paragraph (d)(3) of this section) that are not ancillary to a trade or business activity (within the meaning of §1.469-1T(e)(2)) as part of a trade or business activity;

(ii) Treats operations that are not rental operations and are not ancillary to a rental activity (within the meaning of §1.469-1T(e)(3)) as part of a rental activity;

(iii) Includes in a passive activity of a taxpayer any oil or gas well that would be treated, under paragraph (e)(1) of this section, as a separate undertaking in determining the taxpayer's activities;

(iv) Includes in a passive activity of a taxpayer any interest in a dwelling unit that would be treated, under paragraph (k)-(7) of this section, as a separate activity of the taxpayer; or

(v) Is inconsistent with the taxpayer's method of organizing business and rental operations into activities for the taxpayer's first taxable year beginning after December 31, 1986.

(3) *Allocation of disallowed deductions in succeeding taxable year.* If any of the taxpayer's passive activity deductions or the taxpayer's credits from passive activities are disallowed under §1.469-1T for the last taxable year of the taxpayer ending before August 10, 1989, such disallowed deductions or credits shall be allocated among the taxpayer's activities for the first taxable year of the taxpayer ending after August 9, 1989, using any reasonable method. See §1.469-1T(f)(4).

§1.469-5T [Amended]

Par. 7. Section 1.469-5T is amended as follows:

1. Paragraph (f)(1) is amended by removing the parenthetical phrase "(directly or indirectly, other than through a C corporation)".

2. Paragraph (h) is amended by adding the following new paragraph (h)(3):

(h) * * *

(3) *Coordination with rules governing the treatment of passthrough entities.* If a taxpayer takes into account for a taxable year of such taxpayer any item of gross income or deduction from a partnership or S corporation that is characterized as an item of gross income or deduction from an activity in which the taxpayer materially participated under §1.469- 2T(e)(1), such taxpayer shall be treated as materially participating in such activity for such taxable year for purposes of applying paragraph (a)(5) and (6) of this section to any succeeding taxable year of such taxpayer.

* * * * *

3. Paragraph (j) is amended by redesignating paragraph (j) (including its heading) as paragraph (j)(2) and adding the following new heading and paragraph (j)(1):

* * * * *

(j) *Material participation for preceding taxable years*—(1) *In general.* For purposes of paragraph (a)(5) and (6) of this section, a taxpayer has materially participated in an activity for a preceding taxable year if such activity includes an undertaking that involves substantially the same business and rental operations as an undertaking that was included in an activity in which the taxpayer materially participated (determined without regard to paragraph (a)(5) of this section) for such preceding taxable year.

* * * * *

4. Paragraph (k), *Example (5)*, is amended by removing "1999" and adding in its place "2000" wherever the former occurs.

Par. 8. Section 1.469-11T is amended as follows:

1. Paragraph (c)(2)(i) is revised.

2. Paragraph (c)(3)(i)(A) is revised.

3. Paragraph (c)(3)(ii) is revised.

4. The examples in paragraph (c)(4) are revised.

5. In paragraph (c)(5)(i), the introductory text is revised.

6. The first four examples in paragraph (c)(5)(iii) are revised.

7. The revised provisions read as follows:

§1.469-11T Effective date and transition rules (temporary).

* * * * *

(c) * * *

(2) *Qualified interest*—(i) *In general*. For purposes of this paragraph (c), a taxpayer's interest in an undertaking (the "current-year undertaking") shall be treated as a qualified interest in the activity in which such undertaking is included for the taxable year if and only if the currentyear undertaking continues business and rental operations of an undertaking that was—

(A) Held by the taxpayer on October 22, 1986, and at all times thereafter; or

(B) Acquired by the taxpayer after October 22, 1986, directly or indirectly, pursuant to one or more written binding contracts to which the taxpayer was a party (see paragraph (c)(7) of this section) on October 22, 1986, and held by the taxpayer at all times after such acquisition.

* * * * *

(3) * * *

(i) * * *

(A) Any of the business and rental operations that are part of such activity continue business and rental operations that were being conducted by any person on October 22, 1986; or

* * * * *

(ii) *Character before 1987 irrelevant*. For purposes of this paragraph (c), an activity may be treated as a pre-enactment activity without regard to whether such activity continues business and rental operations that would have been part of a passive activity of the taxpayer for any taxable year beginning before January 1, 1987, had section 469 and the regulations been in effect for such year.

(4) * * *

Example (1). On October 22, 1986, the taxpayer owned an interest in property used as a personal residence. After October 22, 1986, the taxpayer ceased to use the property as a personal residence and began to use it in a rental activity (within the meaning of §1.469-1T(e)(3)). The rental activity is a pre-enactment activity (within the meaning of paragraph (c)(3) of this section) because the property used in the rental activity was in existence on August 16, 1986. The rental activity does not continue business and rental operations of any undertaking in which the taxpayer held an interest on October 22, 1986, because the taxpayer did not hold the property in an activity on that date. In addition, the taxpayer did not acquire an interest in an undertaking involving such operations pursuant to a written binding contract to which the taxpayer was a party on October 22, 1986. Accordingly, the taxpayer's interest in the rental activity is not a qualified interest (within the meaning of paragraph (c)(2) of this section), and the taxpayer does not have a pre-enactment interest in the rental activity.

Example (2). The taxpayer owns an interest in a partnership, which owns property used in a rental activity (within the meaning of §1.469-1T(e)(3)). The taxpayer acquired the partnership interest pursuant to a written binding contract to which the taxpayer was a party on October 22, 1986. The partnership acquired its interest in the rental property pursuant to written binding contracts to which the partnership was a party on October 22, 1986. Construction of the property used in the rental activity commenced prior to August 16, 1986. Under paragraph (c)(7)(ii) of this section, the taxpayer is treated as a party to the contracts to which the partnership was a party on October 22, 1986. Therefore, the taxpayer's interest in the rental activity is a qualified interest (within the meaning of paragraph (c)(2) of this section) because the taxpayer's interest in the rental property (*i.e.*, in undertakings involving business and rental operations that are continued in the rental activity) was acquired after October 22, 1986, pursuant to written binding contracts to which the taxpayer was a party on that date. Because the property used in the rental activity was under construction on August 16, 1986, the rental activity is a pre-enactment activity (within the meaning of paragraph (c)(3) of this section). Accordingly, the taxpayer's interest in the rental activity is a pre-enactment interest.

Example (3). The facts are the same as in example (2), except that the partnership acquired the property after October 22, 1986, pursuant to a contract entered into after October 22, 1986. The taxpayer's interest in the rental activity is not a pre-enactment interest because the taxpayer's interest in the rental property was not acquired pursuant to written binding contracts to which the taxpayer was a party on October 22, 1986.

Example (4). The taxpayer owned a pre-enactment interest in an activity that continues business and rental operations that were conducted by the taxpayer on October 22, 1986. After that date, the taxpayer died, and the decedent's interest in the activity passed to the decedent's estate. Because a decedent and the decedent's estate are not the same taxpayer, the estate must independently satisfy the requirements for a pre-enactment interest regardless of the fact that the decedent had a pre-enactment interest in the activity. Since the activity was being conducted by the decedent on October 22, 1986, the activity is a pre-enactment activity (within the meaning of paragraph (c)(3) of this section). Because, however, the activity does not continue the business and rental operations of an undertaking that the estate held on October 22, 1986, or acquired pursuant to a written binding contract, the estate does not have a qualified interest in the activity (within the meaning of paragraph (c)(2) of this section).

(5) *Effect of changes in a taxpayer's interest in a pre-enactment activity*—(i) *In general*. If the taxpayer's share for a taxable year of an item of income, gain, loss, deduction, or credit from an interest in a pre-enactment activity was increased or decreased at any time after October 22, 1986, and prior to the end of such taxable year (other than pursuant to a written binding contract to which the taxpayer was a party on October 22, 1986), the share of such item that is attributable to a pre-enactment interest in such activity shall be determined by taking into account— * * *

* * * * *

(iii) * * *

Example (1). A taxpayer owns interests in a pre-enactment activity through an S corporation. On October 22, 1986, the taxpayer owned a 10-percent interest in the S corporation. After October 22, 1986, the taxpayer acquires an additional 5-percent interest in the S corporation pursuant to a contract entered into after October 22, 1986. Under this paragraph (c)(5), only items from the 10-percent interest that the taxpayer owned on October 22, 1986, are attributable to the taxpayer's pre-enactment interest in the activity.

Example (2). On October 22, 1986, individuals A and B each owned a rental property. After October 22, 1986, A and B contribute their rental properties to a partnership in exchange for which each receives a 50-percent interest in all items of income, gain, loss, deduction, and credit of the partnership. Under paragraph (c)(5)(i) of this section, A's 50-percent share of each partnership item attributable to the rental property contributed by A is attributable to a pre-enactment interest. None of A's share of the partnership items attributable to the rental property contributed by B is attributable to a pre-enactment interest.

Example (3). The facts are the same as in example (2), except that under the partnership agreement the items of income, gain, loss, deduction, and credit attributable to the rental property A contributed to the partnership are allocated 80 percent to A and 20 percent to B. Under paragraph (c)(5)(i) of this section, A's 80-percent share of each partnership item attributable to the rental property contributed by A is attributable to a pre-enactment interest.

Example (4). The facts are the same as in example (3) except that on January 1, 1988, the partnership liquidates, distributing to A the rental property contributed by A to the partnership. Under paragraph (c)-(5)(i) of this section, only 80 percent of A's income, gain, loss, deductions, and credits from the property for 1988 and subsequent years is attributable to a pre-enactment interest.

* * * * *

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 9. The authority for Part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 10. Section 602.101(c) is amended by inserting in the appropriate places in the table "§1.469-4T(k) ... 1545-1037" and "§1.469-4T(o) ... 1545-1037".

There is need for immediate guidance with respect to the provisions contained in this Treasury decision. For this reason, it is found impracticable to issue this Treasury decision with notice and public procedure under subsection (b) of section 553 of Title 5 of the United States Code or subject to the effective date limitation of subsection (d) of that section.

Lawrence B. Gibbs,
Commissioner of Internal Revenue.

Approved March 20, 1989.

Dennis E. Ross,
Acting Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on May 11, 1989, 8:45 a.m., and published in the issue of the Federal Register for May 12, 1989, 54 F.R. 20527)

26 CFR 1.469-4T: Limitations on passive activity losses and credits—definition of activity.

Lines of business are set out for purposes of applying section 1.469-4T of the Temporary Income Tax Regulations. See Rev. Proc. 89-38, page 920.

Subpart D.—Inventories

Section 472.—Last-in, First-out Inventories

26 CFR 1.472-1: Last-in, first-out inventories.

LIFO; price indexes, department stores. The September 1988 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, 1988.

Rev. Rul. 89-10

The following price indexes for September 1988 were issued by the Bureau of Labor Statistics on October 25, 1988, for use by department stores, and are accepted by the Internal Revenue Service, under section 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, 1988.

Indexes are prepared on a national basis for the store total, for 23 major groups of departments, and for three special combinations — soft goods, durable goods and miscellaneous goods. The store total index covers all departments, including some not listed separately, with the following exceptions: candy, foods, liquor, tobacco, as well as contract departments.

BUREAU OF LABOR STATISTICS, DEPARTMENT STORE INVENTORY PRICE INDEXES BY DEPARTMENT GROUPS
(January 1941 = 100 unless otherwise noted)

Groups	September 1987	September 1988	Percent Change from September 1987 to September 1988[1]
1. Piece Goods	380.6	414.6	8.9
2. Domestics and Draperies	585.4	607.4	3.8
3. Women's and Children's Shoes	548.4	574.6	4.8
4. Men's Shoes	758.7	818.4	7.9
5. Infants' Wear	537.5	560.6	4.3
6. Women's Underwear	436.3	460.7	5.6
7. Women's Hosiery[2]	239.0	242.6	1.5
8. Women's and Girls' Accessories	468.0	496.7	6.1
9. Women's Outerwear and Girls' Wear	384.1	391.9	2.0
10. Men's Clothing	502.7	528.3	5.1
11. Men's Furnishings	504.4	520.0	3.1
12. Boys' Clothing and Furnishings	432.2	451.8	4.5
13. Jewelry	734.9	779.6	6.1
14. Notions	489.7	498.6	1.8
15. Toilet Articles and Drugs	683.9	709.2	3.7
16. Furniture and Bedding	562.0	583.0	3.7
17. Floor Coverings	483.6	493.7	2.1
18. Housewares	733.6	730.9	− 0.4
19. Major Appliances	250.5	251.9	0.6
20. Radio and Television	96.6	94.6	− 2.1
21. Recreation and Education[3]	102.0	106.9	4.8
22. Home Improvements[3]	102.5	105.8	3.2
23. Auto Accessories[3]	101.2	103.3	2.1
Groups 1 15: Soft Goods	509.2	529.0	3.9
Groups 16 - 20: Durable Goods	451.7	452.8	0.2
Groups 21 - 23: Misc. Goods[3]	101.9	106.0	4.0
Store Total	489.1	503.8	3.0

[1]Absence of a minus sign before percentage change in this column signifies price increase.

[2]Title reflects change in item sampling structure made during 1978 CPI Revision whereby Girls' Hosiery was included in Group 8, Women's and Girl's Accessories, not Group 7.

[3]Indexes on a January 1986 = 100 base

26 CFR 1.472-1: Last-in, first-out inventories.

LIFO; price indexes; department stores. The October 1988 Bureau of Labor Statistics price indexes are accepted for use by department stores employing the retail inventory and last-in, first-out inventory methods for valuing inventories for tax years ended on, or with reference to, October 31, 1988.

Rev. Rul. 89-19

The following price indexes for October 1988 were issued by the Bureau of Labor Statistics on November 25, 1988, for use by department stores, and are accepted by the Internal Revenue Service, under section 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, 1988.

Indexes are prepared on a national basis for the store total, for 23 major groups of departments, and for three special combinations—soft goods, durable goods and miscellaneous goods. The store total index covers all departments, including some not listed separately, with the following exceptions: candy, foods, liquor, tobacco, as well as contract departments.

BUREAU OF LABOR STATISTICS, DEPARTMENT STORE INVENTORY PRICE INDEXES BY DEPARTMENT GROUPS
(January 1941 = 100 unless otherwise noted)

Groups	October 1987	October 1988	Percent Change from October 1987 to October 1988[1]
1. Piece Goods	392.2	416.4	6.2
2. Domestics and Draperies	582.5	606.4	4.1
3. Women's and Children's Shoes	558.6	599.1	7.3
4. Men's Shoes	762.1	825.5	8.3
5. Infants' Wear	552.2	560.3	1.5
6. Women's Underwear	445.1	467.5	5.0
7. Women's Hosiery[2]	238.3	242.3	1.7
8. Women's and Girls' Accessories	477.7	508.5	6.4
9. Women's Outerwear and Girls' Wear	396.6	407.3	2.7
10. Men's Clothing	510.2	542.2	6.3
11. Men's Furnishings	506.9	525.8	3.7
12. Boys' Clothing and Furnishings	448.7	466.8	4.0
13. Jewelry	741.7	786.9	6.1
14. Notions	490.1	503.0	2.6
15. Toilet Articles and Drugs	683.9	714.1	4.4
16. Furniture and Bedding	563.5	586.3	4.0
17. Floor Coverings	480.0	502.9	4.8
18. Housewares	728.7	730.2	0.2
19. Major Appliances	245.6	249.1	1.4
20. Radio and Television	96.3	94.3	− 2.1
21. Recreation and Education[3]	102.7	107.4	4.6
22. Home Improvements[3]	103.0	105.1	2.0
23. Auto Accessories[3]	101.4	102.8	1.4
Groups 1 - 15: Soft Goods	516.9	539.1	4.3
Groups 16 20: Durable Goods	448.7	452.3	0.8
Groups 21 - 23: Misc. Goods[3]	102.5	106.1	3.5
Store Total	492.9	509.2	3.3

[1]Absence of a minus sign before percentage change in this column signifies price increase.

[2]Title reflects change in item sampling structure made during 1978 CPI Revision whereby Girls' Hosiery was included in Group 8, Women's and Girl's Accessories, not Group 7.

[3]Indexes on a January 1986 = 100 base

26 CFR 1.472-1: Last-in, first-out inventories.

LIFO; price indexes; department stores. The November 1988 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, November 30, 1988.

Rev. Rul. 89-28

The following price indexes for November 1988 were issued by the Bureau of Labor Statistics on December 22, 1988, for use by department stores, and are accepted by the Internal Revenue Service, under section 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, November 30, 1988.

Indexes are prepared on a national basis for the store total, for 23 major groups of departments, and for three special combinations - soft goods, durable goods and miscellaneous goods. The store total index covers all departments, including some not listed separately, with the following exceptions: candy, foods, liquor, tobacco, as well as contract departments.

BUREAU OF LABOR STATISTICS, DEPARTMENT STORE INVENTORY PRICE INDEXES BY DEPARTMENT GROUPS
(January 1941 = 100 unless otherwise noted)

Groups	November 1987	November 1988	Percent Change from November 1987 to November 1988[1]
1. Piece Goods	392.3	417.0	6.3
2. Domestics and Draperies	572.4	595.9	4.1
3. Women's and Children's Shoes	562.7	590.5	4.9
4. Men's Shoes	769.1	828.2	7.7
5. Infants' Wear	553.4	558.4	0.9
6. Women's Underwear	448.6	476.2	6.2
7. Women's Hosiery[2]	238.3	243.6	2.3
8. Women's and Girls' Accessories	489.0	504.7	3.1
9. Women's Outerwear and Girls' Wear	394.0	401.0	1.8
10. Men's Clothing	512.2	541.4	5.7
11. Men's Furnishings	506.6	528.8	4.4
12. Boys' Clothing and Furnishings	453.7	473.7	4.4
13. Jewelry	737.0	780.1	5.8
14. Notions	493.5	511.3	3.6
15. Toilet Articles and Drugs	684.7	718.3	4.9
16. Furniture and Bedding	566.8	591.2	4.3
17. Floor Coverings	480.2	500.7	4.3
18. Housewares	731.4	734.5	0.4
19. Major Appliances	243.8	251.6	3.2
20. Radio and Television	96.2	93.8	− 2.5
21. Recreation and Education[3]	103.7	107.9	4.1
22. Home Improvements[3]	104.4	105.1	0.7
23. Auto Accessories[3]	101.1	102.9	1.8
Groups 1 - 15: Soft Goods	516.1	536.4	3.9
Groups 16 - 20: Durable Goods	449.0	454.2	1.2
Groups 21 - 23: Misc. Goods[3]	103.3	106.4	3.0
Store Total	493.3	508.5	3.1

[1]Absence of a minus sign before percentage change in this column signifies price increase.

[2]Title reflects change in item sampling structure made during 1978 CPI Revision whereby Girls' Hosiery was included in Group 8, Women's and Girl's Accessories, not Group 7.

[3]Indexes on a January 1986 = 100 base

26 CFR 1.472-1: Last-in, first-out inventories.

LIFO; price indexes; department stores. The December 1988 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, December 31, 1988.

Rev. Rul. 89-40

The following price indexes for December 1988 were issued by the Bureau of Labor Statistics on January 23, 1989, for use by department stores, and are accepted by the Internal Revenue Service, under section 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, December 31, 1988.

Indexes are prepared on a national basis for the store total, for 23 major groups of departments, and for three special combinations—soft goods, durable goods and miscellaneous goods. The store total index covers all departments, including some not listed separately, with the following exceptions: candy, foods, liquor, tobacco, as well as contract departments.

BUREAU OF LABOR STATISTICS, DEPARTMENT STORE INVENTORY PRICE INDEXES BY DEPARTMENT GROUPS
(January 1941 = 100 unless otherwise noted)

Groups	December 1987	December 1988	Percent Change from December 1987 to December 1988[1]
1. Piece Goods	389.4	411.9	5.8
2. Domestics and Draperies	565.6	595.0	5.2
3. Women's and Children's Shoes	559.3	584.5	4.5
4. Men's Shoes	770.3	823.8	6.9
5. Infants' Wear	545.8	558.0	2.2
6. Women's Underwear	435.8	473.7	8.7
7. Women's Hosiery[2]	239.0	246.6	3.2
8. Women's and Girls' Accessories	485.4	505.3	4.1
9. Women's Outerwear and Girls' Wear	378.0	387.4	2.5
10. Men's Clothing	502.9	537.3	6.8
11. Men's Furnishings	500.9	525.2	4.9
12. Boys' Clothing and Furnishings	447.5	469.8	5.0
13. Jewelry	730.7	779.1	6.6
14. Notions	493.9	518.2	4.9
15. Toilet Articles and Drugs	685.7	723.1	5.5
16. Furniture and Bedding	569.4	587.4	3.2
17. Floor Coverings	486.8	488.5	0.3
18. Housewares	731.1	732.9	0.2
19. Major Appliances	240.1	250.1	4.2
20. Radio and Television	95.4	93.6	− 1.9
21. Recreation and Education[3]	103.9	107.5	3.5
22. Home Improvements[3]	103.7	105.6	1.8
23. Auto Accessories[3]	101.5	103.6	2.1
Groups 1 - 15: Soft Goods	507.2	531.0	4.7
Groups 16 20: Durable Goods	447.7	452.0	1.0
Groups 21 23: Misc. Goods[3]	103.4	106.4	2.9
Store Total	488.2	505.0	3.4

[1]Absence of a minus sign before percentage change in this column signifies price increase.

[2]Title reflects change in item sampling structure made during 1978 CPI Revision whereby Girls' Hosiery was included in Group 8, Women's and Girl's Accessories, not Group 7.

[3]Indexes on a January 1986 = 100 base

26 CFR 1.472-1: Last-in, first-out inventories.

LIFO; price indexes; department stores. The January 1989 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, January 31, 1989.

Rev. Rul. 89-54

The following price indexes for January 1989 were issued by the Bureau of Labor Statistics on February 24, 1989, for use by department stores, and are accepted by the Internal Revenue Service, under section 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, January 31, 1989.

Indexes are prepared on a national basis for the store total, for 23 major groups of departments, and for three special combinations - soft goods, durable goods and miscellaneous goods. The store total index covers all departments, including some not listed separately, with the following exceptions: candy, foods, liquor, tobacco, as well as contract departments.

BUREAU OF LABOR STATISTICS, DEPARTMENT STORE INVENTORY PRICE INDEXES BY DEPARTMENT GROUPS
(January 1941 = 100 unless otherwise noted)

Groups	January 1988	January 1989	Percent Change from January 1988 to January 1989[1]
1. Piece Goods	405.0	409.8	1.2
2. Domestics and Draperies	570.6	591.2	3.6
3. Women's and Children's Shoes	547.1	570.7	4.3
4. Men's Shoes	775.7	832.4	7.3
5. Infants' Wear	545.9	553.0	1.3
6. Women's Underwear	426.7	466.2	9.3
7. Women's Hosiery[2]	238.2	246.4	3.4
8. Women's and Girls' Accessories	474.5	504.2	6.3
9. Women's Outerwear and Girls' Wear	362.1	367.9	1.6
10. Men's Clothing	493.9	527.0	6.7
11. Men's Furnishings	498.1	517.9	4.0
12. Boys' Clothing and Furnishings	434.3	457.8	5.4
13. Jewelry	745.6	785.3	5.3
14. Notions	495.0	522.3	5.5
15. Toilet Articles and Drugs	691.1	724.0	4.8
16. Furniture and Bedding	568.4	586.8	3.2
17. Floor Coverings	491.8	508.7	3.4
18. Housewares	734.6	735.6	0.1
19. Major Appliances	245.1	248.8	1.5
20. Radio and Television	95.1	94.6	− 0.5
21. Recreation and Education[3]	103.5	107.8	4.2
22. Home Improvements[3]	103.4	105.9	2.4
23. Auto Accessories[3]	101.9	104.2	2.3
Groups 1 15: Soft Goods	500.9	521.3	4.1
Groups 16 20: Durable Goods	450.0	454.1	0.9
Groups 21 - 23: Misc. Goods[3]	103.2	106.7	3.4
Store Total	485.2	500.6	3.2

[1]Absence of a minus sign before percentage change in this column signifies price increase.

[2]Title reflects change in item sampling structure made during 1978 CPI Revision whereby Girls' Hosiery was included in Group 8, Women's and Girl's Accessories, not Group 7.

[3]Indexes on a January 1986 = 100 base

26 CFR 1.472-1: Last-in, first-out inventories.

LIFO; price indexes; department stores. The February 1989 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, February 28, 1989.

Rev. Rul. 89-71

The following price indexes for February 1989 were issued by the Bureau of Labor Statistics on March 23, 1989, for use by department stores, and are accepted by the Internal Revenue Service, under section 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, February 28, 1989.

Indexes are prepared on a national basis for the store total, for 23 major groups of departments, and for three special combinations — soft goods, durable goods and miscellaneous goods. The store total index covers all departments, including some not listed separately, with the following exceptions: candy, foods, liquor, tobacco, as well as contract departments.

BUREAU OF LABOR STATISTICS, DEPARTMENT STORE INVENTORY PRICE INDEXES BY DEPARTMENT GROUPS
(January 1941 = 100 unless otherwise noted)

Groups	February 1988	February 1989	Percent Change from February 1988 to February 1989[1]
1. Piece Goods	397.7	418.3	5.2
2. Domestics and Draperies	583.8	607.9	4.1
3. Women's and Children's Shoes	545.2	577.4	5.9
4. Men's Shoes	778.9	831.0	6.7
5. Infants' Wear	537.1	564.5	5.1
6. Women's Underwear	437.0	470.8	7.7
7. Women's Hosiery[2]	237.6	245.3	3.2
8. Women's and Girls' Accessories	480.1	502.3	4.6
9. Women's Outerwear and Girls' Wear	360.7	367.4	1.9
10. Men's Clothing	496.5	526.4	6.0
11. Men's Furnishings	498.7	520.4	4.4
12. Boys' Clothing and Furnishings	431.2	442.5	2.6
13. Jewelry	752.5	790.2	5.0
14. Notions	495.8	523.6	5.6
15. Toilet Articles and Drugs	693.7	726.2	4.7
16. Furniture and Bedding	565.5	580.8	2.7
17. Floor Coverings	488.8	492.0	0.7
18. Housewares	728.3	734.0	0.8
19. Major Appliances	243.6	251.1	3.1
20. Radio and Television	95.6	94.1	− 1.6
21. Recreation and Education[3]	103.8	107.8	3.9
22. Home Improvements[3]	105.1	108.3	3.0
23. Auto Accessories[3]	102.2	104.4	2.2
Groups 1 15: Soft Goods	502.8	524.1	4.2
Groups 16 - 20: Durable Goods	447.9	452.4	1.0
Groups 21 23: Misc. Goods[3]	103.7	107.2	3.4
Store Total	486.1	502.1	3.3

[1] Absence of a minus sign before percentage change in this column signifies price increase.

[2] Title reflects change in item sampling structure made during 1978 CPI Revision whereby Girls' Hosiery was included in Group 8, Women's and Girl's Accessories, not Group 7.

[3] Indexes on a January 1986 = 100 base

26 CFR 1.472-1: Last-in, first-out inventories.

LIFO; price indexes; department stores. The March 1989 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, March 31, 1989.

Rev. Rul. 89-83

The following price indexes for March 1989 were issued by the Bureau of Labor Statistics on April 20, 1989, for use by department stores, and are accepted by the Internal Revenue Service, under section 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, March 31, 1989.

Indexes are prepared on a national basis for the store total, for 23 major groups of departments, and for three special combinations—soft goods, durable goods and miscellaneous goods. The store total index covers all departments, including some not listed separately, with the following exceptions: candy, foods, liquor, tobacco, as well as contract departments.

BUREAU OF LABOR STATISTICS, DEPARTMENT STORE INVENTORY PRICE INDEXES BY DEPARTMENT GROUPS
(January 1941 = 100 unless otherwise noted)

Groups	March 1988	March 1989	Percent Change from March 1988 to March 1989[1]
1. Piece Goods	409.7	425.2	3.8
2. Domestics and Draperies	594.7	608.4	2.3
3. Women's and Children's Shoes	554.3	586.2	5.8
4. Men's Shoes	782.7	822.6	5.1
5. Infants' Wear	545.6	562.9	3.2
6. Women's Underwear	446.7	471.4	5.5
7. Women's Hosiery[2]	242.4	242.1	− 0.1
8. Women's and Girls' Accessories	486.0	515.1	6.0
9. Women's Outerwear and Girls' Wear	387.4	394.7	1.9
10. Men's Clothing	509.1	537.3	5.5
11. Men's Furnishings	508.9	528.5	3.9
12. Boys' Clothing and Furnishings	437.1	441.5	1.0
13. Jewelry	756.2	789.7	4.4
14. Notions	495.0	523.7	5.8
15. Toilet Articles and Drugs	696.5	730.2	4.8
16. Furniture and Bedding	576.9	574.5	− 0.4
17. Floor Coverings	495.8	486.8	− 1.8
18. Housewares	732.0	722.6	− 1.3
19. Major Appliances	243.5	245.2	0.7
20. Radio and Television	95.6	93.2	− 2.5
21. Recreation and Education[3]	104.4	107.8	3.3
22. Home Improvements[3]	103.2	108.4	5.0
23. Auto Accessories[3]	102.0	103.4	1.4
Groups 1 - 15: Soft Goods	517.0	535.3	3.5
Groups 16 - 20: Durable Goods	450.6	445.7	− 1.1
Groups 21 23: Misc. Goods[3]	103.7	107.0	3.2
Store Total	494.6	506.2	2.3

[1]Absence of a minus sign before percentage change in this column signifies price increase.

[2]Title reflects change in item sampling structure made during 1978 CPI Revision whereby Girls' Hosiery was included in Group 8, Women's and Girl's Accessories, not Group 7.

[3]Indexes on a January 1986 = 100 base

26 CFR 1.472-2: Requirements incident to adoption and use of LIFO inventory method.

Inventories; LIFO; financial conformity requirements; affiliated group with foreign parent. Rev. Rul. 78-246 continues to be a valid exception to the LIFO conformity requirement for certain foreign parent-subsidiary groups of corporations. The exception is also applicable to the combined financial statements of certain foreign controlled brother-sister groups of corporations, but does not apply to U.S. owned groups of corporations. Rev. Rul. 78-246 amplified.

Rev. Rul. 89-41

ISSUE

Must the last-in, first-out (LIFO) method of inventory valuation be used in the consolidated financial statements of certain foreign-owned groups of financially related corporations when one or more of the related corporations use the LIFO method of valuing inventories for federal income tax purposes?

FACTS

Situation 1: FP, a foreign corporation, owns all of the outstanding stock of *S1*, a domestic corporation, and of *FS1*, *FS2*, and *FS3*, foreign corporations. *S1* uses the LIFO method of inventory valuation for federal income tax purposes. *FP*, *FS1*, *FS2*, and *FS3* do not use the LIFO method of accounting for federal income tax purposes and are each engaged in a business outside the United States. The inventories of *S1*, *FS1*, *FS2*, and *FS3* are included in the consolidated financial statement of *FP*. *FP* owns, through *FS1*, *FS2*, and *FS3*, operating assets of substantial value that are used in the foreign operations of *FS1*, *FS2*, and *FS3*. These assets constitute 30% or more of the total operating assets of the consolidated group.

Situation 2: A, *B*, and *C*, nonresident alien individuals, together own all of the outstanding stock of *X*, a domestic corporation, and of *F1*, *F2*, and *F3*, foreign corporations. *X* uses the LIFO method of inventory valuation for federal income tax purposes. *F1*, *F2*, and *F3* do not use the LIFO method of accounting for federal tax purposes and are each engaged in a business outside the United States. *X*, *F1*, *F2*, and *F3* issue a combined financial statement. The inventories of *X*, *F1*, *F2*, and *F3* are included in this combined financial statement. *F1*, *F2*, and *F3* own operating assets of substantial value that are used in foreign operations. These assets constitute 30% or more of the total operating assets of the combined group.

Situation 3: P, a domestic corporation, owns all of the outstanding stock of *FS1*, a foreign corporation, and of *S1*, *S2*, and *S3*, domestic corporations. *FS1* uses the LIFO method of inventory valuation for federal income tax purposes. *P*, *S1*, *S2*, and *S3* do not use the LIFO method of accounting for federal income tax purposes. The inventories of *FS1*, *S1*, *S2*, and *S3* are included in the consolidated financial statement of *P*. *FS1* is engaged in a business outside the United States. *P* owns, through *S1*, operating assets of substantial value that are used in the foreign operations of *S1*. These assets constitute 30% or more of the total operating assets of the consolidated group.

ANALYSIS

Section 472(a) of the Internal Revenue Code of 1986 authorizes the use of the LIFO inventory method for federal income tax purposes. Section 472(c) of the Code requires that for the first year the method is used, the method must also be used in computing income for purposes of reports to shareholders, partners, other proprietors, or beneficiaries, and reports used for credit purposes. Thereafter, the Commissioner may terminate the taxpayer's use of the LIFO method if the taxpayer uses any method other than LIFO in computing income for these purposes. Section 472(e)(2).

Rev. Rul. 78-246, 1978-1 C.B. 146, holds that the LIFO method of inventory valuation need not be used in the consolidated financial statements of the foreign parent of a consolidated group that engages in substantial foreign operations, even though one or more of its subsidiaries use the LIFO method of valuing inventories for federal tax purposes. A group engages in substantial foreign operations if the parent owns, either directly or through members of the group, operating assets of substantial value (for this purpose, 30 percent or more of the group's total operating assets) that are used in foreign operations. Rev. Rul. 78-246 revokes Rev. Rul. 73-57, 1973-1 C.B. 218, which had reached a contrary conclusion.

Rev. Rul. 78-246 relies on the legislative history of the conformity requirements in sections 472(c) and (e)(2). The sections were enacted to ensure that the LIFO method will conform as nearly as possible to the best accounting practice in the trade or business, determined on the basis of the United States standards of accounting practice (*see* H. Rep. No. 2330, 75th Cong., 3d Sess. 34 (1938)). Because Congress was specifically concerned with domestic accounting practice, the conformity requirements of section 472 were not intended to determine what would be the best accounting practice in a foreign country. Accordingly, Rev. Rul. 78-246 concludes that it is inappropriate to impose the LIFO method of inventory valuation upon a foreign parent corporation with respect to the inventory of any subsidiary that uses the LIFO method of inventory valuation for federal income tax purposes when the group is engaged in substantial foreign operations.

In *Insilco Corp. v. Commissioner*, 73 T.C. 589 (1980), *aff'd mem.*, 659 F. 2d 1059 (2d Cir. 1981), the Tax Court held that the LIFO conformity rules were met by a domestic subsidiary using the LIFO method for federal income tax purposes where the subsidiary used the LIFO method to compute its income in its financial reports issued to its domestic parent company, even though the parent company converted the subsidiary's earnings to a non-LIFO basis in the parent's consolidated financial statements. In response to this decision, Congress enacted section 472(g) of the Code.

Section 472(g)(1) provides that all members of the same group of financially related corporations are treated as one taxpayer for purposes of the conformity requirements of sections 472(c) and (e)(2). Section 472(g)(2) defines a "group of financially related corporations" as any affiliated group as defined in section 1504, determined by substituting "50%" for "80%" each place it appears in section 1504(a) and without regard to section 1504(b), and any other group of corporations that consolidate or combine for purposes of financial statements. Section 472(g) of the Code was added to the Code by section 95 of the Tax Reform Act of 1984, 1984-3 C.B. (Vol. 1) 124.

Section 472(g) of the Code was enacted because Congress was concerned that taxpayers could "avoid the effect of the LIFO conformity rule under the *Insilco* decision through the creation of holding companies or subsidiaries". (H.R. 98-432, Part 2, 98th Cong. 2d Sess. 1380 (1984); S. Rep. 98-169, Vol. 1, 98th Cong. 2d Sess. 486 (1984)). Congress believed that the LIFO conformity rule should be applied to all financial reports of all corporations in which the taxpayer's inventory is included.

Thus, under section 472(g), it was intended that the conformity requirement generally apply to a parent corporation that issues financial statements to its shareholders on a consolidated basis with a subsidiary (or on a combined basis with an affiliated company) that uses the LIFO method of accounting for tax purposes, or a parent that uses the equity method of financial accounting to include the results of operations of a financially related corporation that uses the LIFO method of accounting for tax purposes. However, Congress made it clear that the "limited exceptions to the conformity requirement provided under present law (or the similar limited exceptions provided by the Treasury, if appropriate, in the future) should be allowed." The legislative history identifies Rev. Rul. 78-246 as one of those limited exceptions to the conformity requirement which were to continue to be allowed.

Therefore, the Internal Revenue Service will continue to adhere to the position set forth in Rev. Rul. 78-246. Furthermore, the Service has determined that it is appropriate to apply the rule of Rev. Rul. 78-246 to corporations that issue financial statements on a combined basis with affiliated corporations, for the reasons stated in Rev. Rul. 78-246. However, the position set forth in Rev. Rul. 78-246 applies only to certain foreign owned groups of affiliated corporations; it does not apply to United States owned groups of affiliated corporations. The rationale of Rev. Rul. 78-246 does not extend to the foreign subsidiary of a domestic parent. Such a broad application of that rationale is not consistent with section 472(c) and is excluded by the enactment of section 472(g)(2), which includes foreign corporations in the definition of a "group of financially related corporations," and the legislative history to section 472(g).

In *situation 1, FP, S1, FS1, FS2,* and *FS3* are a group of financially related corporations as defined in section 472(g)(2)(A). Under section 472(g)(1), they are treated as one taxpayer for purposes of the conformity requirement of subsections (c) and (e)(2) of section 472. However, the group is engaged in substantial foreign operations within the meaning of Rev. Rul. 78-246. Accordingly, although *S1* uses the LIFO method of inventory valuation for federal income tax purposes, that method need not be used for its inventories when they are included in the consolidated financial statements of the group. *S1* must otherwise comply, however, with the conformity requirements of sections 472(c) and (e)(2) of the Code in inventorying its goods to ascertain income, profit, or loss for the purposes of a report or statement (covering the taxable year for which the LIFO method is used) to shareholders, partners, other proprietors, or beneficiaries, or one used for credit purposes.

In *situation 2, X, F1, F2,* and *F3* are a group of financially related corporations as defined in section 472 (g)(2)(B). Under section 472(g)(1), the group is treated as one taxpayer for purposes of the conformity requirement of subsections (c) and (e)(2) of section 472. However, the group is engaged in substantial foreign operations as defined in Rev. Rul. 78-246. Therefore, although *X* uses the LIFO method of inventory valuation for federal income tax purposes, that method need not also be used for its inventories when they are included in the combined financial statements of the group. *X* must otherwise comply, however, with the conformity requirements of section 472(c) and (e)(2) of the Code in inventorying its goods to ascertain income, profit, or loss for the purposes of a report or statement (covering the taxable year for which the LIFO method is used) to shareholders, partners, other proprietors, or beneficiaries, or one used for credit purposes.

In *situation 3, P, FS1, S1, S2,* and *S3* are a group of financially related corporations as defined in section 472(g)(2)-(A). Under section 472(g)(1), they are treated as one taxpayer for purposes of the conformity requirements of subsections (c) and (e)(2) of section 472. Although the group is engaged in substantial foreign operations within the meaning of Rev. Rul. 78-246, that revenue ruling does not apply to United States owned groups of financially related corporations. Accordingly, because *FS1* uses the LIFO method of inventory valuation for federal income tax purposes, that method must be used for its inventories when they are included in the consolidated financial statements of the group.

HOLDINGS

Situation 1. The LIFO method of inventory valuation need not be used for the inventories of *S1* when they are included in the consolidated financial statement of *FP, S1, FS1, FS2,* and *FS3.*

Situation 2. The LIFO method of inventory valuation need not be used for the inventories of *X* when they are included in the combined financial statement of *X, F1, F2,* and *F3.*

Situation 3. The LIFO method of inventory valuation must be used for the inventories of *FS1* when they are included in the consolidated financial statement of P, *FS1, S1, S2,* and *S3.*

EFFECT ON OTHER REVENUE RULINGS

Rev. Rul. 78-246 is amplified.

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26 CFR 1.472-2: Requirements incident to adoption and use of LIFO inventory method.

A procedure is provided that sets forth the application of section 472(c) and section 472(e)(2) of the Code in the examination of federal income tax returns when a taxpayer, with the consent of the Commissioner, changes from the LIFO inventory method to another inventory method and is required by APB 20 to restate financial statements for prior years under the new inventory method. See Rev. Proc. 89-10, page 796.

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26 CFR 1.472-3: Time and manner of making election.

A procedure is provided that sets forth the application of section 472(c) and section 472(e)(2) of the Code in the examination of federal income tax returns when a taxpayer, with the consent of the Commissioner, changes from the LIFO inventory method to another inventory method and is required by ARB 20 to restate financial statements for prior years under the new inventory method. See Rev. Proc. 89-10, page 796.

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26 CFR 1.472-8: Dollar-value method of pricing LIFO inventories.

LIFO; inventory price index computation method; appropriate representative month. The Commissioner will not consent to a taxpayer's request to change its month for selecting price indexes under the IPI regulations unless the previously elected month is no longer an appropriate representative month. A month is an appropriate representative month if there is a nexus between the selected month, the taxpayer's method for determining current-year cost, and the taxpayer's historical experience of inventory purchases during the year.

Rev. Rul. 89-29

ISSUE

In the situations described below, will the Commissioner consent to a taxpayer's request to change its month for selecting price indexes in computing the LIFO value of its dollar-value pool under the inventory price index (IPI) computation method provided by section 1.472-8(e)(3) of the Income Tax Regulations?

FACTS

In each of the situations below, the taxpayer, a retailer, uses the accrual method of accounting, and employs a calendar tax year. Beginning with its tax year ending December 31, 1985, the taxpayer elected the dollar-value LIFO inventory method by filing Form 970, Application to Use LIFO Inventory Method. On the Form 970, the taxpayer: (1) elected the latest acquisitions method to determine the cost of the goods in the closing inventory over those in the opening inventory under section 1.472-8(e)-(2)(ii)(*a*) of the regulations; (2) elected the IPI computation method provided by section 1.472-8(e)(3); (3) elected to use a single pool for its entire inventory; and (4) made a "one-time binding election" under section 1.472-8(e)(3)(iii)(C) of the regulations regarding which month's Producer Prices and Price Indexes (PPI) to use in determining the current-year cost of the pool. In *Situations 1, 2,* and *3*, below, the taxpayer chose the PPI for December; in *Situation 4*, below, it chose the PPI for January.

In each of the four situations, the taxpayer's experience is that it purchases its inventory fairly uniformly throughout the year. The first purchases of inventory items normally occur in January and the last purchases normally occur in December. The taxpayer does not use the retail method of pricing inventories under section 1.471-8 and is not eligible to use the retail price indexes prepared by the United States Bureau of Labor Statistics for use by department stores.

Situation 1. The taxpayer filed a Form 3115, Application for Change in Accounting Method, requesting to change from the December PPI to the November PPI for computing the LIFO value of the pool, beginning with its tax year ending December 31, 1987.

Situation 2. The taxpayer filed a Form 3115 requesting (1) to change from the latest acquisitions method to the earliest acquisitions method, and (2) to change from the December PPI to the January PPI, effective for the tax year ending December 31, 1987.

Situation 3. Pursuant to the provisions of section 1.442-1(c) of the regulations, the taxpayer changed its annual accounting period from the calendar tax year to a fiscal tax year ending June 30. The short period required to effect the change of annual accounting period ends on June 30, 1987. The taxpayer filed a Form 3115 requesting to change from the December PPI to the June PPI, beginning with the short tax year ending June 30, 1987.

Situation 4. The taxpayer filed a Form 3115 requesting to change from the January PPI to the December PPI beginning with the tax year ending December 31, 1987.

LAW AND ANALYSIS

Section 1.472-8(e)(3)(iii)(C) of the regulations states, in part, that taxpayers that do not use the retail inventory method must either select indexes as of the month or months most appropriate to the taxpayer's method of determining the current-year cost of the inventory pool under section 1.472-8(e)(2)(ii) or make a one-time binding election of an appropriate representative month during the tax year. The election must be clearly set forth on Form 970.

Section 1.472-8(e)(2)(ii)(*b*) of the regulations provides that the total current-year cost of items making up a dollar-value LIFO pool may be determined by reference to the actual cost of the goods purchased or produced during the tax year in the order of acquisition (earliest acquisitions method). Section 1.472-8(e)(2)(ii)(*a*) provides that the total current-year cost may be determined by reference to the actual cost of the goods most recently purchased or produced (latest acquisitions method).

Section 446(e) of the Code and section 1.446-1(e)(2)(i) of the regulations provide 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. See Rev. Proc. 84-74, 1984-2 C.B. 736, for the procedures to be followed in requesting the Commissioner's consent to change a method of accounting.

Selection of an "appropriate representative month" under section 1.472-8(e)(3)(iii)(C) of the regulations is an alternative to using the indexes as of the month or months most appropriate to the taxpayer's method of determining the current-year cost of the inventory pool, and normally the appropriate representative month will be one of the months most appropriate to the taxpayer's method. Thus, an appropriate representative month must be a month that has a nexus, or relationship, to the taxpayer's method of determining current-year cost and its historical experience of inventory purchases during the year. The timing of the index (the month selected) must relate to the timing of the determination of current-year cost; otherwise, distortion could occur. For example, if a taxpayer uses the latest acquisitions method for determining current-year cost, an appropriate representative month is almost invariably a month toward the end of the year (assuming uniform purchases during the year). If a taxpayer uses the earliest acquisitions method for determining current-year cost, an appropriate representative month is almost invariably a month toward the beginning of the year (assuming uniform purchases during the year).

In *Situation 1*, the taxpayer's "one-time binding" election of the December PPI as "an appropriate representative month" was proper because there is a nexus between the month of December, the taxpayer's election to use the latest acquisitions method, and the taxpayer's historical experience of inventory purchases during the year. In other words, the election of the December PPI was an "appropriate representative month," within the meaning of section 1.472-8-(e)(3)(iii)(C) of the regulations, because the taxpayer had elected the latest acquisitions method, and it normally made its latest purchases in December.

Since the taxpayer had elected an appropriate representative month and that month continues to be an appropriate representative month, consent will not be granted to use the November PPI, regardless of whether November is also an appropriate representative month. The words "one-time binding election" in section 1.472-8(e)(3)(iii)(C) of the regulations mean that the taxpayer's election of an appropriate representative month may not be changed unless the elected month is not an appropriate representative method.

In *Situation 2*, if the Commissioner consents to the taxpayer's request to change from the latest acquisitions method to the earliest acquisitions method, December will no longer be an appropriate representative month because there will be no nexus between that month, the earliest acquisitions method, and the taxpayer's historical experience of inventory purchases during the year. If the taxpayer continued to use PPI indexes for December, distortion could result because the timing of the index (December) would not relate to the timing of the determination of current-year cost (beginning of the year). Therefore, the Commissioner will consent to the taxpayer's request to change to the January PPI.

In *Situation 3,* December is no longer an appropriate representative month because the taxpayer changed its annual accounting period from the calendar tax year to a fiscal tax year ending June 30. There is no nexus between the use of the December PPI, the latest acquisitions method and the taxpayer's historical experience of inventory purchases during the year. The taxpayer's latest purchases for the year now occur in June rather than December. Therefore, the Commissioner will consent to the taxpayer's request to change to the June PPI.

In *Situation 4,* the taxpayer is requesting a change from a month that is not an appropriate representative month to a month that is an appropriate representative month. Therefore, the Commissioner will consent to the taxpayer's request to change to the December PPI.

In *Situations 2, 3,* and *4,* not only will the Commissioner consent to the request to change the taxpayer's month, but a change would be required even if the taxpayer did not request a change, since the taxpayer in each situation would be using a month that is not an appropriate representative month.

HOLDING

The Commissioner will not consent to a taxpayer's request to change its month for selecting price indexes in computing the LIFO value of its dollar-value pool under the IPI regulations unless the previously elected month is no longer an appropriate representative month under section 1.472-8(e)(3)(iii)(C) of the regulations. A month is an appropriate representative month if there is a nexus between the selected month, the taxpayer's method for determining current-year cost, and the taxpayer's historical experience of inventory purchases during the year.

Part III. Adjustments

Section 481.—Adjustments Required by Changes In Method of Accounting

26 CFR 1.481-5: Adjustments taken into account with consent.

A procedure is provided for certain taxpayers to obtain expeditious consent from the Commissioner to change their method of accounting for package design costs to a capitalization method in accordance with Rev. Rul. 89-23. See Rev. Proc. 89-16, page 822.

26 CFR 1.481-5: Adjustments taken into account with consent.

Taxpayers that incur package design costs are allowed to deem the useful lives of certain package designs to be 60 months. See Rev. Proc. 89-17, page 827.

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 January 1989. See Rev. Rul. 89-1, page 260.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of February 1989. See Rev. Rul. 89-15, page 262.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of March 1989. See Rev. Rul. 89-34, page 263.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of April 1989. See Rev. Rul. 89-39, page 264.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of May 1989. See Rev. Rul. 89-65, page 265.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of June 1989. See Rev. Rul. 89-77, page 266.

Subchapter F.—Exempt Organizations
Part I.—General Rule

Section 501.—Exemption from Tax on Corporations, Certain Trusts, etc.

26 CFR 1.501(c)(3)-1: Organizations organized and operated for religious, charitable, scientific, testing for public safety, literary, or educational purposes or for the preventions of cruelty to children or animals.

Whether churches such as those described in Rev. Rul. 78-232, 1978-1 C.B. 69, and Rev. Rul. 81-94, 1981-1 C.B. 330, are "tax shelters" for purposes of the substantial understatement penalty. See Rev. Rul. 89-74, page 311.

Part II.—Private Foundations

Section 509.—Private Foundation Defined

26 CFR 1.509(a)-3: Broadly, publicly supported organizations.

Guidelines for the circumstances where grant-making private foundations will not be considered to be responsible for substantial and material changes in the sources of financial support of recipient organizations for purposes of sections 1.509(a)-3(c)(1)(iii) and 1.509(a)-3(e)(3) of the regulations. See Rev. Proc. 89-23, page 844.

Subchapter G.—Corporations Used to Avoid Income Tax on Shareholders
Part II.—Personal Holding Companies

Section 542.—Definition of Personal Holding Company

26 CFR 1.542-3: Stock ownership requirement.

Personal holding company; rules for determining ownership. For purposes of classifying a corporation as a personal holding company under the stock ownership requirement in section 542(a)(2) of the Code, stock that is attributed from one person to another under the family and partnership rules of section 544(a)-(2), is not taken into account a second time either as stock of the person who owns it directly or as stock of a third person to whom it is also attributable. In the event that stock is owned directly by one person and is attributed to another, the first person may be counted among the five largest individual shareholders by virtue of attribution to that person of ownership of stock that is directly owned by others and that has not otherwise been taken into account for purposes of section 542(a)(2).

Rev. Rul. 89-20

ISSUES

For purposes of classifying a corporation as a personal holding company under the stock ownership requirement in section 542(a)(2) of the Internal Revenue Code—

(1) If ownership of stock in the corporation is attributed from one person to another under the family and partnership ownership rules of section 544(a)(2), may the stock be taken into account a second time either as stock of the person who owns it directly or as stock of a third person to whom it is also attributable?

(2) If not, and if the stock owned directly by one person is attributed to another, may the first person nevertheless be counted among the five largest shareholders by virtue of attribution to that person of ownership of stock that is directly owned by others and that is not otherwise taken into account for purposes of section 542(a)(2)?

FACTS

Situation 1

X is a publicly held corporation and has 1,000 shares of outstanding stock, all of which are common and are of equal value. *A* owns 200 shares of *X* stock; *A*'s child, *F*, owns 80 shares of *X* stock; *A*'s sibling, *B*, owns 50 shares of *X* stock; *B*'s spouse, *G*, owns 45 shares of *X* stock. *C*, *D*, and *E* are unrelated to *A*, *B*, *F*, or *G*, and each owns 40 shares of *X* stock. No other shareholder owns more than 40 shares of *X* stock, and all other shareholders are unrelated.

Situation 2

Y is a publicly held corporation and has 1,000 shares of outstanding stock, all of which are common and of equal value. *L* owns 50 shares of *Y* stock; *L*'s sibling, *K*, owns 110 shares of *Y* stock; *L*'s child, *M*, owns 45 shares of *Y* stock; *M*'s partner in *Q* partnership, *P*, owns 55 shares of *Y* stock; *M*'s spouse, *N*, owns 40 shares of *Y* stock. *R*, *S*, *T*, and *U* are unrelated to *K*, *L*, *M*, *N*, *Q*, and *P*, and *R*, *S*, *T*, and *U* each owns 70, 70, 70, and 60 shares, respectively, of *Y* stock. No other shareholder owns more than 40 shares of *Y* stock, and all other shareholders are unrelated.

LAW AND ANALYSIS

Section 541 of the Code imposes on the undistributed personal holding company income of every personal holding company a personal holding company tax equal to 28 percent (38.5 percent in the case of tax years beginning in 1987) of the undistributed personal holding company income.

Section 542(a) of the Code provides that a corporation will be classified as a personal holding company if (1) at least 60 percent of its adjusted ordinary gross income (as defined in section 543(b)(2)) for the tax year is personal holding company income, and (2) if at any time during the last half of the tax year more than 50 percent in value of its outstanding stock is owned, directly or indirectly, by or for not more than five individuals.

Section 544 of the Code provides rules for determining stock ownership. Section 544(a)(2) provides that for purposes of determining whether a corporation is a personal holding company, insofar as such determination is based on stock ownership under section 542(a)(2), an individual shall be considered as owning the stock owned, directly or indirectly, by or for the individual's family or by or for the individual's partner. For purposes of section 544(a)(2), the family of an individual includes only the individual's brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants.

Section 544(a)(5) of the Code and section 1.544-6(a)(3) of the Income Tax Regulations provide that stock constructively owned by an individual by reason of the application of the family and partnership rule provided in section 544(a)(2) shall not be considered as actually owned by such individual for the purpose of again applying such rule in order to make another individual the constructive owner of such stock.

Rev. Rul. 82-107, 1982-1 C.B. 103, demonstrates implicitly that stock may not be taken into account more than once. That ruling concerns an individual to whom stock is attributed from the individual's partners in two different partnerships. With the attribution taken into account, the individual is the largest shareholder of the corporation. One of the partners whose stock is attributed to that individual, however, owns directly more stock than is owned directly by any other shareholder. Despite that fact, the partner's stock is taken into account by virtue of its attribution to the individual, and the partner is not treated as one of the five largest individual shareholders.

The example in section 1.544-3(a) of the regulations illustrates the application of section 544(a)(2) of the Code, relating to constructive ownership by reason of family and partnership ownership. The example indicates that it is necessary first to identify the five individuals, for purposes of section 542(a)(2), that own the largest number of shares, directly and constructively.

For purposes of identifying the five largest individual shareholders, it is necessary to identify the individual shareholder who owns the largest number of shares, directly and constructively. In identifying the next largest individual shareholder, the largest individual shareholder's stock ownership, direct and constructive, is excluded from consideration. Similarly, to determine the next largest individual shareholder, the shareholders' stock that has been counted previously is excluded from consideration. After the five largest individual shareholders are identified in this way, the value of the largest five individuals' shares are added together to determine whether their total value exceeds 50 percent of the value of the corporation's outstanding stock for purposes of section 542(a)(2).

In the example in section 1.544-3(a) of the regulations, an individual, *DBW* (*D*'s brother's wife), is not identified as being one of the five largest individual shareholders. This omission is significant since that individual directly and constructively owns 170 shares, a number of shares that is not less than the number owned by some of the individuals that are identified as being among the five largest individual shareholders (*A*, *B*, and *EWB*). Because *DB* (*D*'s brother) owns directly and constructively more shares than *DBW*, *DBW*'s shares are allocated to *DB* for purposes of identifying the five largest individual shareholders and of determining whether five or fewer individual shareholders own more than 50 percent in value of the corporation's outstanding stock.

In *Situation 1*, under the constructive stock ownership provisions of section 544(a)(2) of the Code, *A* is considered to own 330 shares of *X* stock, 200 directly and 130 constructively from *A*'s child, *F*, and from *A*'s sibling, *B*. *F* is considered to own 280 shares, 80 directly and 200 constructively from *A*. *B* is considered to own 295 shares, 50 directly and 245 constructively from *A* and from *B*'s spouse, *G*. *G* is considered to own 95 shares, 45 directly and 50 constructively from *B*. No shares are attributed to *C*, *D* or *E*, who own directly 40 shares each.

With 330 shares, *A* is the largest individual shareholder of *X*. The shares owned directly by *F* and *B* are thus attributed to *A*. The shares owned by *A*, *F*, and *B* cannot be taken into account again, directly or indirectly, in determining the five largest individual shareholders.

G in the present situation differs from *DBW* in the example in section 1.544-3(a) of the regulations in that *DBW*'s shares were counted by her spouse, *DB*, to make him the major shareholder. In the present situation, *G* is not a person whose shares can be attributed to *A*. Thus, *G*'s shares have not been counted towards *A*'s total. *G*'s family consists of *B* and *G*. Although *B* is in *A*'s family and *G*'s family, as well as *B*'s own family, *B*'s shares have been counted by *A* and cannot be recounted for attribution to *G*. Thus, with the 45 shares owned directly, *G* is the second largest individual shareholder of *X* for purposes of section 542(a)(2) of the Code.

The next three largest individual shareholders of *X* are *C*, *D*, and *E*, each of whom owns 40 shares of *X*, or a total of 120 shares. Therefore, the five largest individual shareholders of *X* are *A*, *G*, *C*, *D*, and *E*. They own 495 shares, which do not represent more than 50 percent in value of *X*'s outstanding stock. Therefore, *X* does not meet the stock ownership requirement of section 542(a)(2) of the Code and is not a personal holding company.

In *Situation 2,* under the constructive ownership provisions of section 544(a)(2) of the Code, *L* is considered to own 205 shares of *Y* stock, 50 directly and 155 constructively from *L*'s sibling, *K*, and *L*'s child, *M*. *K* is considered to own 160 shares of *Y* stock, 110 directly and 50 constructively from *L*. *M* is considered to own 190 shares of *Y* stock, 45 directly and 145 shares constructively from *L, N,* and *P*. *N* is considered to own 85 shares of *Y* stock, 40 directly and 45 constructively from *M*; *P* is considered to own 100 shares of *Y* stock, 55 directly and 45 constructively from *M*. No shares have been attributed to *R, S, T,* or *U,* who directly own 70, 70, 70, and 60 shares, respectively, of *Y* stock.

With 205 shares, *L* is the largest individual shareholder of *Y*. The shares owned directly by *K* and *M* are thus attributed to *L*. The shares owned by *K, L,* and *M* cannot be taken into account again, directly or indirectly, in determining the five largest individual shareholders.

The fact however, that *M*'s shares have been attributed to *L* does not preclude *M* from being counted among the five largest individual shareholders for purposes of section 542(a)(2) of the Code, provided that section 544(a)(4) attributes to *M* a sufficient amount of *Y* stock.

M constructively owns 95 shares of *Y* from *N* and *P*. The 95 shares that *M* constructively owns are counted in determining whether *M* is among the five largest individual shareholders for purposes of section 542(a)(2) of the Code. As a result, *M* is the second largest individual shareholder of *Y*. The next three largest individual shareholders of *Y* are *R, S,* and *T*, each of whom owns 70 shares of *Y*, or a total of 210 shares. Therefore, the five largest individual shareholders of *Y* are *L, M, R, S,* and *T*. They own 510 shares, which represent more than 50 percent in value of *Y*'s outstanding stock. Therefore, *Y* meets the stock ownership requirement of section 542(a)(2) of the Code.

HOLDING

For purposes of classifying a corporation as a personal holding company under the stock ownership requirement in section 542(a)(2) of the Code, stock that is attributed from one person to another under the family and partnership rules of section 544(a)(2), is not taken into account a second time either as stock of the person who owns it directly or as stock of a third person to whom it is also attributable. In the event that stock is owned directly by one person and is attributed to another, the first person may be counted among the five largest individual shareholders by virtue of attribution to that person of ownership of stock that is directly owned by others and that has not otherwise been taken into account for purposes of section 542(a)(2).

Part IV.—Deduction for Dividends Paid

Section 561.—Definition of Deduction for Dividends Paid

26 CFR 1.561-2: When dividends are considered paid.

Whether the term "shareholder" refers to the legal owner of a regulated investment company's shares rather than the beneficial owner of the shares, for purposes of the payment of dividends. See Rev. Rul. 89-79, below.

Section 562.—Rules Applicable in Determining Dividends Eligible for Dividends Paid Deduction

26 CFR 1.562-2: Preferential dividends.
(Also Sections 561, 851, 852; 1.561-2, 1.851-1, 1.852-1, 1.852-3.)

Dividends paid deduction; preferential dividends; regulated investment companies. For purposes of applying the $10,000,000 initial investment requirement of section 562(c) of the Code, the term "shareholder" refers to the legal owner of a regulated investment company's shares rather than to the beneficial owner.

Rev. Rul. 89-79

ISSUE

For purposes of applying the $10,000,000 initial investment requirement of section 562(c) of the Internal Revenue Code, does the term "shareholder" refer to the legal owner or to the beneficial owner of a regulated investment company's shares?

FACTS

X is a domestic corporation registered with the Securities and Exchange Commission under the Investment Company Act of 1940, 15 U.S.C. sections 80a-1 to 80b-2, as an open-end management investment company. *X* qualifies as a regulated investment company within the meaning of section 851(a) of the Code.

Most persons that invest in *X* as fiduciaries maintain master shareholder accounts with *X*. Each of the master shareholder accounts on the books of the regulated investment company may represent shares in *X* held by the fiduciary on behalf of numerous trusts, estates, and other participants. Through these master accounts, the fiduciaries make purchases and participate in redemptions of shares of *X*, and receive payments of dividends, on behalf of the beneficial owners of shares of *X*. The initial investments in *X* by the fiduciaries sometimes equal or exceed $10,000,000 per account.

X determines the distributions to be paid with respect to each share on its books by allocating income to each account and then subtracting an allocable portion of its management fees and administrative expenses. *X* allocates income among accounts in a manner that is proportionate to the number of shares held. *X* allocates management and administrative expenses among accounts in the following manner.

Certain administrative expenses of *X* are uniform with respect to each shareholder account, regardless of the number of shares held in the account. Thus, in the case of such expenses, *X*'s cost-per-share decreases as the account size increases. In the case of accounts in which there was an initial investment of at least $10,000,000, *X* allocates a portion of such expenses on the basis of a uniform-cost-per-account. *X* treats a fiduciary as the shareholder in determining the initial investment in an account. *X* allocates the remaining portion of such administrative expenses among the other accounts on a uniform-cost-per-share basis. Administrative expenses that do not vary on a per-share basis and all management fees are allocated among all accounts on a uniform-cost-per-share basis.

As a result of this method of allocation, *X* pays a higher per-share dividend with respect to accounts meeting the $10,000,000 initial investment threshold.

LAW AND ANALYSIS

Section 851(a) of the Code defines a "regulated investment company" (RIC) as any domestic corporation that at all times during the tax year is registered under the Investment Company Act of 1940 (15 U.S.C. sections 80a-1 to 80b-2), as amended, as a management company, business development company, or unit investment trust.

Section 852(b) of the Code provides for the taxation of RICs. It provides that investment company taxable income shall be the taxable income of the RIC with certain adjustments, including a deduction for dividends paid during the tax year (as defined in section 561).

Section 561(a) of the Code provides that the deduction for dividends paid equals the sum of the dividends paid during the tax year.

Section 562(c) of the Code provides that a distribution shall not be considered as a dividend for purposes of computing the dividends paid deduction unless such distribution is pro rata, with no preference to any shares of stock as compared with other shares of the same class, and with no preference to one class of stock as compared with another class except to the extent that the former is entitled (without reference to waivers of their rights by shareholders) to such preference. Section 657(a) of the Tax Reform Act of 1986 (1986 Act), 1986-3 (Vol. 1) C.B. 216, amended section 562(c) to provide that, in the case of a distribution to a shareholder that made an initial investment of at least $10,000,000 in a RIC, the distribution shall not be treated as non pro rata or preferential solely by reason of an increase in the distribution attributable to reductions in administrative expenses of the company. The result of the amendment is that the passthrough of administrative cost savings in the form of increased dividends to eligible shareholders does not cause a RIC's dividends to be treated as preferential dividends that are not deductible under section 561(a).

Although the term shareholder, when used in the Code, generally refers to the beneficial owner of shares, interpretation of that term, in section 562(c), to refer to the legal owner of the shares is consistent with the purposes of that section. The amendment of section 562(c) was premised on the assumption that large accounts impose on RICs lower per-share administrative costs than small accounts. Congress concluded that the preferential dividend rules should not preclude a RIC from passing through these administrative cost savings to certain large accounts. Typically, these administrative cost savings relate to the size of the account maintained by the legal owner of the shares, rather than to the size of the interests in that account held by the ultimate beneficial owners. That is, the fact that a large fiduciary master shareholder account may represent the interests of multiple beneficial owners does not change the fact that a RIC's per-share administrative costs are lower for the master account than for smaller accounts. Interpreting the term "shareholder," as used in section 562(c), to refer to the beneficial owner rather than the legal owner of the RIC shares would frustrate the purposes of the section.

HOLDING

For purposes of applying the $10,000,000 initial investment requirement of section 562(c) of the Code, the term "shareholder" refers to the legal owner of a RIC's shares.

EFFECTIVE DATE

This revenue ruling applies to dividends distributed after October 22, 1986, the effective date of section 657(b) of the 1986 Act, 1986-3 (Vol. 1) C.B. 216.

Section 565.—Consent Dividends

26 CFR 1.565-1: General rule.

T.D. 8244

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

Consent Dividends

AGENCY: Internal Revenue Service, Treasury.

ACTION: Final Regulations.

SUMMARY: This document contains final Income Tax Regulations relating to the consent dividend provisions of section 565 of the Internal Revenue Code of 1986. A review of the legislative history of section 565 has prompted certain amendments to the regulations under section 565. These amendments will provide the public with additional guidance to comply with the provisions of section 565.

EFFECTIVE DATE: These regulations are effective for tax years ending after December 15, 1987.

SUPPLEMENTARY INFORMATION:

PAPERWORK REDUCTION ACT

The collection of information contained in this final regulation has been reviewed and approved by the Office of Management and Budget in accordance with the requirements of the Paperwork Reduction Act (44 U.S.C. 3504(h)) under control number 1545-0043. The estimated annual burden associated with the collection of information in this final rule is 45 minutes per respondent.

These estimates are an approximation of the average time expected to be necessary for a collection of information. They are based on such information as is available to the Internal Revenue Service. Individual respondents may require greater or less time, depending on their particular circumstances.

Comments concerning the accuracy of this burden estimate and suggestions for reducing this burden should be directed to the Internal Revenue Service, Attn: IRS Reports Clearance Officer TR:FP, Washington, DC 20224, and to the Office of Management and Budget, Paperwork Reduction Project, Washington, DC 20503.

BACKGROUND

On December 15, 1987, the FEDERAL REGISTER published proposed amendments (52 FR 47554) [T.D. 8166, 1988-1 C.B. 254] to the Income Tax Regulations (26 CFR Part 1) under section 565 of the Internal Revenue Code of 1986. These amendments to the prior regulations under section 565 shall be applicable for tax years ending after December 15, 1987. Written comments to the notice were received. No public hearing was held. After consideration of all comments regarding the proposed amendments, those amendments are adopted by this Treasury Decision with revisions in response to those comments. The significant comments and revisions are discussed below.

EXPLANATION OF PROVISIONS

In response to comments, the language of section 1.565-1(a)(2) has been expanded to make it clear that a corporation, 50 percent or more of whose adjusted ordinary gross income is adjusted income from rents, continues to be able to utilize the consent dividend under section 565, as described in section 543(a)(2)(B)(iii), for purposes of avoiding personal holding company status. In addition, certain stylistic and organizational changes were made that were not intended to have substantive effect.

SPECIAL ANALYSES

It has been determined that these rules are not major rules as defined in Executive Order 12291. Therefore a Regulatory Impact Analysis is not required. Although this Treasury Decision was preceded by a notice of proposed rulemaking that solicited public comments, it has been determined that the notice was not required by 5 U.S.C. §553 since the regulations proposed in that notice and adopted by this Treasury Decision will not have a significant impact on a substantial number of small entities. Therefore, a final Regulatory Flexibility Analysis is not required by the Regulatory Flexibility Act (5 U.S.C. Chapter 6).

* * * * * *

Adoption of amendments to the regulations

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

INCOME TAX REGULATIONS
(26 CFR Part 1)

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

Authority: 26 CFR 7805. * * *

Par. 2. Sections 1.565-1T through 1.565-6T are removed.

Par. 3. New §§1.565-1 through 1.565-3, §1.565-5 and §1.565-6 are added at the appropriate place to read as follows:

§.565-1 General rule.

(a) *Consent dividends.* The dividends paid deduction, as defined in section 561, includes the consent dividends for the taxable year. A consent dividend is a hypothetical distribution (as distinguished from an actual distribution) made by:

(1) A corporation that has a reasonable basis to believe that it is subject to the accumulated earnings tax imposed in part I of subchapter G, chapter 1 of the Code, or

(2) A corporation described in part II (personal holding companies or a corporation with adjusted income from rents described in section 543(a)(2)(A) which utilizes the consent dividends described in section 543(a)(2)(B)(iii) to avoid personal holding company status) or part III (foreign personal holding companies) of subchapter G or in part I (regulated investment companies) or part II (real estate investment trusts) of subchapter M, chapter 1 of the Code.

A consent dividend may be made by a corporation described in this paragraph to any person who owns consent stock on the last day of the taxable year of such corporation and who agrees to treat the hypothetical distribution as an actual dividend, subject to the limitations in section 565, §1.565-2, and paragraph (c)(2) of this section, by filing a consent at the time and in the manner specified in paragraph (b) of this section.

(b) *Making and filing of consents.* (1) A consent shall be made on Form 972 in accordance with this section and the instructions on the form issued therewith. It may be made only by or on behalf of a person who was the actual owner on the last day of the corporation's taxable year of any class of consent stock, that is, the person who would have been required to include in gross income any dividends on such stock actually distributed on the last day of such year. Form 972 shall contain or be verified by a written declaration that it is made under the penalties of perjury. In the consent such person must agree to include in gross income for his taxable year in which or with which the taxable year of the corporation ends a specific amount as a taxable dividend.

(2) See paragraph (c) of this section and §1.565-2 for the rules as to when all or a portion of the amount so specified will be disregarded for tax purposes.

(3) A consent may be filed at any time not later than the due date of the corporation's income tax return for the taxable year for which the dividends paid deduction is claimed. With such return, and not later than the due date thereof, the corporation must file Forms 972 duly executed by each consenting shareholder, and a return on Form 973 showing by classes the stock outstanding on the first and last days of the taxable year, the dividend rights of such stock, distributions made during the taxable year to shareholders, and giving all the other information required by the form. Form 973 shall contain or be verified by a written declaration that is made under the penalties of perjury.

(c) *Taxability of amounts specified in consents.* (1) The filing of a consent is irrevocable, and except as otherwise provided in section 565(b), §1.565-2, and paragraph (c)(2) of this section, the full amount specified in a consent filed by a shareholder of a corporation described in paragraph (a) of this section shall be included in the gross income of the shareholder as a taxable dividend. Where the shareholder is taxable on a dividend only if received from sources within the United States, the amount specified in the consent of the shareholder shall be treated as a dividend from sources within the United States in the same manner as if the dividend had been paid in money to the shareholder on the last day of the corporation's taxable year. See paragraph (b) of this section relating to the making and filing of consents, and section 565(e) and §1.565-5, with respect to the payment requirement in the case of nonresident aliens and foreign corporations.

(2) To the extent that the Commissioner determines that the corporation making a consent dividend is not a corporation described in paragraph (a) of this section, the amount specified in the consent is not a consent dividend and the amount specified in the consent will not be included in the gross income of the shareholder. In addition, where a corporation is described in paragraph (a)(1) but not paragraph (a)(2) of this section, to the extent that the Commissioner determines that the amount specified in a consent is larger than the amount of earnings subject to the accumulated earnings tax imposed by part I of subchapter G, such excess is not a consent dividend under paragraph (a) of this section and will not be included in the gross income of the shareholder.

(3) Except as provided in section 565(b), §1.565-2 and paragraph (c)(2) of this section, once a shareholder's consent is filed, the full amount specified in such consent must be included in the shareholder's gross income as a taxable dividend, and the ground upon which a deduction for consent dividends is denied the corporation does not affect the taxability of a shareholder whose consent has been filed for the amount specified in the consent. For example, although described in part I, II, or III of subchapter G, or part I or II of subchapter M, chapter I of the Code, the corporation's taxable income (as adjusted under section 535(b), 545(b), 556(b), 852(b)(2), or 857(b)(2), as appropriate) may be less than the total of the consent dividends.

(4) A shareholder who is a nonresident alien or a foreign corporation is taxable on the full amount of the consent dividend that otherwise qualifies under this section even though that payment has not been made as required by section 565(e) and §1.565-5.

(5) Income of a foreign corporation is not subject to the tax on accumulated earnings under part I of subchapter G, chapter 1 of the Code except to the extent of U.S. source income, adjusted as permitted under section 535. See section 535(b) and (d) and §1.535-1(b). Therefore, foreign source earnings (other than those distributions subject to resourcing under section 535 (d)) of a foreign corporation that is not described in paragraph (a)(2) of this section cannot qualify for consent dividend treatment. Accordingly, a consent dividend made by a foreign corporation described in paragraph (a)(1) of this section shall not be effective with respect to all of the corporation's earnings, but shall relate solely to earnings which would have been, in the absence of the consent dividend, subject to the accumulated earnings tax.

§1.565-2 Limitations.

(a) *General rule.* Amounts specified in consents filed by shareholders or other beneficial owners of a corporation described in §1.565-1(a) are not treated as consent dividends to the extent that—

(1) They would constitute a preferential dividend or

(2) They would not constitute a dividend (as defined in section 316),

if distributed in money to shareholders on the last day of the taxable year of the corporation. If any portion of any amount specified in a consent filed by a shareholder of a corporation described in the preceding sentence is not treated as a consent dividend under section 565(b) and this section, it is disregarded for all tax purposes. For example, it is not taxable to the consenting shareholder, and paragraph (c) of §1.565-1 is not applicable to this portion of the amount specified in the consent.

(b) *Preferential Distribution.* (1) A preferential distribution is an actual distribution, or a consent distribution, or a combination of the two, which involves a preference to one or more shares of stock as compared with other shares of the same class or to one class of stock as compared with any other class of stock. See section 562(c) and §1.562-2.

(2) The application of section 565(b)-(1) and §1.565-2(b) may be illustrated by the following examples:

Example (1). The X Corporation, a personal holding company, which makes its income tax returns on the calendar year basis, has 200 shares of stock outstanding, owned by A and B in equal amounts. On December 15, 1987, the corporation distributes $600 to B and $100 to A. As a part of the same distribution, A executes a consent to include $500 in his gross income as a taxable dividend although such amount is not distributed to him. The X Corporation, assuming the other requirements of section 565 have been complied with, is entitled to a consent dividends deduction of $500. Although the consent dividend is deemed to have been paid on December 31, 1987, the last day of the taxable year of the corporation, the total amount of all distributions constitutes a single nonpreferential distribution of $1200.

Example (2). The Y Corporation, a personal holding company, which makes its income tax returns on the calendar year basis, has one class of consent stock outstanding, owned in equal amounts by A, B, and C. If A and B each receive a distribution in cash of $5,000 and C consents to include $3,000 in gross income as a taxable dividend, the combined actual and consent distribution of $13,000 is preferential. See section 562(c) and §1.562-2(a). Similarly, if no one receives a distribution in cash, but A and B each consents to include $5,000 as a taxable dividend in gross income and C agrees to include only $3,000, the entire consent distribution is preferential.

Example (3). The Z Corporation, which makes its income tax returns on the calendar year basis and is subject, for the taxable year in question, to the accumulated earnings tax, has only two classes of stock outstanding, each class being consent stock and consisting of 500 shares. Class A, with a par value of $40 per share, is entitled to two-thirds of any distribution of earnings and profits. Class B, with a par value of $20 per share, is entitled to one-third of any distribution of earnings and profits. On December 15, 1987, there is distributed on the class B stock $2 per share, or $1,000, and shareholders of the class A stock consent to include in gross income amounts equal to $2 per share, or $1,000, The entire distribution of $2000 is preferential, inasmuch as the class B stock has received more than its pro rata share of the combined amounts of the actual distributions and the consent distributions.

(c) *Section 316 Limitation.* (1) An additional limitation under section 565(b) is that the amounts specified in consents which may be treated as consent dividends cannot exceed the amounts which would constitute a dividend (as defined in section 316) if the corporation had distributed the total specified amounts in money to shareholders on the last day of the taxable year of the corporation. If only a portion of such total would constitute a dividend, then only a corresponding portion of each specified amount is treated as a consent dividend.

(2) The application of section 565(b)-(2) and §1.565-2(c) may be illustrated by the following example:

Example. The X Corporation, a corporation described in §1.565-1(a)(1) or (2), which makes its income tax returns on the calendar year basis, has only one class of stock outstanding, owned in equal amounts by A and B. It makes no distributions during the taxable year 1987. Its earnings and profits for the calendar year 1987 amount to $8,000, there being at the beginning of such year no accumulated earnings or profits. A and B execute proper consents to include $5,000 each in their gross income as a dividend received by them on December 31, 1987. The sum of the amounts specified in the consents executed by A and B is $10,000, but if $10,000 had actually been distributed by the X corporation on December 31, 1987 only $8,000 would have constituted a dividend under section 316(a). The amount which could be considered as consent dividends in computing the dividends paid deduction for purposes of the accumulated earnings tax is limited to $8,000, or $4,000 of the $5,000 specified in each consent. The remaining $1,000 in each consent is disregarded for all tax purposes. (In the case of a personal holding company, see also the example in §1.565-3(b).)

§1.565-3 Effect of consent.

(a) *General Rule.* The amount of the consent dividend that is described in paragraph (a) of §1.565-1 shall be considered, for all purposes of the Code, as if it were distributed in money by the corporation to the shareholder on the last day of the taxable year of the corporation, received by the shareholder on such day, and immediately contributed by the shareholder as paid-in capital to the corporation on such day. Thus, the amount of the consent dividend will be treated by the shareholder as a dividend. The shareholder will be entitled to the dividends received deduction under section 243 or 245 with respect to such consent dividend. The basis of the shareholder's consent stock in a corporation will be increased by the amount thus treated in his hands as a dividend which he is considered as having contributed to the corporation as paid-in capital. The amount of the current dividend will also be treated as a dividend received from sources within the United States in the same manner as if the dividend had been paid in money to the shareholders. Among other effects of the consent dividend, the earnings and profits of the corporation will be decreased by the amount of the consent dividends. Moreover, if the shareholder is a corporation, its accumulated earnings and profits will be increased by the amount of the consent dividend with respect to which it makes a consent.

(b) *Example.* The application of section 565(c) may be illustrated by the following example:

Example. Corporation A, a personal holding company and a calendar year taxpayer, has one shareholder, individual B, whose consent to include $10,000 in his gross income for the calendar year 1987 has been timely filed. A has $8,000 of earnings and profits at the beginning of 1987. A has $10,000 of undistributed personal holding company income (determined without regard to distributions under section 316(b)(2)) for 1987. B must include $10,000 in his gross income as a taxable income and is treated as having immediately contributed $10,000 to A as paid-in capital. See section 316(b)(2).

§1.565-5 Nonresident aliens and foreign corporations.

(a) *Withholding.* In the event that a corporation makes a consent dividend, as described in §1.565-1(a), to a shareholder that is subject to a withholding tax under section 1441 or 1442 on a distribution of cash or other property, the corporation must remit an amount of tax equal to the withholding tax that would be imposed under section 1441 or 1442 if an actual cash distribution equal to the consent dividend had been paid to the shareholder on the last day of the corporation's taxable year. Such payment must be in one of the following forms:

(1) Cash,

(2) United States postal money order,

(3) Certified check drawn on a domestic bank, provided that the law of the place where the bank is located does not permit the certification to be rescinded prior to presentation,

(4) A cashier's check of a domestic bank, or

(5) A draft on a domestic bank or a foreign bank maintaining a United States agency or branch and payable in United States funds.

The amount of such payment shall be credited against the tax imposed on the shareholder.

§1.565-6 Definitions.

(a) *Consent stock.* (1) The term "consent stock" includes what is generally known as common stock. It also includes participating preferred stock, the participation rights of which are unlimited.

(2) The definition of consent stock may be illustrated by the following example:

Example. If in the case of the X Corporation, a personal holding company, there is only one class of stock outstanding, it would all be consent stock. If, on the other hand, there were two classes of stock, class A and class B, and class A was entitled to 6 percent before any distribution could be made on class B, but class B was entitled to everything distributed after class A had received its 6 percent, only class B stock would be consent stock. Similarly, if class A, after receiving its 6 percent, was to participate equally or in some fixed proportion with class B until it had received a second 6 percent, after which class B alone was entitled to any further distributions, only class B stock would be consent stock. The same result would follow if the order of preferences were class A 6 percent, then class B 6 percent, then class A a second 6 percent, either alone or in conjunction with class B, then class B the remainder. If, however, class A stock is entitled to ultimate participation without limit as to amount, then it, too, may be consent stock. For example, if class A is to receive 3 percent and then share equally or in some fixed proportion with class B in the remainder of the earnings or profits distributed, both class A stock and class B stock are consent stock.

(b) *Preferred dividends.* (1) The term "preferred dividends" includes all fixed amounts (whether determined by percentage of par value, a stated return expressed in a certain number of dollars per share, or otherwise) the distribution of which on any class of stock is a condition precedent to a further distribution of earnings or profits (not including a distribution in partial or complete liquidation). A distribution, though expressed in terms of a fixed amount, is not a preferred dividend, however, unless it is preferred over a subsequent distribution within the taxable year upon some class or classes of stock other than one on which it is payable.

(2) The definition of preferred dividends may be illustrated by the following example:

Example. If, in the case of the X Corporation, there are only two classes of stock outstanding, class A and class B, and class A is entitled to a distribution of 6 percent of par, after which the balance of the earnings and profits are distributable on class B exclusively, class A's 6 percent is a preferred dividend. If the order of preferences is class A $6 per share, class B $6 per share, then class A and class B in fixed proportions until class A receives $3 more per share, then class B the remainder, all of class A's $9 per share and $6 per share of the amount distributable on class B are preferred dividends. The amount which class B is entitled to receive in conjunction with the payment to class A of its last $3 per share is not a preferred dividend, because the payment of such amount is preferred over no subsequent distribution except one made on class B itself. Finally, if a distribution must be $6 on class A, $6 on class B, then on class A and class B share and share alike, the distribution on class A of $6 and the distribution on class B of $6 are both preferred dividends.

OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT (CFR PART 602)

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

Authority: 26 U.S.C. 7805.

Par. 5. Section 602.101(c) is amended by inserting in the appropriate place in the table:

"§1.565-1 ... 1545-0043."
"§1.565-2 ... 1545-0043."
"§1.565-3 ... 1545-0043."
"§1.565-5 ... 1545-0043."
"§1.565-6 ... 1545-0043."

Lawrence B. Gibbs,
Commissioner of Internal Revenue.

Approved January 13, 1989.

O. Donaldson Chapoton,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on March 13, 1989, 8:45 a.m., and published in the issue of the Federal Register for March 14, 1989, 54 F.R. 10537)

Subchapter H.—Banking Institutions
Part II.—Mutual Savings Banks, etc.

Section 593.—Reserves for Losses on Loans

26 CFR 1.593-1: Additions to reserve for bad debts.

In determining the net operating loss carryforward period under section 172(b)(1)(L) of the Code, (1) when must a taxpayer be an organization to which section 593 applies; and (2) which version of section 593 (former section 593 or section 593 as amended by the Tax Reform Act of 1986) applies. See Rev. Rul. 89-78, page 80.

26 CFR 1.593-11: Qualifying real property loan and nonqualifying loan defined.

A loan made for the purchase of stock in a cooperative housing corporation, and secured by such stock, is a qualifying real property loan within the meaning of section 593(d)(1). See Rev. Rul. 89-59, page 317.

Subchapter I.—Natural Resources
Part I.—Deductions

Section 612.—Basis for Cost Depletion

26 CFR 1.612-4: Charges to capital and to expense in case of oil and gas wells.

Guidance is provided regarding which costs incurred in the course of fabricating, transporting and installing an offshore oil and gas drilling and production platform and the related facilities and equipment are within the option to expense intangible drilling and development costs provided by section 263(c) of the Code. See Rev. Rul. 89-56, page 83.

Subchapter J.—Estates, Trusts, Beneficiaries, and Decedents
Subpart C.—Estates and Trusts Which May Accumulate Income or Which Distribute Corpus

Section 664.—Charitable Remainder Trusts

26 CFR 1.664-2: Charitable remainder annuity trust.

The Service ordinarily will not issue rulings as to whether an inter vivos charitable remainder trust that provides for annuity payments during one measuring life satisfies the requirements described in section 664(d)(1) of the Code. See Rev. Proc. 89-19, page 841.

26 CFR 1.664-2: Charitable remainder annuity trust.

Sample form of declaration of trust that meets the requirements for an inter vivos charitable remainder annuity trust providing for annuity payments during one life. See Rev. Proc. 89-21, page 842.

26 CFR 1.664-3: Charitable remainder unitrust.

The Service ordinarily will not issue rulings as to whether an inter vivos charitable remainder trust that provides for unitrust payments during one measuring life satisfies the requirements described in section 664(d)(2) of the Code. See Rev. Proc. 89-19, page 841.

26 CFR 1.664-3: Charitable remainder unitrust.

Sample form of declaration of trust that meets the requirements for an inter vivos charitable remainder unitrust providing for unitrust payments during one life. See Rev. Proc. 89-20, page 841.

Subchapter K.—Partners and Partnerships
Part I.—Determination of Tax Liability

Section 701.—Partners, Not Partnership, Subject To Tax

In accordance with sections 702(a) and (b) of the Code and section 1.702-1(a)(8)(ii) of the regulations, a controlled foreign corporation's distributive share of partnership income is taken into account separately by the controlled foreign corporation, and the character of such income is determined as if it were realized directly by the controlled foreign corporation from the source from which the partnership realized such income. See Rev. Rul. 89-72, page 257.

Section 702.—Income and Credits of Partner

26 CFR 1.702-1: Income and credits of partner.

T.D. 8247

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1

Requirement for Certain Partnerships and S Corporations to Separately State Meal, Travel, and Entertainment Expenses

AGENCY: Internal Revenue Service, Treasury.

ACTION: Final regulations and removal of temporary regulations.

SUMMARY: This document provides final regulations relating to the requirement for certain partnerships and S corporations to separately state meal, travel, and entertainment expenses. These regulations are necessary because of changes made to prior law by the Tax Reform Act of 1986. These regulations provide the public with guidance needed to comply with the law.

EFFECTIVE DATE: The regulations are effective for taxable years beginning on or after January 1, 1987.

SUPPLEMENTARY INFORMATION:

On March 2, 1988, the FEDERAL REGISTER published (53 FR 6670) [LR-29-87, 1988-1 C.B. 927] proposed amendments to the Income Tax Regulations (26 CFR Part 1) under sections 702 and 1366 of the Internal Revenue Code, as well as temporary regulations (T.D. 8182, 53 FR 6602) [1988-1 C.B. 258] containing the same rules. The amendments to the regulations were made necessary because of amendments to the Code by section 142 of the Tax Reform Act of 1986 (the Act). Three comments were received on the notice of proposed rulemaking. A public hearing was not requested or held. After consideration of the comments regarding the proposed amendments, those amendments are adopted as revised by this Treasury decision. These regulations supersede the temporary regulations issued under §§1.702-1T and 1.1366-1T.

Section 142 of the Act made significant changes to the rules for deducting meal, travel, and entertainment expenses. These changes are effective for taxable years beginning on or after January 1, 1987. On March 2, 1987, the Internal Revenue Service published Notice 87-23 in the Internal Revenue Bulletin (1987-1 C.B. 467). The notice announced special effective date rules that required partnerships and S corporations that have taxable years beginning before January 1, 1987, and ending with or within partners' or shareholders' taxable years beginning on or after January 1, 1987, to separately state meal, travel, and entertainment expenses paid or incurred after December 31, 1986. With respect to skybox rentals, partnerships and S corporations that have taxable years beginning before January 1, 1989, and ending with or within partners' or shareholders' taxable years beginning on or after January 1, 1987, are required to separately state rents paid or incurred after December 31, 1986. On June 22, 1987, the Service published Notice 87-45 in the Internal Revenue Bulletin (1987-1 C.B. 502). Notice 87-45 provided additional instructions to Form 1065 and Form 1120S concerning certain expenses for meals, travel, and entertainment of 1986-87 fiscal year corporations. The temporary regulations and cross-referencing notice of proposed rulemaking implemented the special effective date rules announced in the notices.

Three comments were received on the notice of proposed rulemaking. All three commentators stated that the special effective date rules in the proposed regulations are inconsistent with the statutory effective date for section 142 of the Act. The commentators suggested that the limitations imposed by section 142 of the Act should not apply to expenses paid or incurred by a partnership or an S corporation until the first day of the partnership's or S corporation's taxable year beginning after December 31, 1986. This suggestion was not adopted by the final regulations because the limitations imposed by section 142 of the Act should be applied to expenses incurred after the statutory effective date of section 142 of the Act and deducted on the returns of partners and shareholders in taxable years beginning on or after January 1, 1987. This effective date rule is consistent with congressional intent in the Act of applying the reductions of tax rates and the restrictions on deductions as of the same date.

Special Analyses

These rules are not major rules as defined in Executive Order 12291. Therefore, a Regulatory Impact Analysis is not required. Although this Treasury decision was preceded by a notice of proposed rulemaking that solicited public comments, the notice was not required by 5 U.S.C. 553 since the regulations proposed in that notice and adopted by this Treasury decision are interpretative. Therefore, a final Regulatory Flexibility Analysis is not required by the Regulatory Flexibility Act (5 U.S.C. Chapter 6).

* * * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR Part 1 is amended as follows:

PART 1—INCOME TAX; TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1986

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

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

Par. 2. Section 1.702-1T is removed.

Par. 3 Section 1.702-1 is amended by redesignating paragraph (e) as paragraph (f), and by adding a new paragraph (e) to read as set forth below.

§1.702-1 Income and credits of partner.
* * * * *

(e) *Special rules on requirement to separately state meal, travel, and entertainment expenses.* Each partner shall take into account separately his or her distributive share of meal, travel, and entertainment expenses paid or incurred after December 31, 1986, by partnerships that have taxable years beginning before January 1, 1987, and ending with or within partners' taxable years beginning on or after January 1, 1987. In addition, with respect to skybox rentals under section 274(1)(2), each partner shall take into account separately his or her distributive share of rents paid or incurred after December 31, 1986, by partnerships that have taxable years beginning before January 1, 1989, and ending with or within partners' taxable years beginning on or after January 1, 1987.

Par. 4. Section 1.1366-1T is removed.

Par. 5. Section 1.1366-1 is added and reserved, and new §1.1366-2 is added at the appropriate place to read as follows:

§1.1366-2 Special rules on requirement to separately state meal, travel, and entertainment expenses.

Each shareholder shall take into account separately his or her pro rata share of meal, travel, and entertainment expenses paid or incurred after December 31, 1986, by S corporations that have taxable years beginning before January 1, 1987, and ending with or within shareholders' taxable years beginning on or after January 1, 1987. In addition, with respect to skybox rentals under section 274(1)(2), each shareholder shall take into account separately his or her pro rata share of rents paid or incurred after December 31, 1986, by S corporations that have taxable years beginning before January 1, 1989, and ending with or within shareholders' taxable years beginning on or after January 1, 1987.

Lawrence B. Gibbs,
Commissioner of Internal Revenue.

Approved March 16, 1989.

Dennis E. Ross,
Acting Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on April 4, 1989, 8:45 a.m., and published in the issue of the Federal Register for April 5, 1989, 54 F.R. 13679)

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26 CFR 1.702-1: Income and credits of partner.

If a partner's distributive share of the partnership's expenses under section 179 of the Code is not fully deductible by the partner because, when combined with the partner's section 179 expenses from other sources, the partner's section 179 expenses from all sources exceed the maximum amount allowable to the partner under section 179(b)(1), is the partner's basis in the partnership interest reduced by the partner's full distributive share of the partnership's section 179 expenses, including the partnership's section 179 expenses that the partner cannot deduct? See Rev. Rul. 89-7, this page.

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26 CFR 1.702-1: Income and credits of partner.

In accordance with sections 702(a) and (b) of the Code and section 1.702-1(a)(8)(ii) of the regulations, a controlled foreign corporation's distributive share of partnership income is taken into account separately by the controlled foreign corporation, and the character of such income is determined as if it were realized directly by the controlled foreign corporation from the source from which the partnership realized such income. See Rev. Rul. 89-72, page 257.

Section 703.—Partnership Computations

If a partner's distributive share of the partnership's expenses under section 179 of the Code is not fully deductible by the partner because, when combined with the partner's section 179 expenses from other sources, the partner's section 179 expenses from all sources exceed the maximum amount allowable to the partner under section 179(b)(1), is the partner's basis in the partnership interest reduced by the partner's full distributive share of the partnership's section 179 expenses, including the partnership's section 179 expenses that the partner cannot deduct? See Rev. Rul. 89-7, this page.

In accordance with sections 702(a) and (b) of the Code and section 1.702-1(a)(8)(ii) of the regulations, a controlled foreign corporation's distributive share of partnership income is taken into account separately by the controlled foreign corporation, and the character of such income is determined as if it were realized directly by the controlled foreign corporation from the source from which the partnership realized such income. See Rev. Rul. 89-72, page 257.

Section 705.—Determination of Basis of Partner's Interest

26 CFR 1.705-1: Determination of basis of partner's interest.
(Also Sections 179, 702, 703, 1.179-1, 1.702-1.)

Partnerships; basis of partner's interest in a partnership. A partner's distributive share of section 179 expenses will be reflected in the adjusted basis of the partner's interest through the basis adjustments required by section 705(a) whether or not the partner is allowed a deduction for such expense.

Rev. Rul. 89-7

ISSUE

If a partner's distributive share of the partnership's expenses under section 179 of the Internal Revenue Code is not fully deductible by the partner because, when combined with the partner's section 179 expenses from other sources, the partner's section 179 expenses from all sources exceed the maximum amount allowable to the partner under section 179(b)(1), is the partner's basis in the partnership interest reduced by the partner's full distributive share of the partnership's section 179 expenses, including the partnership's section 179 expenses that the partner cannot deduct?

FACTS

In 1988, *AB*, a partnership, elected under section 179(a) of the Code to expense the entire cost of certain qualifying property that it purchased and placed in service during that year. A similar election was made by another partnership, *AC*. With respect to each of the partnerships, *A* had a three-fifths interest in each item of partnership income, gain, deduction, loss, and credit. The partnerships separately stated each partner's distributive share of section 179 expenses for that year. The sum of *A*'s distributive share of section 179 expenses from *AB* and *AC* exceeded $10,000. *AB* and *AC* reduced the basis of the specific property to which the section 179 election applied by the total amount of section 179 expenses allocated to the partners as required by section 1.179-1(f)(2) of the Income Tax Regulations. The partnerships are both calendar year partnerships. But for the limitation contained in section 179(b)(1), *A*, *AB*, and *AC* each meet all the other limitations and restrictions of section 179.

LAW AND ANALYSIS

Section 179(a) of the Code provides that a taxpayer may elect to treat the cost of any section 179 property as an expense that is not chargeable to capital account. Any cost so treated shall be allowed as a deduction for the taxable year in which the section 179 property is placed in service. Under section 1.179-1(a) of the regulations, taxpayers may elect to treat as an expense all or a portion of the cost of section 179 property.

Section 179(b)(1) of the Code provides that the aggregate cost of property that may be taken into account under section 179(a) shall not exceed $10,000.

Section 179(d)(1) of the Code provides that the term "section 179 property" means any recovery property that is section 38 property and that is acquired by purchase for use in the active conduct of a trade or business.

Section 179(d)(8) of the Code and section 1.179-2(c) of the regulations provide that, in the case of a partnership, the dollar limitation contained in section 179(b)(1) shall apply with respect to the partnership and with respect to each partner.

Section 1.179-1(f)(2) of the regulations provides that, generally, the basis of a partnership's section 179 property must be reduced to reflect the amount of the section 179 expense elected by the partnership. This reduction must be made even if the section 179(b) dollar limitation prevents a partner from deducting all or a portion of the amount allocated by the partnership.

Section 1.179-1(h) of the regulations provides that the election to expense the cost of section 179 property is made by the partnership.

Section 702(a)(7) of the Code provides that in determining a partner's income tax, each partner shall take into account separately the partner's distributive share of the partnership's items of income, gain, loss, deduction, and credit (in addition to those items specifically listed in sections 702(a)(1) through 702(a)(6)) to the extent provided by regulations prescribed by the Secretary. Section 1.702-1(a)(8)(ii) of the regulations provides that each partner must take into account separately the distributive share of any partnership item that if separately taken into account by any partner would result in an income tax liability for the partner different from that which would result if that partner did not take the item into account separately.

Section 703(a) of the Code provides that the taxable income of a partnership is computed in the same manner as in the case of an individual, except that the items described in section 702(a) must be separately stated and certain deductions specified in section 703(a)(2) are not allowed to the partnership. The deduction allowable under section 179 is not among the deductions disallowed under section 703(a)(2).

Section 705(a) of the Code provides, in part, that the adjusted basis of a partner's interest in a partnership shall be the basis of such interest determined under section 722 (relating to contributions to a partnership) or section 742 (relating to transfers of partnership interests) increased by the partner's distributive share for the taxable year and prior taxable years of taxable income of the partnership as determined under section 703(a) and decreased (but not below zero) by distributions by the partnership as provided in section 733 and by the sum of the partner's distributive share for the taxable year and prior taxable years of losses of the partnership and expenditures of the partnership not deductible in computing its taxable income and not properly chargeable to capital account.

The deduction allowable under section 179 of the Code must be separately stated under section 702(a)(7) because a partner's income tax liability may differ depending on whether or not this deduction is separately stated by the partnership. In compliance with section 179(d)(8) of the Code and section 1.179-2(c) of the regulations, *A* deducted only $10,000 of the total section 179 expenses separately stated and allocated to *A* by the partnerships.

Under section 703(a) of the Code, the deductible section 179 expenses of a partnership for a taxable year reduce the taxable income or increase the taxable loss of the partnership for the year. In addition, the section 179 expenses of a partnership that are not deductible in computing the partnership's taxable income or loss for a taxable year by reason of the application of the section 179(b) limitations to the partnership constitute expenditures of the partnership that are not properly chargeable to capital account. Accordingly, *A*'s distributive share of the section 179 expenses of the partnerships will be reflected in the adjusted basis of *A*'s interest in each partnership through the basis adjustments required by section 705(a), whether or not *A* is allowed a deduction for such expenses.

HOLDING

The adjusted basis of *A*'s interest in *AB* and *AC* must be reduced under section 705 by *A*'s distributive share of the section 179 expenses of the partnerships even though *A* may be prohibited from deducting all or a portion of such expenses under section 179(b)(1).

Section 709.—Treatment Of Organization And Syndication Fees

26 CFR 1.709-1: Treatment of organization and syndication costs.
(Also Section 165; 1.165-1.)

Partnerships; partnership syndication expenses. Section 709 of the Code precludes a deduction under section 165 for an abandonment loss despite the fact that expenses were incurred in a syndication effort that failed and was abandoned. Rev. Rul. 79-2 distinguished.

Rev. Rul. 89-11

ISSUE

Whether syndication expenses incurred in connection with the syndication of a partnership are deductible under section 165 of the Internal Revenue Code if the syndication effort to which the expenses relate fails and that effort is abandoned.

FACTS

In 1985, corporation *X* formed a limited partnership, *PRS*, and became its general partner. *A*, an individual, became a limited partner. Shortly after the formation of *PRS*, corporation *X* entered into an agreement with underwriter *Y* to undertake a best-efforts public offering of limited partner interests in *PRS*. In connection with this syndication effort, corporation *X* paid certain costs toward the syndication of partnership *PRS*. The syndication effort, however, was unsuccessful and was abandoned.

In 1986, corporation *X* entered into an agreement with underwriter *Z* to undertake a best-efforts public offering of limited partner interests in *PRS*. In connection with this second effort, corporation *X* incurred further syndication costs. This second syndication effort was successful and numerous investors were admitted as limited partners in *PRS*. The amounts expended in connection with the 1985 syndication effort had no value to *PRS* or corporation *X* in the 1986 syndication effort.

LAW AND ANALYSIS

Section 165(a) provides that there shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.

Section 1.165-1(b) of the Income Tax Regulations provides that to be allowable as a deduction under section 165(a), a loss must be evidenced by closed and completed transactions, fixed by identifiable events, and actually sustained during the taxable year.

Section 1.165-2(a) of the regulations provides that a loss incurred in a business or a transaction entered into for profit and arising from the sudden termination of the usefulness in such business or transaction of any nondepreciable property, in a case where such business or transaction is discontinued or if such property is permanently discarded from use therein, shall be allowed as a deduction under section 165 for the taxable year in which the loss is actually sustained.

Section 709(a) of the Code provides that, except as provided in section 709(b), no deduction shall be allowed under chapter 1 of subtitle A of the Code to a partnership or to any partner for any amount paid or incurred to organize a partnership or to promote the sale of an interest in such partnership. Section 709(b) allows a partnership to amortize its organizational expenses over a period of not less than 60 months. Syndication expenses are not subject to the election under section 709(b) of the Code and must be capitalized. Section 1.709-2(a) and (b) of the regulations. *See also* S. Rep. No. 938, 94th Cong., 2d Sess. 94 (1976), 1976-3 (Vol. 3) C.B. 132.

Section 1.709-1(b)(2) of the regulations provides that if there is a winding up and complete liquidation of a partnership before the end of the amortization period described in section 709(b) of the Code, the unamortized amount of organizational expenses is deductible by the partnership under section 165 as a loss in the partnership's final taxable year. This section of the regulations provides, however, that no partnership deduction is allowed with respect to capitalized syndication expenses.

Rev. Rul. 85-32, 1985-1 C.B. 186, holds that syndication costs incurred in connection with the sale of partner interests are chargeable by the partnership to capital account and can not be amortized. In addition, that ruling states that "[N]o deduction is permitted at the partnership or partner level with respect to the partnership's ... capitalized syndication expenses."

Syndication costs can be paid in a number of ways. For example, they can be paid directly by the partnership, indirectly by a general partner, or by investors paying a portion of costs, such as sales commissions, at the time those investors acquire their partner interests. Rev. Rul. 81-153, 1981-1 C.B. 387, stands for the principle that the cost of marketing partner interests are syndication costs regardless of who pays the costs. Rev. Rul. 81-153 considered two situations in which an investor paid sales commissions in connection with the investor's acquisition of a limited partner interest. The ruling holds that in both situations the sales commissions are considered to have been paid by the partnership. In effect, the amount of the sales commission is treated as a capital contribution by the investor to the partnership and a payment of a syndication expense by the partnership. In this case, the syndication costs paid by corporation *X* are viewed as amounts paid by *PRS*. The investor's basis in the limited partner interest includes the amount paid as sales commissions and not merely the net cash received by the partnership.

In Rev. Rul. 79-2, 1979-1 C.B. 98, expenses incurred by shareholders in preparation for public offering of their shares of stock in a corporation were required to be capitalized as an intangible asset of the shareholders, separate from their stock. The ruling holds that the shareholders are allowed loss deductions with respect to the capitalized expenses for the year the offering was abandoned. The facts here are distinguishable from those in Rev. Rul. 79-2, because a partnership is involved.

PRS was required to capitalize the syndication expenses incurred in connection with the 1985 syndication effort because section 1.709-2(b) of the regulations directs that partnership syndication costs must be capitalized. Rev. Rul. 85-32 holds that syndication costs are chargeable to capital account. The terms "capitalize" and "chargeable to capital account" indicate that the partnership is to record the syndication expenditures as an intangible asset on its balance sheet. Because here, as in Rev. Rul. 79-2, the usefulness to *PRS* of the intangible asset created upon capitalization of the syndication costs terminated upon the abandonment of the effort, a question is presented as to whether *PRS* is allowed a loss deduction under section 165 of the Code and section 1.165-2(a) of the regulations.

The "no deduction shall be allowed" language in section 709 of the Code precludes the deduction of syndication costs under any circumstances. Rev. Rul. 85-32 states that, with respect to the deductibility of syndication costs, the provisions of section 709 of the Code and the related regulations supersede any other section contained in chapter 1 of the Code. *See also Egolf v. Commissioner*, 87 T.C. 34, 46 (1986); Rev. Rul. 87-111, 1987-2 C.B. 160. Furthermore, section 1.709-1(b)(2) provides that section 709 precludes the allowance of a loss deduction to the partnership under section 165 for capitalized syndication expenses upon the winding up and liquidation of a partnership. Obviously, the intangible asset represented by capitalized syndication expenditures can have no value to a partnership upon its liquidation, but the regulations expressly deny a loss deduction to the partnership at that time. To allow a loss deduction with respect to capitalized syndication expenditures if those expenditures became worthless before the winding up of the partnership would, therefore, be inconsistent with the direction given in the regulations.

HOLDING

Section 709 of the Code precludes the allowance of a deduction for partnership syndication expenses regardless of whether the syndication effort is successful.

EFFECT ON OTHER RULINGS

Rev. Rul. 79-2 is distinguished.

Part II.—Contributions, Distributions, and Transfers
Subpart D.—Provisions Common to Other Subparts

Section 752.—Treatment of Certain Liabilities

26 CFR 1.752-0T: Table of contents (temporary).

T.D. 8237

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

Treatment of Partnership Liabilities; Allocations Attributable to Nonrecourse Liabilities

AGENCY: Internal Revenue Service, Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains final and temporary regulations concerning the treatment of partnership liabilities and the allocation of deductions attributable to nonrecourse debt. The temporary regulations reflect changes to the applicable tax law made by section 79 of the Tax Reform Act of 1984. The text of the temporary regulations set forth in this document also serves as the text of the proposed regulations cross-referenced in the notice of proposed rulemaking in ***[PS-229-84, page 1057, this Bulletin].

DATES: Sections 1.752-.0T through 1.752-4T, section 1.704-1T, and the amendments to sections 1.704-1 and 602.101 are effective as of December 29, 1988. The temporary regulations under section 752 are generally applicable to any partnership liability incurred on or after January 30, 1989, although the temporary regulations apply as of March 1, 1984 to certain liabilities for which a partner bears the economic risk of loss. Section 1.704-1T is generally applicable for partnership taxable years beginning after December 29, 1988, unless the partnership elects to apply the provisions of that section to the first taxable year of such partnership ending after December 29, 1988. Additional guidance on the applicability of the temporary regulations under sections 752 and 704 is contained in §§1.752-4T and 1.704-1T(b)(4)(iv)(*m*).

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 §§1.752-4T(c) and 1.704-1T(b)(4)(iv)(*m*)(*2*) have been reviewed and, pending receipt and evaluation of public comments, approved by the Office of Management and Budget (OMB) under control number [1545 - 1090]. The estimated annual burden per respondent varies from 3 minutes to 8 minutes, depending on individual circumstances, with an estimated average of 5 minutes.

These estimates are an approximation of the average time expected to be necessary for a collection of information. They are based on such information as is available to the Internal Revenue Service. Individual respondents may require greater or less time, depending on their particular circumstances.

For further information concerning these collections of information, and where to submit comments on these collections of information, the accuracy of the estimated burden, and suggestions for reducing this burden, please refer to the preamble to the cross-referenced notice of proposed rulemaking published in *** [PS-229-84, page 1057, this Bulletin].

BACKGROUND

This document adds new temporary regulations §§1.752-0T, -1T, -2T, -3T, and -4T. The temporary regulations under section 752 reflect changes to the applicable tax law made by section 79 of the Tax Reform Act of 1984 (Pub. L. 98-369) [1984-3 (Vol. 1) C.B. 1, 105], which overruled the decision in *Raphan v. United States,* 3 Cl. Ct. 457 (1983), and directed the Treasury Department to prescribe regulations under section 752 relating to the treatment of guarantees, assumptions, indemnity agreements, and similar arrangements.

This document also adds new temporary regulation §1.704-1T and amends §1.704-1 to make conforming changes. The temporary regulation under section 704(b) reflects amendments to the rules governing the allocation of deductions attributable to nonrecourse debt that coordinate those rules with the temporary regulations under section 752, modify the treatment of minimum gain, and take account of comments that have been submitted to the Service.

EXPLANATION OF PROVISIONS OF TEMPORARY REGULATIONS UNDER SECTION 752

Overview

Under section 752, a partner's share of the liabilities of the partnership is reflected in the adjusted basis of the partner's interest in the partnership by treating any increase in the partner's share of those liabilities as a contribution of money to the partnership by the partner and any decrease in the partner's share of those liabilities as a distribution of money to the partner by the partnership. Section 752 also treats the assumption of a partnership liability by a partner as a contribution of cash by the partner, and the assumption of a partner's liability by the partnership as a distribution of cash to the partner. Under the regulations in effect under section 752 prior to the amendments made by this document (the "existing regulations"), the partners generally share recourse liabilities of the partnership in accordance with the ratios in which the partners share partnership losses, while the partners share nonrecourse liabilities of the partnership in accordance with the ratios in which they share partnership profits. The existing regulations define a nonrecourse liability as any liability with respect to which "none of the partners have any personal liability."

In *Raphan v. United States,* 3 Cl. Ct. 457 (1983), *rev'd,* 759 F. 2d 879 (Fed. Cir. 1985), the United States Claims Court held that a guarantee by a general partner of an otherwise nonrecourse debt of the partnership did not require the partner to be treated as personally liable for that debt. The Tax Reform Act of 1984 (the "1984 Act") specifically provided that the decision in *Raphan* is not to be followed in applying section 752 and the regulations thereunder. In addition, Congress directed Treasury to revise and update its regulations under section 752 to take account of current commercial practices and arrangements, such as assumptions, guarantees, and indemnities. See section 79(b) of the 1984 Act; see also H.R. Rep. No. 861, 98th Cong., 2d Sess. 869 (1984). The legislative history indicated that the revisions to the section 752 regulations should be based on the manner in which the partners, and persons related to the partners, share the economic risk of loss for a partnership liability (other than a bona fide nonrecourse liability). H.R. Rep. No. 861, 98th Cong., 2d Sess. 869 (1984).

In accordance with the legislative history of the 1984 Act, the temporary regulations under section 752 employ an economic risk of loss analysis (1) to determine whether a partnership liability is a recourse or nonrecourse liability, and (2) to determine the partners' shares of any recourse liability of the partnership. In recognition of the diversity of current lending practices and financing techniques, the temporary regulations have been designed to take account of the wide variety of commercial practices by which the partners may share the economic risk of loss for a partnership liability, including guarantees, assumptions and indemnities.

Sharing Recourse Liabilities—

Economic Risk of Loss

Under the temporary regulations, a partnership liability is a recourse liability to the extent that any partner bears the economic risk of loss for that liability, and a partner's share of any recourse liability of the partnership equals the portion, if any, of the economic risk of loss for such liability that is borne by such partner. Generally, a partner bears the economic risk of loss for a partnership liability to the extent that the partner (or a person related to the partner) would be obligated to make a payment to the creditor or a contribution to the partnership with respect to a partnership liability (and would not be entitled to be reimbursed for such payment or contribution by another partner, a person related to another partner, or the partnership) if (1) all of the partnership's assets (including money) were worthless, (2) all of the partnership's liabilities were due and payable in full, (3) the partnership disposed of all of its assets in a fully taxable transaction for no consideration (other than relief from certain liabilities), and (4) the partnership allocated its items of income, gain, loss, deduction, and credit for the year among the partners and liquidated the partners' interests in the partnership. The temporary regulations provide that a person is related to a partner if such person and the partner bear a relationship to each other that is specified in section 267(b) or 707(b)(1), with the following modifications: (1) "80 percent or more" is substituted for "more than 50 percent" each place it appears in those sections; (2) brothers and sisters are excluded from the members of a person's family; and (3) section 267(f)(1)(A) is disregarded.

Under the approach taken by the temporary regulations, a partner bears the economic risk of loss for a partnership liability to the extent that the partner (or a person related to the partner) would bear the economic burden of discharging the obligation represented by that liability if the partnership were unable to do so. For example, equal partners in a general partnership will share the economic risk of loss for any partnership recourse debt equally because they will share any economic burden corresponding to that debt equally. Similarly, in the case of a limited partnership, a limited partner generally will not bear the economic risk of loss for any partnership liability because a limited partner generally has no obligation to contribute additional capital to the partnership. However, if a partner (or a person related to the partner)—whether such partner is a limited partner or a general partner—could be required to make a payment to a creditor or a contribution to the partnership in order to discharge a partnership liability, the partner may be considered to bear the economic risk of loss for such liability.

Thus, the determination of whether a partner bears the economic risk of loss for a partnership liability takes into account the manner in which the partners have agreed to share economic losses relating to the liabilities of the partnership under all the arrangements among the partners, persons related to the partners, and the partnership. For example, even though a partnership creditor may be entitled to seek repayment only from the general partner of a limited partnership, the limited partners, and not the general partner, may bear the economic risk of loss for the liability to the extent that the limited partners are obligated under the partnership agreement or otherwise to discharge the partnership's obligation to the creditor. Also, if the partnership maintains capital accounts for its partners in accordance with §1.704-1(b)(2)(iv) and the partners are obligated to restore any deficit balances in their capital accounts (as set forth in §1.704-1(b)(2)(ii)(*3*)), the manner in which the partners will share the economic risk of loss for any partnership liability will be affected by their capital account balances.

In determining the amount of any obligation of a partner to make a payment to a creditor or a contribution to the partnership with respect to a partnership liability, the temporary regulations reduce the partner's obligation by the amount of any reimbursement that the partner would be entitled to receive from another partner, a person related to another partner, or the partnership. The Service is continuing to study whether a right to be reimbursed for a payment or contribution by an unrelated person (*e.g.*, pursuant to an indemnification agreement from a third party) should be taken into account in the same manner and solicits comment on this issue.

The temporary regulations also include the following special rules regarding the determination of whether a partner bears the economic risk of loss for a partnership liability:

(1) A partner who contributes (or otherwise provides) property to the partnership that is used solely as security for a partnership liability will bear the economic risk of loss for the partnership liability (to the extent of the value of such property).

(2) A partner who does not have a direct obligation to make a payment to a creditor or a contribution to the partnership with respect to a partnership liability may be considered to bear the economic risk of loss for the liability if the partner undertakes other obligations that are tantamount to guaranteeing the obligation.

(3) A partner who (directly or indirectly) guarantees the payment of interest on an otherwise nonrecourse liability will, in certain circumstances, be considered to bear the economic risk of loss for the liability.

In addition, the temporary regulations provide that if a partner (or a person related to the partner) makes a nonrecourse loan to the partnership, such partner shall be considered to bear the economic risk of loss for that liability unless (1) the partner's interest (including the interest of any person related to such partner) in each item of partnership income, gain, loss, deduction, or credit is 10 percent or less, and (2) the loan constitutes qualified nonrecourse financing within the meaning of section 465(b)(6).

The economic risk of loss analysis employed in the temporary regulations generally corresponds to, and further develops, the economic risk of loss analysis employed in the regulations under section 704(b). The coordination of these two sections reflects the fact that one of the principal purposes for including partnership liabilities in the bases of the partners' interests in the partnership is to support the deductions that will be claimed by the partners for the items attributable to those liabilities.

The allocation of partnership liabilities among the partners serves to equalize the partnership's basis in its assets ("inside basis") with the partners' bases in their partnership interests ("outside basis"). The provision of additional basis to a partner for the partner's partnership interest will permit the partner to receive distributions of the proceeds of partnership liabilities without recognizing gain under section 731, and to take deductions attributable to partnership liabilities without limitation under section 704(d) (which limits the losses that a partner may claim to the basis of the partner's interest in the partnership). By equalizing inside and outside basis, section 752 simulates the tax consequences that the partners would realize if they owned undivided interests in the partnership's assets, thereby treating the partnership as an aggregate of its partners. Of course, this goal can only be achieved if the partners that are allocated the deductions attributable to a partnership liability are allocated the basis for that liability.

Accordingly, the coordination of the economic risk of loss analysis employed in sections 704(b) and 752 generally requires that the basis for a partnership liability be allocated to the partner that will be allocated the deductions attributable of that liability. Since the economic risk of loss analysis employed under section 752 applies without regard to whether the partnership satisfies the substantial economic effect safe harbor set forth in §1.704-1(b)(2), the temporary regulations provide additional guidance on the determination of the partners' interests in the partnership under section 704(b). See §1.704-1(b)(3).

Taxpayers should draw no inferences from the economic risk of loss analysis employed by the temporary regulations under section 752 regarding the application of section 465.

Sharing Nonrecourse Liabilities

If no partner bears the economic risk of loss for a partnership liability, the liability is a nonrecourse liability of the partnership. The legislative history of the 1984 Act indicates that Congress did not expect the revisions to the regulations under section 752 to make major changes in the manner in which the partners share nonrecourse liabilities, although the regulations could attempt to provide more certainty than presently exists. H.R. Rep. No. 861, 98th Cong., 2d Sess. 869 (1984).

Under the temporary regulations, as in the existing regulations, the partners generally share nonrecourse liabilities in accordance with their interests in partnership profits. The temporary regulations do, however, require that the nonrecourse liabilities of a partnership be allocated among the partners first to reflect the partners' shares of (1) any partnership minimum gain (within the meaning of §1.704-1T(b)(4)(iv)(*f*)), and (2) any tax gain that would be allocated to the partners under section 704(c) (or in the same manner as under section 704(c) to reflect a revaluation of partnership property under §1.704-1(b)-(2)(iv)(*f*) or (*r*)) if the partnership disposed of (in a taxable transaction) all partnership property subject to one or more nonrecourse liabilities of the partnership in full satisfaction of such liabilities and for no other consideration ("section 704(c) minimum gain"). To the extent that partnership nonrecourse liabilities exceed the portion of such liabilities allocated to the partners in the manner described in the preceding sentence, such excess nonrecourse liabilities are allocated among the partners in accordance with the general rule, that is, in proportion to the partners' interests in partnership profits. For this purpose, the partnership agreement may specify the partners' interests in partnership profits as long as the interests so specified are reasonably consistent with allocations (which have substantial economic effect) of some significant item of partnership income or gain among the partners. In any case in which all items of partnership income, gain, loss, and deduction are allocated equally between the partners, they will share the nonrecourse liabilities of the partnership equally (unless there is section 704(c) minimum gain) because they will share partnership profits and partnership minimum gain equally.

The allocation of nonrecourse liabilities among the partners in accordance with their shares of partnership minimum gain and section 704(c) minimum gain coordinates the treatment of nonrecourse liabilities under section 752 with the treatment of nonrecourse liabilities under the section 704(b) regulations. As in the case of recourse liabilities, this reflects the fact that one of the principal purposes for including partnership liabilities in the bases of the partners' interests in the partnership is to support the deductions that will be claimed by the partners for the items attributable to those liabilities. The modifications made by the temporary regulations to the rules governing the allocation of nonrecourse liabilities have also been designed (1) to reflect more accurately the manner in which the partners will share the partnership income that is used to discharge nonrecourse liabilities, and (2) to provide more certainty regarding the application of section 752 to nonrecourse debt.

AMENDMENTS TO RULES GOVERNING THE ALLOCATION OF DEDUCTIONS ATTRIBUTABLE TO NONRECOURSE DEBT UNDER SECTION 704(b)

This document amends and restates as new temporary regulation §1.704-1T the rules governing the allocation of deductions attributable to nonrecourse debt (the "nonrecourse debt regulations"), and makes certain conforming changes to the existing regulations under section 704(b). The temporary regulation adopts the same definition of nonrecourse liability for purposes of section 704(b) as is included in the temporary regulations under section 752. In so doing, the regulation determines whether a partner bears the economic risk of loss for an otherwise nonrecourse liability in accordance with the temporary regulations under section 752. Among other consequences, the temporary regulation thereby extends the special rules under section 704(b) applicable to nonrecourse loans for which a partner bears the economic risk of loss to nonrecourse loans for which a person related to a partner bears the economic risk of loss.

The temporary regulation also modifies the treatment of partnership minimum gain by requiring that items of income and gain be allocated to the partners at any time there is a net decrease in partnership minimum gain allocable to the disposition of partnership property subject to one or more nonrecourse liabilities of the partnership. In contrast to the rule in the existing regulations, the minimum gain chargeback set forth in the temporary regulation is mandatory — that is, the rule applies whether or not the partnership agreement includes a minimum gain chargeback provision or a deficit restoration obligation. The modifications to the minimum gain chargeback rules are considered necessary to take account of the fact that an allocation of minimum gain (like an allocation of nonrecourse deductions) cannot have economic effect because no partner can receive an economic benefit corresponding to such gain.

In addition, the Service has received comments recommending, among other things, that (1) the partners' shares of partnership minimum gain take into account distributions of proceeds of nonrecourse loans to the extent that such nonrecourse loans have caused an increase in partnership minimum gain, (2) the Service provide additional guidance on the application of the nonrecourse debt regulations to tiered partnerships, and (3) the Service provide additional guidance regarding the rules applicable to nonrecourse loans for which a partner bears the economic risk of loss. The 3amendments made by this document to the nonrecourse debt regulations adopt provisions responding to these comments.

Thus, under the temporary regulation, minimum gain attributable to proceeds of a nonrecourse borrowing that are distributed to the partners is allocated to the partners who received those distributions. With respect to tiered partnerships, the temporary regulation contains rules describing how increases and decreases in the partnership minimum gain of the lower-tier (or subsidiary) partnership will be taken into account in determining the increases and decreases in the partnership minimum gain of the upper-tier (or parent) partnership. These rules generally are designed to produce the same consequences for the upper-tier partnership as would have resulted if it had held a direct interest in the lower-tier partnership's assets and liabilities.

In the case of nonrecourse loans for which a partner bears the economic risk of loss ("partner nonrecourse debts"), the temporary regulation includes a series of rules clarifying the treatment of such loans. In general, any item of loss, deduction, or section 705(a)(2)(B) expenditure that is attributable to a partner nonrecourse debt (as determined under rules similar to those governing nonrecourse deductions) must be allocated to the partner who bears the economic risk of loss for that debt. Correspondingly, any decrease in the minimum gain attributable to a partner nonrecourse debt may require items of income and gain to be allocated to the lending partner in accordance with rules similar to the general nonrecourse liability minimum gain chargeback rules.

The Service is continuing to consider other comments submitted on the nonrecourse debt regulations and solicits comment on the appropriateness of the amendments to those regulations made by this document and the need for additional changes.

Special Analyses

These rules are not major rules as defined in Executive Order 12291. Therefore, a Regulatory Impact Analysis is not required. A general notice of proposed rulemaking is not required by 5 U.S.C. §553 for interpretative regulations. Therefore, these rules do not constitute regulations subject to the Regulatory Flexibility Act (5 U.S.C. Chapter 6) and a Regulatory Flexibility Analysis is not required.

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Adoption of Amendments to the Regulations

Accordingly, 26 CFR Parts I and 602 are amended as follows:

PART I—INCOME TAX; TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1986

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

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

Par. 2. Section 1.752-1 is removed.

Par. 3. Sections 1.752-0T, 1.752-1T, 1.752-2T, 1.752-3T, and 1.752-4T are added in the appropriate place to read as follows:

§1.752-0T Table of contents (temporary).

This section lists the captions that appear in the temporary regulations under section 752.

§1.752-1T Treatment of partnership liabilities— General rules (temporary).

(a) *General principles.* Under section 752, a partner's share of the liabilities of the partnership is reflected in the adjusted basis of the partner's interest in the partnership by treating any increase in the partner's share of those liabilities as a contribution of money to the partnership by the partner and any decrease in the partner's share of those liabilities as a distribution of money to the partner by the partnership. Section 752 also treats the assumption of a partnership liability by a partner as a contribution of cash by the partner, and the assumption of a partner's liability by the partnership as a distribution of cash to the partner. This section provides general rules governing the application of section 752, including rules for determining a partner's share of the liabilities of the partnership. See paragraph (g) of this section for the definition of liability. The determination of a partner's share of a partnership liability under the rules of this section depends on whether that liability is a recourse or nonrecourse liability.

(1) *Recourse liabilities.* (i) Under this section, a partnership liability is a

recourse liability to the extent that any partner bears the economic risk of loss for that liability, and a partner's share of any recourse liability of the partnership equals the portion, if any, of the economic risk of loss for such liability that is borne by such partner. See paragraph (d)(1) and (2) of this section for rules relating to recourse liabilities of a partnership and paragraph (d)(3) of this section for the meaning of economic risk of loss.

(ii) Generally, a partner bears the economic risk of loss for a partnership liability to the extent that the partner (or person related to the partner) would be obligated to make a payment to the creditor or a contribution to the partnership with respect to a partnership liability (and would not be entitled to be reimbursed for such contribution or payment by another partner, a person related to another partner, or the partnership) if all of the partnership's liabilities were due and payable in full, all of the partnership's assets (including money) were worthless, the partnership disposed of all of its assets in a fully taxable transaction for no consideration (other than relief from certain liabilities), and the partnership allocated its items of income, gain, loss, deduction, and credit for the year among the partners and liquidated the partners' interests in the partnership. See paragraph (d)(3)(iii) of this section (relating to the meaning of the term "constructive liquidation") for the events that are deemed to occur for purposes of determining whether a partner bears the economic risk of loss for a partnership liability, paragraph (d)(3)-(iv), (v), (vi), and (vii) for special rules relating to the definition of economic risk of loss, and paragraph (h) of this section for the definition of related person.

(iii) Under this approach, a partner bears the economic risk of loss for a partnership liability to the extent that the partner (or a person related to the partner) would bear the economic burden of discharging the obligation represented by that liability if the partnership were unable to do so. For example, equal partners in a general partnership will share the economic risk of loss for any partnership recourse debt equally because they will share any economic burden corresponding to that debt equally. Similarly, in the case of a limited partnership, a limited partner generally will not bear the economic risk of loss for any partnership liability because a limited partner generally has no obligation to contribute additional capital to the partnership. However, if a partner (or a person related to the partner)—whether such partner is a limited partner or a general partner—could be required to make a contribution to the partnership or a payment to the creditor in order to discharge a partnership liability (or to reimburse another partner (or a person related to another partner) for any such contribution or payment), the partner may be considered to bear the economic risk of loss for such liability under paragraph (d)(3) of this section. Thus, the determination of whether a partner bears the economic risk of loss for a partnership liability takes into account the manner in which the partners have agreed to share economic losses relating to the liabilities of the partnership under all the arrangements among the partners, persons related to the partners, and the partnership. For example, even though a partnership creditor may be entitled to seek repayment only from the general partner of a limited partnership, the limited partners, and not the general partner, may bear the economic risk of loss for the liability to the extent that the limited partners are obligated under the partnership agreement or otherwise to discharge the partnership's obligation to the creditor. Also, if the partnership maintains capital accounts for its partners in accordance with §1.704-1(b)(2)(iv) and the partners are obligated to restore any deficit balances in their capital accounts (as set forth in §1.704-1(b)(2)(ii)(*3*)) , the manner in which the partners will share the economic risk of loss for any partnership liability will be affected by their capital account balances.

(iv) The economic risk of loss analysis employed in this section generally corresponds to, and further develops, the economic risk of loss analysis employed in the regulations under section 704(b). The coordination of these two sections reflects the fact that one of the principal purposes for including partnership liabilities in the bases of the partners' interests in the partnership is to support the deductions that will be claimed by the partners for the items attributable to those liabilities.

(2) *Nonrecourse liabilities.* (i) If no partner bears the economic risk of loss for a partnership liability, the liability is a nonrecourse liability of the partnership. See paragraph (e) of this section for rules relating to nonrecourse liabilities of a partnership. Under this section, the partners generally share nonrecourse liabilities in accordance with their interests in partnership profits. This section does, however, require that the nonrecourse liabilities of a partnership be allocated among the partners first to reflect the partners' shares of any partnership minimum gain (within the meaning of §1.704-1T(b)(4)(iv)(*f*)) and any tax gain that would be allocated to the partners under section 704(c) (or in the same manner as under section 704(c) to reflect a revaluation of partnership property under §1.704-1(b)(2)(iv)(*f*) or (*r*)) if the partnership disposed of (in a taxable transaction) all partnership property subject to one or more nonrecourse liabilities of the partnership in full satisfaction of such liabilities and for no other consideration ("section 704(c) minimum gain"). To the extent that partnership nonrecourse liabilities exceed the portion of such liabilities allocated to the partners in the manner described in the preceding sentence, such excess nonrecourse liabilities are allocated among the partners in accordance with the general rule, that is, in proportion to the partners' interests in partnership profits. For this purpose, the partnership agreement may specify the partners' interests in partnership profits as long as the interests so specified are reasonably consistent with allocations (which have substantial economic effect) of some significant item of partnership income or gain among the partners. In any case in which all items of partnership income, gain, loss, and deduction are allocated equally among the partners, they will share the nonrecourse liabilities of the partnership equally (unless there is section 704(c) minimum gain) because they will share partnership profits and partnership minimum gain equally.

(ii) The allocation of nonrecourse liabilities among the partners in accordance with their shares of partnership minimum gain and section 704(c) minimum gain coordinates the treatment of nonrecourse liabilities under this section with the treatment of nonrecourse liabilities under the section 704(b) regulations. As in the case of recourse liabilities, this reflects the fact that one of the principal purposes for including partnership liabilities in the bases of the partners' interests in the partnership is to support the deductions that will be claimed by the partners for the items attributable to those liabilities.

(iii) The following example illustrates the application of the rules of this section to nonrecourse liabilities:

Example. The AB partnership purchases depreciable property for a $1,000 nonrecourse purchase money note that is a nonrecourse liability under the rules of this section. Assume that this is the only nonrecourse liability of the partnership, and that no principal payments are due on the purchase money note for a year. The partnership agreement allocates all depreciation deductions for such property to A. In addition, the partnership agreement provides that, for purposes of allocating the nonrecourse liability between the partners under the rules of this section, the partners' interests in partnership profits shall equal 50 percent each, which is reasonably consistent with allocations (which have substantial economic effect) of some significant item of partnership income and gain. Immediately after purchasing the depreciable property, the partners share the nonrecourse liability equally because they are treated as though they have equal interests in partnership profits. Under paragraph (b) of this section, A and B are each treated as if they contributed $500 to the partnership to reflect each partner's increase in his or her share of partnership liabilities (from $0 to $500). The minimum gain with respect to an item of partnership property subject to a nonrecourse liability equals the amount of gain that would be recognized if the partnership disposed of the property in full satisfaction of the nonrecourse liability and for no other consideration. Therefore, if the partnership claims a depreciation deduction of $200 for the depreciable property in the year it acquires that property, partnership minimum gain for the year will increase by $200 (the excess of the $1,000 nonrecourse liability over the $800 adjusted tax basis of the property). See §1.704-1T(b)(4)(iv)(*c*). Assuming that the allocation of all of the $200 depreciation deduction to A is valid under section 704(b), A will have a $200 share of partnership minimum gain at the end of that year because the depreciation deduction is treated as a nonrecourse deduction. See §1.704-1T(b)(4)(iv)(*b*) and (*f*). Accordingly, at the end of that year, A will be allocated $200 of the nonrecourse liability to match A's share of partnership minimum gain and the remaining $800 of the nonrecourse liability will be allocated equally between A and B ($400 each). As a result, A's share of partnership liabilities increases by $100 (from $500 to $600) and B's share of partnership liabilities decreases by $100 (from $500 to $400). Consequently, A is treated under paragraph (b) of this section as if A contributed an additional $100 to the partnership, and B is treated under paragraph (c) of this section as if B received a distribution of $100 from the partnership.

(b) *Increase in partner's share of liabilities.* Any increase in a partner's share of the liabilities of the partnership, or any increase in a partner's individual liabilities by reason of the partner's assumption of liabilities of the partnership, shall be treated as a contribution of money by that partner to the partnership. See example (1) of paragraph (k) of this section.

(c) *Decrease in partner's share of liabilities.* Any decrease in a partner's share of the liabilities of the partnership, or any decrease in a partner's individual liabilities by reason of the assumption by the partnership of the individual liabilities of such partner, shall be treated as a distribution of money by the partnership to that partner. See example (1) of paragraph (k) of this section.

(d) *Partner's share of recourse liabilities*—(1) *In general.* A partner's share of the recourse liabilities of the partnership equals that portion of the recourse liabilities of the partnership for which such partner bears the economic risk of loss (within the meaning of paragraph (d)(3) of this section).

(2) *Recourse liability defined.* For purposes of this section, a partnership liability is a recourse liability of the partnership to the extent, but only to the extent, that one or more partners bear the economic risk of loss (within the meaning of paragraph (d)(3) of this section) for such liability.

(3) *Economic risk of loss*—(i) *In general.* Except as otherwise provided in this paragraph (d)(3), a partner bears the economic risk of loss for a liability of the partnership at any time to the extent, but only to the extent, that either—

(A) The partner would be obligated to make—

(*1*) A net payment to a creditor or other person with respect to such liability; or

(*2*) A net contribution to the partnership with respect to such liability;

if the partnership constructively liquidated (within the meaning of (paragraph (d)(3)(iii) of this section) at that time; or

(B) The partner (or a person related to such partner) is the creditor with respect to such liability (*i.e.*, the liability represents a debt owed to such partner or related person) and, but for this paragraph (d)(3)(i)(B), such liability would be a nonrecourse liability of the partnership (within the meaning of paragraph (e)(2) of this section).

See examples (3) through (18) of paragraph (k) of this section. See paragraph (d)(3)(ii) of this section for rules regarding the determination of a partner's obligation to make a net payment to a creditor or other person or a net contribution to the partnership with respect to a partnership liability. For purposes of subdivision (B) of this paragraph (d)(3)(i), if a liability of the partnership that is owed to a partner or a person related to a partner includes or reflects an obligation owed to another person to which property owned by the partnership is subject (generally known as a "wrapped indebtedness"), then such other person, and not such partner or related person, shall be treated as the person to whom the portion of the partnership liability corresponding to the wrapped indebtedness is owed. See example (19) of paragraph (k) of this section. If the aggregate amount of the economic risk of loss that all partners are determined to bear with respect to a partnership liability (or portion thereof) under the first sentence of this paragraph (d)(3)(i) exceeds the amount of such liability (or portion thereof), then the economic risk of loss borne by each partner with respect to such liability shall equal the amount determined by multiplying the amount of such liability (or portion thereof) by the fraction obtained by dividing the amount of the economic risk of loss that such partner is determined to bear with respect to that liability (or portion thereof) under the first sentence of this paragraph (d)(3)(i) by the sum of such amounts for all partners. See example (9)(iv) of paragraph (k) of this section.

(ii) *Obligation to make payment or contribution in connection with constructive liquidation*—(A) *Obligation to make net payment to creditor or other person with respect to partnership liability*—(1) *In general.* Except as otherwise provided in this paragraph (d)(3)-(ii), the net payment that a partner would be obligated to make to a creditor or other person with respect to a partnership liability if the partnership constructively liquidated (within the meaning of paragraph (d)(3)(iii) of this section) equals the excess (if any) of—

(*i*) The sum of the payments that such partner and any persons related to such partner would be obligated to make to a creditor or other person with respect to such liability at the time of such liquidation; over

(*ii*) The amount of any reimbursements (within the meaning of paragraph (d)(3)(ii)(C) of this section) that such partner and any persons related to such partner would be entitled to receive with respect to any such payments.

See examples (4), (9)(iii) , (11), (12)(ii) and (iii) , (14), (17), and (18)(ii) of paragraph (k) of this section.

(2) *Obligation to make payment*—(*i*) *In general.* For purposes of this paragraph (d)(3), a partner, a person related to a partner, or the partnership has an obligation to make a payment to a creditor or other person with respect to a partnership liability at any time to the extent, but only to the extent, that the partnership, such partner, or such related person is obligated (whether by agreement or operation of law) at such time to make—

(*A*) A payment to the creditor in full or partial satisfaction of such liability; or

(*B*) A payment to another partner, a person related to another partner, or the partnership with respect to any payment made by any such other person pursuant to an obligation of such other person to make a payment described in subdivision (*A*) or (*B*) of this paragraph (d)(3)(ii)(A)(*2*)(*i*).

Any obligation of a partner that constitutes an obligation to make a contribution to the partnership (within the meaning of paragraph (d)(3)(ii)(B)(*2*) of this section) shall not be treated as an obligation to make a payment to a creditor or other person with respect to a partnership liability. See paragraph (d)(3)(ii)(E) of this section for rules regarding the time in which an obligation to make a payment to a creditor or other person must be satisfied.

(*ii*) *Providing money or other property for use as security for partnership liability.* For purposes of this paragraph (d)(3), if—

(*A*) A partner contributes or otherwise provides money or other property (other than a promissory note of which such partner is the maker that is not readily tradeable on an established securities market) to the partnership; and

(*B*) Such money or other property is used in the partnership's activities solely to secure the payment of a partnership liability;

then the partnership's obligation to use such money or other property to discharge such liability shall be treated as an obligation of such partner to make a payment to a creditor or other person with respect to that liability. For purposes of the preceding sentence, money or other property contributed to the partnership that is described in subdivision (*A*) of this paragraph (d)(3)(ii)(A)(*2*)(*ii*) and that is used to secure the payment of a partnership liability is presumed to be used in the partnership's activities solely to secure the payment of a partnership liability if substantially all of the items of income, gain, loss, and deduction attributable to such money or other property are allocated to the contributing partner and the portion of such items allocated to the contributing partner is greater than such partner's share of any other significant item of partnership income, gain, loss, or deduction. In addition, if a partner contributes or otherwise provides money or other property to the partnership and the partnership uses such money or other property to acquire other property that is used solely in the partnership's activities to secure the payment of a partnership liability, such other property shall be treated as property contributed or otherwise provided to the partnership by such partner for purposes of this paragraph (d)(3)(ii)(A)(*2*)(*ii*). For example, if a partner with a 50 percent interest in partnership income, gain, loss, and deduction contributes money to the partnership, such money is used to purchase government securities that are pledged to secure the payment of a partnership liability, and such partner is allocated 99 percent of the income from such securities, then the partnership's obligation to use the securities to discharge a partnership liability is treated as an obligation of such partner to make a payment to a creditor or other person with respect to that liability. See example (12)(ii) of paragraph (k) of this section.

(B) *Obligation to make net contribution with respect to partnership liability*—(*1*) *In general.* Except as otherwise provided in this paragraph (d)(3)(ii), the net contribution that a partner would be obligated to make to the partnership with respect to a partnership liability if the partnership constructively liquidated (within the meaning of paragraph (d)(3)(iii) of this section) equals the amount determined by multiplying the net contribution that such partner would be obligated to make to the partnership at the time of such liquidation (within the meaning of paragraph (d)(3)(ii)(B)(*3*) of this section) by the fraction obtained by dividing—

(*i*) The outstanding partnership indebtedness (within the meaning of paragraph (d)(3)(ii)(B)(*4*) of this section) with respect to that liability at the time of such liquidation; by

(*ii*) The sum of the net contributions that all partners would be obligated to make to the partnership at the time of such liquidation.

See examples (6), (7), (8), (9)(ii) and (iii), (10)(ii), (12)(iv), (13)(ii) and (iii), and (15)(iv) of paragraph (k) of this section.

(*2*) *Obligation to contribute.* Except as otherwise provided in this paragraph (d)(3), a partner has an obligation to make a contribution to the partnership at any time to the extent, but only to the extent, of the sum of—

(*i*) The outstanding principal balance of any promissory note of which such partner is the maker that is owned by the partnership and was contributed to the partnership by such partner (other than a promissory note that is readily tradeable on an established securities market at the time of contribution);

(*ii*) The amount of any obligation of such partner that arises under the partnership agreeme or by operation of law to make subsequent contributions of money or other property to the partnership (other than pursuant to a promissory note of which such partner is the maker); and

(*iii*) The amount of any obligation of such partner or a person related to such partner to reimburse any partner for a contribution to the partnership that is described in this paragraph (d)(3)(ii)(B)(*2*).

For purposes of this paragraph (d)(3)(ii), if a partner contributes a promissory note to the partnership during a partnership taxable year beginning after December 29, 1988 and the maker of such note is a person related to such partner (within the meaning of paragraph (h) of this section, but without regard to subdivision (4) of that paragraph), then such promissory note shall be treated as a promissory note of which such partner is the maker. See paragraph (d)(3)(ii)(E) of this section for rules regarding the time in which an obligation to make a contribution to the partnership must be satisfied.

(*3*) *Net contribution defined.* For purposes of paragraph (d)(3)(ii)(B)(*1*) of this section, the net contribution that a partner would be obligated to make to the partnership at the time of a constructive liquidation of the partnership equals the aggregate amount of the contributions that such partner would be obligated to make to the partnership if the partnership constructively liquidated at that time, reduced by the aggregate amount of the reimbursements (within the meaning of paragraph (d)(3)(ii)(C) of this section) that such partner or a person related to such partner would be entitled to receive with respect to such contributions. See examples (3)(iii), (5), (6)(iii), (7), and (9)(iii) of paragraph (k) of this section.

(*4*) *Outstanding partnership indebtedness with respect to partnership liability*—(*i*) *In general.* For purposes of paragraph (d)(3)(ii)(B)(*1*) of this section, the outstanding partnership indebtedness with respect to a partnership liability equals the amount of such liability reduced by the sum of—

(*A*) The portion, if any, of such liability that constitutes a liability for which the creditor's right to repayment from the partnership is limited to one or more assets of the partnership (within the meaning of subdivision (*ii*) of this paragraph (d)(3)(ii)(B)(*4*)); and

(*B*) The excess of the sum of the amounts, if any, that are treated under paragraph (d)(3)(ii)(A)(*2*)(*ii*) of this section as obligations of the partners to make payments to a creditor or other person with respect to such liability, over any reimbursements that such partners would be entitled to receive (directly or indirectly) from the partnership with respect to payments made pursuant to those obligations.

The amount described in subdivision (*B*) of this paragraph (d)(3)(ii)(B)(*4*)(*i*) shall not include any amount attributable to any portion of a liability that is described in subdivision (*A*) of this paragraph (d)(3)(ii)(B)(*4*)(*i*). See examples (9)(iii), (12)(iv), and 13(iii) of paragraph (k) of this section.

(*ii*) *Liability for which creditor's right to repayment is limited.* A partnership liability is a liability with respect to which the creditor's right to repayment is limited to one or more assets of the partnership to the extent, but only to the extent, that the outstanding balance of such liabilty exceeds the aggregate amount that the partners would be obligated to contribute to the partnership to discharge that liability if—

(*A*) The partnership constructively liquidated (within the meaning of paragraph (d)(3)(iii) of this section, except that subdivision (A) of that paragraph shall be applied as if all of the partnership's assets (including any money or other property that is described in paragraph (d)(3)(ii)(A)-(*2*)(*ii*) of this section) were worthless); and

(*B*) The partners did not discharge their obligations, if any, to make payments to a creditor or other person with respect to such liability (within the meaning of paragraph (d)(3)(ii)-(A)(*2*) of this section).

See example (3)(ii) of paragraph (k) of this section. For example, if an entity that is treated as a partnership for federal income tax purposes is organized and operated under a local law which provides that none of the members of that entity is liable for its debts and other obligations, then all the liabilities of that entity will generally constitute liabilities for which the creditor's right to repayment is limited to one or more assets of the partnership because the members of that entity are not required to make contributions to the entity to discharge its liabilities.

(*C*) *Reimbursement.* Except as otherwise provided in this paragraph (d)(3)-(ii), if a partner or a person related to a partner is obligated to make a payment to a creditor or other person with respect to a partnership liability or a contribution to the partnership, such partner or related person is entitled to be reimbursed for any payment or contribution made pursuant to such obligation to the extent, but only to the extent, that—

(*1*) Another partner, a person related to another partner, or the partnership would be obligated to make a payment to such partner or related person in the event that such partner or related person makes a payment or contribution pursuant to such obligation; and

(*2*) The reimbursing payment that such other person would be obligated to make is recognized under this paragraph (d)(3)(ii) as an obligation to make a payment to a creditor or other person with respect to a partnership liability or a contribution to the partnership (or in the case of an obligation of the partnership to reimburse a partner for a contribution to the partnership, such obligation would be recognized as an obligation to make a contribution to the partnership if the partnership were a partner).

See examples (4), (7), (11), and (15)(iv) of paragraph (k) of this section.

(D) *Obligations recognized for purposes of this paragraph (d)(3)—(1) In general.* For purposes of this paragraph (d)(3)(ii)—

(*i*) A partner, person related to a partner, or the partnership has an obligation to make a payment to a creditor or other person with respect to a partnership liability or a contribution to the partnership to the extent that any person has a legally enforceable right to require such partner, related person, or partnership to make such payment or contribution;

(*ii*) The determination of whether a partner, person related to a partner, or the partnership would have an obligation to make a payment to a creditor or other person with respect to a partnership liability or a contribution to the partnership if the partnership constructively liquidated shall be based on all the facts and circumstances at the time of such determination; and

(*iii*) Any obligation to make a payment to a creditor or other person with respect to a partnership liability or a contribution to the partnership that would arise if the partnership constructively liquidated (within the meaning of paragraph (d)(3)-(iii) of this section) shall be recognized only to the extent that the existence and amount of such obligation would be determinable with reasonable certainty and such obligation would not otherwise be subject to contingencies that would make it unlikely that the obligation would ever be discharged.

(*2*) *Deemed satisfaction.* Except to the extent that an obligation is not recognized under this paragraph (d)(3)(ii), the rules of this paragraph (d)(3)(ii) shall be applied by assuming that any partner, person related to a partner, or partnership that would be obligated to make a payment to a creditor or other person with respect to a partnership liability or a contribution to the partnership if the partnership constructively liquidated actually discharges such obligation at the time of the constructive liquidation. See examples (6)(iii), (10)(iii) , (11), and (15)(iii) of paragraph (k) of this section. Thus, for example, a partner is generally assumed to discharge an obligation to make a contribution to the partnership even if such partner's net worth is less than the amount of the obligation. To the extent that the obligation of a partner to make a payment to a creditor or other person with respect to a partnership liability or a contribution to the partnership is not recognized under this paragraph (d)(3)(ii), this paragraph (d)(3)(ii) shall be applied as if such obligation did not exist. See example (11)(ii) and (15)(iv) of paragraph (k) of this section.

(*3*) *Exception where plan to circumvent or avoid obligation exists.* An obligation of a partner to make a net payment to a creditor or other person or a net contribution to the partnership with respect to a partnership liability shall not be recognized for purposes of this section to the extent that the facts and circumstances indicate a plan to circumvent or avoid such obligation. See examples (7), (9)(iv) and (v), and (11) of paragraph (k) of this section.

(E) *Time of satisfaction—(1) In general.* Except as otherwise provided in paragraph (d)(3)(ii)(E)(*2*) of this section—

(*i*) An obligation to make a payment to a creditor or other person with respect to a partnership liability shall be recognized for purposes of applying this paragraph (d)(3)(ii) only to the extent that such obligation is required to be satisfied within a reasonable period of time after such partnership liability becomes due and payable; and (*ii*) An obligation to make a contribution to the partnership shall be recognized for purposes of this paragraph (d)(3)(ii) only to the extent that such obligation must be satisfied by the later of—

(*A*) The end of the partnership taxable year in which the partner's interest in the partnership is liquidated; or

(*B*) 90 days after the date of such liquidation.

(*2*) *Obligations that are not required to be satisfied within prescribed time period*—(*i*) *In general.* Any obligation of a partner, a person related to a partner, or the partnership to make a payment to a creditor or other person with respect to a partnership liability or a contribution to the partnership that does not meet the requirements of paragraph (d)(3)(ii)(E)-(*1*) of this section shall be recognized under this paragraph (d)(3)(ii) for purposes of determining the consequences of a constructive liquidation of the partnership (within the meaning of paragraph (d)(3)(iii) of this section) only to the extent of the value that such obligation would have if the partnership constructively liquidated at the time of such determination.

(*ii*) *Value of obligation.* For purposes of subdivision (*i*) of this paragraph (d)(3)(ii)(E)(*2*), the value of an obligation equals—

(*A*) The outstanding principal balance of such obligation if such obligation bears interest for the period commencing on the date that the partnership liability to which such obligation relates is due and payable (in the case of an obligation that does not meet the requirements of paragraph (d)(3)(ii)(E)(*1*)(*i*) of this section) or the date of the liquidation of the partner's interest in the partnership (in the case of an obligation that does not meet the requirements of paragraph (d)(3)(ii)(E)(*1*)(*ii*) of this section) and ending on the date that the obligation is satisfied, and the rate of interest that such obligation bears (appropriately adjusted for the period of compounding) is equal to or greater than the applicable Federal rate (within the meaning of section 1274(d)) at the time of valuation; or

(*B*) If subdivision (*A*) of this paragraph (d)(3)(ii)(E)(*2*)(*ii*) does not apply to such obligation, the imputed principal amount that such obligation would have under section 1274(b) if the partnership constructively liquidated at the time of valuation.

For purposes of the preceding sentence, the imputed principal amount of an obligation is determined by treating such obligation as a debt instrument to which section 1274 applies (without regard to section 1274(b)(3) and section 1274A) and by assuming for purposes of applying section 1274 that the sale or exchange of property in which such debt instrument was given as consideration occurred at the time of valuation. See examples (13)(ii) and (iii) and (15)(iii) of paragraph (k) of this section.

(*3*) *Liquidation of partner's interest*—(*i*) *In general.* For purposes of this paragraph (d)(3)(ii)(E), the liquidation of a partner's interest in the partnership occurs on the earlier of—

(*A*) The date on which the partnership is liquidated; or

(*B*) The date on which the partner's interest in the partnership is liquidated under §1.761-1(d).

(*ii*) *Delayed liquidations.* If— (*A*) A partner's interest in the partnership is not liquidated after the partnership's primary business activities have been discontinued; and

(*B*) The principal purpose for delaying the liquidation of such partner's interest in the partnership is to delay the time at which the partner will be required to satisfy an obligation to make a contribution to the partnership;

any obligation of such partner to make a contribution to the partnership shall be considered to fail the requirements of subdivision (*1*) of this paragraph (d)(3)-(ii)(E) and shall be recognized under this paragraph (d)(3)(ii) only to the extent of its value as determined in accordance with subdivision (*2*) of this paragraph (d)(3)(ii)(E).

(*iii*) *Partnership liquidation defined.* For purposes of this paragraph (d)(3)(ii)-(E), the liquidation of a partnership occurs on the earlier of (*A*) the date on which the partnership terminates under section 708(b)(1)(A) or (*B*) the date on which the partnership ceases to be a going concern even though the partnership may continue in existence for the purpose of winding up its affairs, paying its debts, and distributing any remaining assets to its partners.

(*4*) *Satisfaction of obligation with promissory note.* For purposes of this paragraph (d)(3)(ii)(E), an obligation is not satisfied by the transfer to the obligee of a promissory note (other than a note that is readily tradeable on an established securities market) of which the obligor (or a person related to the obligor) is the maker.

(*5*) *Obligations imposed by law.* Any obligation imposed on a partner or a person related to a partner by state or local law is deemed to satisfy the requirements of subdivision (*1*) of this paragraph (d)(3)(ii)(E). For example, if a partner would be obligated under state law to make a net contribution to the partnership with respect to a partnership liability if the partnership constructively liquidated, such partner is deemed to be obligated to satisfy such obligation within the time period set forth in subdivision (*1*) of this paragraph (d)(3)-(ii)(E).

(*F*) *Obligations limited to value of property*—(*1*) *In general.* If the obligation of a partner or a person related to a partner to make a payment to a creditor or other person with respect to a partnership liability or the obligation of a partner to make a contribution to the partnership is limited to the fair market value of any property, then the amount of such obligation is determined, for purposes of this paragraph (d)(3)(ii), on the basis of the fair market value of such property as of—

(*i*) The time that the amount of such obligation is determined for purposes of this paragraph (d)(3)(ii) if the fair market value of such property is readily ascertainable (*e.g.*, marketable securities) or such property is property of a type that by its terms increases or decreases in value (*e.g.*, a debt instrument on which principal payments are made during its term); or

(*ii*) If the property is not described in subdivision (*i*) of this paragraph (d)(3)(ii)(F)(*1*), the latest of the time that the liability is incurred, the time that the liability is assumed, or the time of the most recent valuation of such property that is made in connection with such liability.

For example, if a partner pledges marketable securities to a partnership creditor to guarantee the payment of a partnership liability and the partner does not assume any personal liability under the guarantee, then the amount that the partner is considered obligated to pay the creditor for purposes of determining the manner in which the partners share the economic risk of loss for the liability equals the fair market value of the marketable securities at the time of any such determination. Alternatively, if the partner had given the creditor a lien on real property, the amount of the obligation would equal the fair market value of such property as of the latest of the time the liability is incurred, the guarantee is made, or the most recent valuation of such property made in connection with the guarantee (*e.g.*, to assure the creditor that the property continues to represent adequate security for the partnership liability).

(*2*) *Partnership interests.* For purposes of this paragraph (d)(3)(ii), in the case of any obligation to make a payment to a creditor or other person with respect to a partnership liability or a contribution to the partnership, any interest in such partnership shall be deemed to have a fair market value of zero. For example, if a partner pledges such partner's interest in the partnership to a partnership creditor to guarantee the payment of a partnership liability and the partner does not assume any personal liability under the guarantee, the partner is not considered to have any obligation to make a payment to the creditor under the guarantee for purposes of this paragraph (d)(3)(ii) because the partnership interest is deemed to have a fair market value of zero.

(*3*) *Promissory notes.* For purposes of applying this paragraph (d)(3)(ii)(F) to a partner or a person related to a partner, the term "property" does not include a promissory note (other than a note that is readily tradeable on an established securities market) of which such partner or such related person is the maker.

(G) *Meaning of certain terms.* For purposes of this section, the term "creditor" means the person to whom any liability is owed, and the term "partnership agreement" has the meaning set forth in §1.761-1(c).

(iii) *Constructive liquidation*—(A) *In general.* For purposes of this section, if a partnership is deemed to constructively liquidate, the following events are deemed to occur—

(*1*) All of the assets of the partnership (other than property that is described in paragraph (d)(3)(ii)(A)-(*2*)(*ii*) of this section) become worthless;

(*2*) All of the liabilities of the partnership (including any wrapped indebtedness described in paragraph (d)(3)(i) of this section) become due and payable in full because of the partnership's failure to make the payments required with respect to such liabilities;

(*3*) The partnership (*i*) transfers in a fully taxable exchange any property described in paragraph (d)(3)(ii)(A)-(*2*)(*ii*) of this section to the owner of any liability to which such property is subject in full or partial satisfaction of such liability and (*ii*) disposes of all of its remaining assets in a fully taxable exchange (involving the transfer of any partnership asset subject to a liability to the owner of that liability) for no consideration (other than relief from any liability for which the creditor's right to repayment is limited to one or more assets of the partnership (within the meaning of paragraph (d)(3)(ii)(B)(*4*)(*ii*) of this section), after taking into account the reduction in any such liability that would result from any transfer described in subdivision (*i*) of this paragraph (d)(3)(iii)-(A)(*3*)); and

(*4*) The partnership allocates its items of income, gain, loss, deduction, and credit for the partnership taxable year ending on the date of the liquidation among the partners in accordance with the partnership agreement and liquidates the partners' interests in the partnership.

See examples (3)(iii), (5)(ii), (12)(ii), (13)(ii), (16)(ii), (17)(ii), and (18) (ii) of paragraph (k) of this section. For purposes of determining the amount of any liability that is deemed satisfied in connection with any constructive liquidation as a result of a transfer of property that is described in paragraph (d)(3)(iii)(A)(*3*)(*i*) of this section, such property shall be considered to have a value equal to the amount of the obligation to make a payment to a creditor or other person that arises under paragraph (d)(3)(ii)(A)(*2*)(*ii*) of this section with respect to such property, provided that such obligation shall be taken into account only to the extent that it is recognized for purposes of applying paragraph (d)(3)(ii) of this section to such constructive liquidation.

(B) *Partnership assets.* For purposes of this paragraph (d)(3)(iii), the assets of the partnership include all of the money and other property (including contractual rights such as insurance policies) owned by the partnership other than (*1*) the obligation of any partner or person related to any partner to make a contribution to the partnership (within the meaning of paragraph (d)(3)(ii)(B)(*2*) of this section), and (*2*) the obligation of any partner or person related to any partner to make a payment described in paragraph (d)(3)-(ii)(A)(*2*)(*i*) of this section to the partnership.

(iv) *Arrangements tantamount to a guarantee.* If one or more partners or persons related to such partners—

(A) Undertake one or more contractual obligations in order to acquire a loan;

(B) Such obligations eliminate substantially all of the risk to the creditor that the partnership will not satisfy its obligations under that loan (assuming that such partners or related persons satisfy their obligations); and

(C) One of the principal purposes of the arrangement is to permit partners other than such partners to include a portion of such liability in the basis of their partnership interests;

then such partners shall be considered to bear the economic risk of loss with respect to such liability in a manner that reflects their relative economic burdens with respect to that liability pursuant to such contractual obligations and no other partner shall be considered to bear the economic risk of loss with respect to such liability. See example (20) of paragraph (k) of this section.

(v) *Nonrecourse debt with respect to which a partner has assumed an obligation to pay interest*—(A) *In general.* For purposes of this section, if one or more partners (or persons related to such partners) would be obligated (whether pursuant to the partnership agreement, by operation of law, or otherwise) to pay more than 20 percent of the total interest that will accrue on any nonrecourse liability of the partnership during the term of such liability (or if the liability has an indefinite term,, the expected term of such liability) if the partnership fails to pay such interest, then each such partner's economic risk of loss for such liability shall be increased by an amount equal to the sum of the present values of the remaining interest payments that such partner (or any person related to such partner) would be obligated to make if the partnership fails to make those payments (taking into account any payment that such partner or related person may be required to make pursuant to that obligation only to the extent that such partner or related person would not be entitled to be reimbursed (within the meaning of paragraph (d)(3)(ii)(C) of this section) for such payment). See example (21) of paragraph (k) of this section. An obligation of a partner to pay any portion of the interest that will accrue on a nonrecourse liability of the partnership shall not be treated as an obligation to pay such interest for purposes of this paragraph (d)(3)(v) unless it is reasonable to expect, based on all the facts and circumstances, that the partner would be required to pay substantially all of the interest subject to that obligation if the partnership failed to pay such interest. For example, if a partner guarantees the payment of all of the interest due on an otherwise nonrecourse liability but the lender can only enforce that guarantee by first foreclosing on the property subject to such liability, it generally will not be reasonable to expect that the partner would be required to pay substantially all of the interest subject to that guarantee if the partnership failed to pay such interest unless substantially all of the interest due on such liability is payable at the end of the term of the liability (*e.g.*, a liability on which no payments of principal or interest are due until maturity). A partnership liability is a nonrecourse liability of the partnership for purposes of this paragraph (d)(3)(v) only to the extent that such liability would, but for this paragraph (d)(3)(v), be a nonrecourse liability (within the meaning of paragraph (e) of this section) of the partnership.

(B) *Present value.* For purposes of this paragraph (d)(3)(v), the present value of any interest payment with respect to a partnership liability is determined by assuming that such payment will be made when due and by using a discount rate equal to—

(*1*) The rate at which such interest payment accrues on the liability; or

(*2*) The applicable Federal rate, compounded semiannually, if the liability is (*A*) a debt instrument to which section 483 applies and there is total unstated interest on such debt instrument, or (*B*) a debt instrument to which section 1274 applies and the issue price of such debt instrument is equal to the imputed principal amount of such debt instrument.

(vi) *Tiered partnerships.* For purposes of this section, if a partnership (the "upper-tier partnership") owns (directly or indirectly through one or more partnerships) an interest in another partnership (the "subsidiary partnership"), the upper-tier partnership bears the economic risk of loss for any liability of the subsidiary partnership to the extent of the sum of—

(A) The economic risk of loss (within the meaning of this paragraph (d)(3), but without regard to this subdivision (vi) of that paragraph) that the upper-tier partnership bears with respect to such liability; and

(B) The amount of the economic risk of loss (within the meaning of this paragraph (d)(3)) that the upper-tier partnership's partners would bear for any portion of such liability with respect to which the upper-tier partnership does not otherwise bear the economic risk of loss if the subsidiary partnership's liabilities constituted liabilities of the upper-tier partnership.

(vii) *De minimis rule.* If a partner would, but for this paragraph (d)(3)(vii), bear the economic risk of loss under paragraph (d)(3)(i)(B) of this section for a partnership liability for a loan from such partner or a person related to such partner, then such partner shall not be considered to bear the economic risk of loss for that liability if—

(A) The partner's interest (including the interest of any person related to such partner) in each item of partnership income, gain, loss, deduction, or credit is 10 percent or less; and

(B) Such loan constitutes qualified nonrecourse financing within the meaning of section 465(b)(6).

(e) *Partner's share of nonrecourse liabilities*—(1) *In general.* A partner's share of the nonrecourse liabilities of a partnership shall equal the sum of—

(i) The partner's share of partnership minimum gain (within the meaning of paragraph (e)(3)(i) of this section);

(ii) The amount of any taxable gain that would be allocated to the partner under section 704(c), or in the same manner as under section 704(c) in connection with a revaluation of partnership property pursuant to §1.704-1(b)(2)(iv)(*f*) or (*r*) (see §1.704-1(b)-(2)(iv)(*f*)(*4*), 1.704-1(b)(4)(i)), if the partnership disposed of (in a taxable transaction) all partnership property subject to one or more nonrecourse liabilities of the partnership in full satisfaction of such liabilities and for no other consideration; and

(iii) The partner's proportionate share of the excess nonrecourse liabilities of the partnership (within the meaning of paragraph (e)(3)(ii) of this section).

See examples (13)(iv), (16)(ii), (17)(iii), (19)(ii), (22) and (23) of paragraph (k) of this section. For purposes of subdivision (ii) of this paragraph (e)(1), the amount of taxable gain that would be recognized by the partnership if it disposed of an item of partnership property subject to one or more nonrecourse liabilities of the partnership in full satisfaction of such liabilities shall be computed by taking into account only the portion of the adjusted tax basis of such property that is allocated to nonrecourse liabilities of the partnership under the principles of §1.704-1T(b)(4)(iv)(*c*)(*1*) and (*2*).

(2) *Nonrecourse liability defined.* For purposes of this section, a liability of a partnership is a nonrecourse liability of the partnership to the extent, but only to the extent, that no partner bears the economic risk of loss (within the meaning of paragraph (d)(3) of this section) for such liability.

(3) *Meaning of certain terms*—(i) *Partner's share of partnership minimum gain.* A partner's share of partnership minimum gain shall be determined in accordance with the rules of §1.704-1T-(b)(4)(iv)(*f*), except that at any time it is necessary to determine a partner's share of partnership liabilities, such partner's share of partnership minimum gain shall be computed as if the partnership taxable year had ended immediately prior to such determination. For purposes of section 752 and the regulations thereunder, any increase in a partner's share of partnership minimum gain shall be deemed to occur immediately before the event that caused such increase.

(ii) *Partner's proportionate share of excess nonrecourse liabilities*—(A) *In general.* A partner's proportionate share of the excess nonrecourse liabilities of the partnership equals the amount determined by multiplying the partner's percentage interest in partnership profits by the excess nonrecourse liabilities of the partnership.

(B) *Excess nonrecourse liabilities.* The excess nonrecourse liabilities of the partnership equal the excess of—

(*1*) The aggregate amount of the nonrecourse liabilities of the partnership; over

(*2*) The aggregate amount of the nonrecourse liabilities of the partnership that are allocable to the partners under paragraph (e)(1)(i) and (ii) of this section.

(C) *Interest in partnership profits.* For purposes of this paragraph (e), the partners' interests in partnership profits shall be determined by taking into account all facts and circumstances relating to the economic arrangement of the partners. However, if—

(*1*) The partnership agreement specifies the partners' interests in partnership profits for purposes of determining such partners' shares of the nonrecourse liabilities of the partnership; and

(*2*) The partners' interests in partnership profits (as specified in the partnership agreement) are reasonably consistent with allocations (which have substantial economic effect under §1.704-1(b)) of some significant item of partnership income or gain among such partners;

then the partners' interests in partnership profits shall, for purposes of this paragraph (e), be deemed to be as specified in the partnership agreement. See example (22)(iii) of paragraph (k) of this section.

(f) *Assumption of liability*—(1) *In general.* Except as otherwise provided in §1.752-2T, for purposes of section 752 and the regulations thereunder, a person is considered to assume a liability to the extent, but only to the extent, that as a result of the assumption—

(i) The assuming person is subjected to personal liability with respect to such liability; and

(ii) in the case of any assumption of a partnership liability by a partner, the person to whom such liability is owed is aware of the assumption and can directly enforce the partner's obligation with respect to such liability, and no other partner or person related to another partner would bear the economic risk of loss for such liability (within the meaning of paragraph (d)(3) of this section) immediately after the assumption if such liability were treated as a partnership liability.

(2) *Effect of assumption*—(i) *Assumption by partnership.* If a partnership assumes a liability of a partner, such liability shall thereafter be treated as a liability of the partnership, and not the partner, for purposes of section 752 and the regulations thereunder.

(ii) *Assumption by partner.* If a partner assumes a liability of the partnership, such liability shall thereafter be treated as a liability of the partner, and not the partnership, for purposes, of section 752 and the regulations thereunder.

(g) *Liability defined.* Except as otherwise provided in the regulations under section 752, an obligation is a liability of the obligor for purposes of section 752 and the regulations thereunder to the extent, but only to the extent, that incurring or holding such obligation gives rise to—

(1) The creation of, or an increase in, the basis of any property owned by the obligor (including cash attributable to borrowings);

(2) A deduction that is taken into account in computing the taxable income of the obligor; or

(3) An expenditure that is not deductible in computing the obligor's taxable income and is not properly chargeable to capital.

See examples (2) and (3)(ii) of paragraph (k) of this section.

(h) *Related person*—(1) *In general.* Except as otherwise provided in this paragraph (h), a person is related to a partner for purposes of this section if and only if such person and the partner bear a relationship to each other that is specified in section 267(b) (without modification by section 267(e)(1)) or section 707(b)(1), taking into account the modifications made by paragraph (h)(2) of this section.

(2) *Modifications to sections 267(b) and 707(b)(1).* For purposes of this section, sections 267(b) and 707(b)(1) shall be applied by—

(i) Substituting "80 percent or more" for "more than 50 percent" each place it appears in such sections;

(ii) Excluding brothers and sisters from the members of a person's family; and

(iii) Disregarding section 267(f)(1)(A).

(3) *Person related to more than one partner*—(i) *In general.* For purposes of this section, if a person is related to more than one partner—

(A) Any obligation of such person to make a payment to a creditor or other person with respect to a partnership liability (within the meaning of paragraph (d)(3)(ii)(A)(2) of this section), any obligation of such person to make a contribution to the partnership (within the meaning of paragraph (d)(3)(ii)(B)(2)(*iii*) of this section), and any reimbursement that such person is entitled to receive with respect to such payment or contribution (within the meaning of paragraph (d)(3)(ii)(C) of this section) shall be allocated to the related partner with the greatest percentage of related ownership with respect to such person; and

(B) Any partnership liability owed to such related person that, but for paragraph (d)(3)(i)(B) of this section, would be a nonrecourse liability of the partnership shall be treated as a liability that is owed to a person related to the partner with the greatest percentage of related ownership with respect to such related person.

If more than one partner holds the same percentage of related ownership with respect to such person and no partner holds a greater percentage, any such obligation, right to reimbursement, or liability shall be allocated equally among such partners unless the facts and circumstances establish that the partners would share any economic burden or benefit corresponding to any such obligation, right to reimbursement, or liability in a different manner.

(ii) *Percentage of related ownership.* The percentage of related ownership of a partner with respect to a related person equals the greater of—

(A) The percentage ownership of the related person by the partner; or

(B) The percentage ownership of the partner by the related person.

In determining the percentage of related ownership of a partner with respect to a related person, the constructive ownership or attribution rules applicable under sections 267(b) and 707(b)(1) (as modified by paragraph (h)(2) of this section) must be taken into account, and if a partner is related to a person under more than one of the relationships set forth under sections 267(b) and 707(b)(1) (as so modified), then the relationship establishing the highest percentage of related ownership must be used. For purposes of this section, natural persons shall be deemed to have a zero percentage of related ownership with respect to each other. For example, if a person that is related to more than one partner is obligated to make a payment to a creditor with respect to a partnership liability, and such person and such partners are related because they are members of the same family, then that obligation must, for purposes of determining the economic risk of loss borne by each partner with respect to such liability, be divided equally among such partners (unless the facts and circumstances establish that the partners would share any economic burden corresponding to such obligation in a different manner) under this paragraph (h)(3) because they have the same percentage of related ownership (zero).

(4) *Related partners.* Except as otherwise provided in this section, if related persons (within the meaning of this paragraph (h)) own (directly or indirectly) interests in the same partnership, then such persons shall not be treated as related persons for purposes of determining the economic risk of loss borne by each of them for the liabilities of such partnership.

(i) [Reserved.]

(j) *Special rules*—(1) *Tiered partnerships.* If a partnership (the "upper-tier partnership") is a partner in another partnership (the "subsidiary partnership"), the upper-tier partnership's share of the liabilities of the subsidiary partnership (other than any liability of the subsidiary partnership that is owed to the upper-tier partnership) shall be treated as liabilities of the upper-tier partnership for purposes of applying section 752 and the regulations thereunder to the partners of the upper-tier partnership.

(2) *Liabilities which are part recourse and part nonrecourse.* If one or more partners bears the economic risk of loss (within the meaning of paragraph (d)(3) of this section) for only a portion of a partnership liability, such liability shall be treated as a recourse liability of the partnership to the extent that the partners bear the economic risk of loss for such liability and as a nonrecourse liability of the partnership in an amount equal to the excess. See examples (13)(iv) and (19)-(ii) of paragraph (k) of this section.

(3) *Increase and decrease in share of liabilities resulting from same transaction.* For purposes of section 752 and the regulations thereunder, if as a result of a single transaction (for example, a contribution by a partner to the partnership of property subject to a liability or the termination of the partnership under section 708(b)) a partner incurs both an increase (or decrease) in the partner's share of the liabilities of the partnership and a decrease (or increase) in the partner's individual liabilities—

(i) Such increase and decrease must be offset against each other prior to the application of paragraph (b) or (c) of this section; and

(ii) Only the amount of the net increase or decrease, if any, in the sum of the partner's share of the liabilities of the partnership and the partner's individual liabilities resulting from such transaction shall be treated as a contribution of money by the partner to the partnership or a distribution of money by the partnership to the partner, respectively, under paragraph (b) or (c) of this section.

See §1.752-2T(b) (examples (1) and (2)).

(4) *Time of determination.* A partner's share of the liabilities of the partnership must be determined whenever such determination is necessary in order to determine the tax liability of the partner or any other person. See §1.705-1(a) for rules regarding when the adjusted basis of a partner's interest in the partnership must be determined.

(5) *Limitation.* For purposes of section 752 and the regulations thereunder, the amount of an indebtedness shall be taken into account only once, even though a partner (in addition to his liability for such indebtedness as a partner) may be separately liable therefore in a capacity other than as a partner.

(k) *Examples.* The following examples illustrate the application of the rules of this section. Except as otherwise provided, these examples assume that (1) the partnerships discussed therein are formed under state laws corresponding to the Uniform Partnership Act or the Revised Uniform Limited Partnership Act, whichever is appropriate, (2) partnership indebtedness constitutes debt for federal income tax purposes, and (3) any debt instrument given in consideration for the sale or exchange of property bears adequate stated interest (within the meaning of section 1274(c)).

Example (1). A and B are equal partners in a general partnership. The partnership borrows $1,000. A and B, as equal partners, share the partnership liability for that obligation equally under the rules of this section. The resulting $500 increase in each partner's share of the liabilities of the partnership is treated as a contribution of $500 by that partner to the partnership. See paragraph (b) of this section. Each time the partnership pays a portion of the outstanding balance of the $1,000 loan, each partner's share of the liabilities of the partnership is decreased by one-half of the payment, and the decrease in each partner's share of partnership liabilities is treated as a distribution of that amount by the partnership to that partner. See paragraph (c) of this section.

Example (2). (i) C and D are partners in a general partnership that uses the cash method of accounting. At the close of its taxable year, the partnership has accrued interest expense of $1,000 and accounts payable of $500 for services performed on behalf of the partnership.

(ii) Under its method of accounting, the partnership's accrued interest expense and accounts payable are not deductible until paid. Also, the partnership obligations represented by those items have not created or increased the basis of any partnership property or given rise to a nondeductible expenditure of the partnership that is not properly chargeable to capital account. As provided by paragraph (g) of this section, an obligation that constitutes a debt for federal income tax purposes is a liability of the obligor only to the extent that incurring or holding such obligation gives rise to (1) the creation of, or an increase in, the basis of any property owned by the obligor, (2) a deduction that is taken into account in computing the taxable income of the obligor, or (3) an expenditure that is not deductible in computing the obligor's taxable income and is not properly chargeable to capital. Therefore, the partnership obligations for accrued but unpaid interest expense and accounts payable are not partnership liabilities for purposes of section 752.

Example (3). (i) E and F form a general partnership with cash contributions of $20,000 each. The partnership agreement provide's that E and F will share all partnership profits and losses equally. The partnership purchases depreciable personal property for $40,000 in cash and a recourse purchase money note for $60,000.

(ii) The indebtedness represented by the purchase money note is a partnership liability because incurring that obligation creates an additional $60,000 of basis in the partnership's depreciable personal property. See paragraph (g) of this section. Under paragraph (d) of this section, the partnership liability for the purchase money note constitutes a recourse liability of the partnership to the extent, but only to the extent, that one or more partners bears the economic risk of loss for such liability, and each partner's share of the recourse liabilities of the partnership equals the portion of those liabilities for which such partner bears the economic risk of loss. To the extent that no partner bears the economic risk of loss for the liability represented by the purchase money note, that liability constitutes a nonrecourse liability of the partnership. See paragraph (e)(2) of this section. Under paragraph (d)(3)(i) of this section, a partner bears the economic risk of loss for a partnership liability to the extent that such partner would be obligated to make a net payment to a creditor or other person or a net contribution to the partnership with respect to such liability if the partnership constructively liquidated (within the meaning of paragraph (d)(3) (iii) of this section).

(iii) In a constructive liquidation of the partnership, all partnership assets are assumed to become worthless and all partnership liabilities are assumed to become due and payable in full. See paragraph (d)(3)(iii)(A)(*1*) and (2) of this section. Thus, if the partnership constructively liquidated, the purchase money note would be due and payable, but the partnership would lack the assets needed to discharge the note. As a result, E and F, as equal general partners, would each be obligated by operation of law to make a net contribution of $30,000 to the partnership with respect to the partnership liability for the purchase money note. See paragraph (d)(3)(ii)(B) of this section. Therefore, under paragraph (d)(3)(i) of this section, E and F each bear the economic risk of loss for $30,000 of that liability. Accordingly, the $60,000 partnership liability for the purchase money note is a recourse liability, and E and F share that liability equally.

Example (4). (i) The facts are the same as in example (3), except that F is a limited partner, who guarantees the purchase money note and has no obligation to make additional capital contributions to the partnership. Under the guarantee, if the partnership defaults on the purchase money note, F is obligated to pay the outstanding balance of the note. In addition, F is subrogated to the seller's rights against the partnership under the purchase money note for any payments made by F pursuant to the guarantee.

(ii) Under F's guarantee, if the partnership constructively liquidated (within the meaning of paragraph (d)(3)(iii) of this section), F would be obligated to make a $60,000 payment to the seller with respect to the partnership liability for the purchase money note. F would, however, be entitled to be reimbursed (within the meaning of paragraph (d)(3)(ii)(C) of this section) by the partnership for any payment made under the guarantee pursuant F's right to subrogation. As a result, F would not be obligated to make a net payment to a creditor or other person with respect to the liability for the purchase money note. See paragraph (d)(3)(ii)(A) of this section. E, as the sole general partner, however, would be obligated to make a net contribution of $60,000 to the partnership with respect to the partnership liability for the purchase money note in order to provide the partnership with the funds needed to pay the outstanding balance of the note that is owed to F, as subrogee. See paragraph (d)(3)(ii)(B) of the section. Thus, E bears the economic risk of loss for the entire $60,000 partnership liability. Accordingly, under paragraph (d) of this section, the liability is a recourse liability, and E's share of that liability is $60,000.

Example (5). (i) The facts are the same as in example (3), except that the partnership agreement provides that capital accounts will be determined and maintained for the partners in accordance with §1.704-1(b)(2)(iv), distributions in liquidation of the partnership (or any partner's interest) are to be made in accordance with the partners' positive capital account balances (as set forth in §1.704-1(b)-(2)(ii)(*b*)(*2*)), and any partner with a deficit balance in the partner's capital account following the liquidation of the partner's interest must restore that deficit to the partnership (as set forth in §1.704-1(b)(2)(ii)(*b*)(*3*)). At the time it incurs the liability for the purchase money note, the partnership has no income, gain, loss, deduction, or credit for the taxable year.

(ii) To determine the economic risk of loss that each partner bears with respect to the partnership liability for the purchase money note, the partnership must be deemed to constructively liquidate (within the meaning of paragraph (d)(3)(iii) of this section). This requires, among other things, that the partnership be treated as if it disposed of all its assets in a fully taxable exchange for no consideration, allocated partnership items of income, gain, loss, deduction, and credit to the partners for the partnership taxable year ending on the date of the liquidation, and liquidated the partner's interests in the partnership. See paragraph (d)(3)(iii)(A)(*3*) and (*4*) of this section. If the partnership constructively liquidated immediately after incurring the purchase money note, the partnership would recognize a taxable loss of $100,000 (which equals the adjusted tax basis of the property) on the disposition of its depreciable personal property for no consideration. Thus, the partnership would have a taxable loss of $100,000 for the hypothetical partnership taxable year ending on the date of the constructive liquidation. The partnership agreement would allocate this loss between E and F as follows:

	E	*F*
Capital account on formation	$20,000	$20,000
Less: loss	(50,000)	(50,000)
Capital account after constructive liquidation	($30,000)	($30,000)

Thus, in order to restore the deficit balances in their capital accounts, E and F would each be obligated to make a net contribution of $30,000 to the partnership with respect to the partnership liability for the purchase money note if the partnership constructively liquidated immediately after it incurred that liability. See paragraph (d)(3)(ii)(B) of this section. Therefore. as in example (3), E and F each bears $30,000 of the economic risk of loss for the partnership liability under paragraph (d)(3)(i) of this section.

Example (6). (i) The facts are the same as in example (5), except that the partnership agreement provides that 90 percent of partnership net taxable loss will be allocated to E and 10 percent to F.

(ii) As in example (5), if the partnership constructively liquidated immediately after incurring the purchase money note, the partnership would recognize a taxable loss of $100,000 on the disposition of its depreciable personal property for no consideration, and the partnership would have a net taxable loss of $100,000 for the hypothetical partnership taxable year ending on the date of the constructive liquidation. The partnership agreement would allocate 90 percent of this net taxable loss to E and 10 percent to F.

	E	*F*
Capital account on formation	$20,000	$20,000
Less: loss	(90,000)	(10,000)
Capital account after constructive liquidation	($70,000)	$10,000

Thus, E would be obligated to make a net contribution of $70,000 to the partnership at the time of the constructive liquidation (within the meaning of paragraph (d)(3)(ii)(B)(*3*) of this section) in order to restore the deficit balance in E's capital account. F, on the other hand, would not be obligated to make a contribution to the partnership, but would be entitled to receive a $10,000 distribution from the partnership.

(iii) Under paragraph (d)(3)(ii)(B)(*1*) of this section, $60,000 of the $70,000 net contribution that E would be obligated to make to the partnership constitutes an obligation to make a net contribution with respect to the partnership liability for the purchase money note (E's net contribution ($70,000) multiplied by the fraction obtained by dividing the outstanding partnership indebtedness with respect to that liability ($60,000) by the sum of the partners' net contributions ($70,000)). The other $10,000 of E's net contribution would fund the distribution to F. While the holder of the purchase money note could attempt to recover the balance due on the note from F as a general partner, E and F have agreed under the partnership agreement that, as between them, E will bear the risk of loss for that liability, and the rules of this section assume that E actually discharges E's obligation to make a net contribution to the partnership at the time of the constructive liquidation. See paragraph (d)(3)(ii)(D)(*2*) of this section. Under paragraph (d)(3)(i) of this section, E bears the economic risk loss for the full amount of the partnership liability for the purchase money note. Therefore, the partnership liability for the note is a recourse liability that is allocated entirely to E. See paragraph (d)(1) and (2) of this section.

Example (7). (i) The facts are the same as in example (6), except that F contributes a promissory note (of which F is the maker) with a principal balance of $60,000 to the partnership. The promissory note is not readily tradable on an established securities market. F's promissory note is payable in five years; however, F's obligation to discharge the note will be accelerated if, prior to that time, the partnership is liquidated.

(ii) F's promissory note constitutes an obligation to make a contribution to the partnership (within the meaning of paragraph (d)(3)(ii)(B)(*2*) of this section). If F contributed the $60,000 principal balance of the promissory note to the partnership immediately after the constructive liquidation, F's capital account would increase by $60,000, giving F a positive capital account balance of $70,000 and the right to the distribution of an additional $60,000 from the partnership.

F's capital account after constructive liquidation	$10,000
Plus: contribution pursuant to promissory note	60,000
Total	$70,000

Because F would be entitled to be reimbursed for a contribution made pursuant to the promissory note, F would not be obligated to make a net contribution to the partnership upon a constructive liquidation. See paragraph (d)(3)(ii)(B)(*3*) and (C) of this section. After F's payment of the $60,000 balance due on the promissory note, the partnership would have only $60,000 in cash to satisfy the $60,000 partnership liability and F's $70,000 positive capital account balance. E would, however, be obligated to make a net contribution of $70,000 to the partnership to restore the deficit balance in E's capital account. As in example (6), $60,000 of this net contribution constitutes a net contribution with respect to the partnership liability and $10,000 is attributable to the partnership's obligation to satisfy F's positive capital account balance. Therefore, as in example (6), E bears the economic risk of loss for the full amount of the partnership liability for the purchase money note unless F's contribution of the promissory note to the partnership constitutes part of a plan to circumvent or avoid E's deficit restoration obligation. See paragraph (d)(3)(ii)(D)-(*3*) of this section regarding the existence of a plan to circumvent or avoid an obligation.

Example (8). (i) G and H form a general partnership to invest in stocks, securities, and other income producing liquid assets. G, the managing partner, contributes $5,000 in cash to the partnership, and H, an investor, contributes $15,000 in cash to the partnership. Immediately after its formation, the partnership obtains a $10,000 recourse loan from a commercial bank and purchases $15,000 of corporate stock, $10,000 of government securities, and a $3,000 certificate of deposit. At the end of its first day of business, the partnership owns the following assets:

	Adjusted basis
Cash	$2,000
Corporate stock	15,000
Government securities	10,000
Certificate of deposit	3,000
Total	$30,000

The partnership agreement provides that the partners will share partnership taxable income and loss equally. The partnership agreement also provides that capital accounts will be determined and maintained for the partners in accordance with §1.704-1(b)(2)(iv), distributions in liquidation of the partnership (or any partner's interest) will be made in accordance with the partner's positive capital account balances (as set forth in §1.704-1(b)(2)(ii)-(*b*)(*2*)), and any partner with a deficit balance in the partner's capital account following the liquidation of the partner's interest must restore that deficit to the partnership (as set forth in §1.704-1(b)-(2)(ii)(*b*)(*3*)).

(ii) The indebtedness represented by the loan is a partnership liability. See paragraph (g) of this section. The partners will share that liability according to the economic risk of loss borne by each partner with respect to such liability. See paragraph (d)(3)-(i) of this section. The determination of the economic risk of loss that each partner bears with respect to the liability for the loan is, in turn, governed by the impact that a constructive liquidation of the partnership would have on the partners' obligations with respect to that liability. If a partnership is deemed to constructively liquidate, all partnership assets, including cash and other financial assets, are deemed to be worthless, and the partnership is treated as if it disposed of those assets in a fully taxable exchange for no consideration. On the deemed disposition of its cash, corporate stock, government securities, and certificate of deposit for no consideration at the end of its first day of business, the partnership would recognize a $30,000 taxable loss. This loss would be allocated equally between the partners.

	G	*H*
Capital account on formation	$5,000	$15,000
Less: loss	(15,000)	(15,000)
Capital accounts after constructive liquidation	($10,000)	$0

Consequently, if the partnership constructively liquidated at the end of its first day of business, G would be obligated to make a net contribution of $10,000 to the partnership to restore the deficit balance in G's capital account. See paragraph (d)(3)-(ii)(B)(*3*) of this section. Under paragraph (d)(3)-(ii)(B)(*1*) of this section, G's deficit restoration obligation would be treated as an obligation to make a net contribution of $10,000 to the partnership with respect to the partnership liability for the loan. Therefore, under paragraph (d)(3)(i) of this section, G bears the economic risk of loss for the full amount of the partnership liability for the loan. As a result, the liability is a recourse liability that is allocated entirely to G. See paragraph (d)(1) and (2) of this section.

Example (9). (i) I and J form a limited partnership. I, the general partner, contributes $10,000 to the partnership, and J, the limited partner, contributes $90,000 to the partnership. The partnership purchases depreciable personal property 1 for $110,000, paid by the delivery of $40,000 in cash and a recourse purchase money note in the principal amount of $70,000 ("note 1"). The partnership also purchases depreciable property 2 for $270,000, paid by the delivery of $60,000 in cash and a recourse purchase money note in the principal amount of $210,000 ("note 2"). J and the seller of property 2 enter into an indemnification agreement whereby J agrees to pay the seller the outstanding balance of note 2 if the partnership fails to make the payments required pursuant to that note. Under the indemnification agreement, if the partnership defaults, the seller may collect the balance due on note 2 directly from J without pursuing its legal remedies against the partnership. The seller may also attempt to collect the balance due on note 2 from the partnership before it proceeds against J under the indemnification agreement. The partnership agreement does not give J any right to seek repayment from the partnership or I for any amount that J pays to the seller pursuant to the indemnification agreement. Similarly, neither the partnership nor I are beneficiaries of the indemnification agreement. The partnership agreement provides that partnership taxable income and loss will be allocated 10 percent to I and 90 percent to J, except that all partnership taxable loss will be allocated to I after the partners' capital accounts are reduced to zero and partnership taxable income must first be allocated to eliminate any deficit balances in the partners' capital accounts. The partnership agreement also provides that capital accounts will be determined and maintained for the partners in accordance with §1.704-1(b)(2)(iv) and distributions in liquidation of the partnership (or any partner's interest) are to be made in accordance with the partner's positive capital account balances (as set forth in §1.704-1(b)(2)(ii)(*b*)(*2*)). The partners are not obligated to restore any deficit balances in their capital accounts following the liquidation of their interests in the partnership. The partnership has no income, gain, loss, deduction, or credit for the period prior to the acquisition of properties 1 and 2.

(ii) The partnership obligations represented by notes 1 and 2 constitute partnership liabilities ("liabilities 1 and 2," respectively). See paragraph (g) of this section. If the partnership constructively liquidated (within the meaning of paragraph (d)(3)(iii) of this section) immediately after incurring liabilities 1 and 2, the partnership would recognize a taxable loss of $380,000 from the disposition of properties 1 and 2 for no consideration. See paragraph (d)(3)(iii)(A)(*3*) of this section. Thus, for the hypothetical taxable year ending on the date of the constructive liquidation, the partnership would have a taxable loss of $380,000. This loss would be allocated between the partners as follows:

	I	*J*
Capital accounts on formation	$10,000	$90,000
Less: loss	(290,000)	(90,000)
Capital accounts after constructive liquidation	($280,000)	$0

After the constructive liquidation, I, as the sole general partner, would be obligated by operation of law to contribute $280,000 to the partnership to discharge the partnership's obligations under notes 1 and 2. J, on the other hand, would be obligated pursuant to the indemnification agreement to pay the outstanding balance of note 2 ($210,000) to the seller of property 2 because of the partnership's failure to make the payments due on that note. See paragraph (d)(3)(iii)(A)(*2*) of this section.

(iii) I's obligation to contribute $280,000 to the partnership constitutes an obligation to make a net contribution to the partnership. See paragraph (d)(3)(ii)(B)(*3*) of this section. Under paragraph (d)(3)(ii)(B)(*1*) of this section, the net contribution that I would be obligated to make to the partnership at the time of the constructive liquidation is allocated among the partnership liabilities to determine the net contribution that I would be obligated to make with respect to each liability. The amount of I's obligation to make a net contribution to the partnership that will be allocated to each partnership liability is determined by multiplying the amount of that obligation by the fraction obtained by dividing the outstanding partnership indebtedness with respect to that liability at the time of the constructive liquidation by the sum of the net contributions that all partners would be obligated to make to the partnership as a result of the liquidation. Under paragraph (d)(3)(ii)(B)(*4*) of this section, the outstanding partnership indebtedness with respect to liabilities 1 and 2 at the time of the constructive liquidation equals the outstanding balances of those liabilities—$70,000 and $210,000, respectively. The sum of the net contributions that the partners would be obligated to make to the partnership at the time of the constructive liquidation equals $280,000 because I is the only partner that would be obligated to make a net contribution to the partnership. Therefore, if the partnership constructively liquidated immediately after incurring liabilities 1 and 2, I would be obligated to make net contributions with respect to liabilities 1 and 2 of 70,000 ($280,000 multiplied by $70,000/$280,000) and $210,000 ($280,000 multiplied by $210,000/$280,000), respectively. In addition, assuming that J has no right under applicable state law to be reimbursed for any payment made pursuant to the indemnification agreement, J would be obligated to make a net payment of $210,000 to a creditor or other person with respect to liability 2. See paragraph (d)(3)(ii)(A) of this section.

(iv) Under paragraph (d)(3)(i)(A) of this section, the economic risk of loss borne by a partner with respect to any partnership liability generally equals the sum of (1) the net payment that such partner would be obligated to make to a creditor or other person and (2) the net contribution that such partner would be obligated to make to the partnership with respect to such liability if the partnership constructively liquidated. If the aggregate amount of the economic risk of loss that all partners would otherwise be determined to bear with respect to a partnership liability exceeds the amount of such liability, however, then the economic risk of loss borne by each partner with respect to such liability shall equal the amount determined by multiplying such liability by the fraction obtained by dividing the economic risk of loss that the partner would otherwise be considered to bear with respect to such liability by the sum of such amounts for all partners. See the next to the last sentence of paragraph (d)(3)(i) of this section. Under the general rule of paragraph (d)(3)(i)(A) of this section, I and J would each bear the economic risk of loss for the full amount of liability 2. I and J each bear the economic risk of loss for the full amount of liability 2 under the general rule because the arrangements between the partners fail to satisfactorily address the manner in which they will share the risk of loss attributable to that liability. In such a case, the facts must be closely scrutinized to determine whether the failure to resolve the manner in which the partners will share the risk of loss attributable to a partnership liability is part of a plan to circumvent or avoid the obligation of any partner to make a net payment to a creditor or other person or a net contribution to the partnership with respect to such liability. See paragraph (d)(3)(ii)(D)(*3*) of this section regarding the existence of a plan to circumvent or avoid an obligation. Assuming that there is not a plan to circumvent or avoid either partner's obligation with respect to liability 2, I and J each bear the economic risk of loss for $105,000 of liability 2 under the next to the last sentence of paragraph (d)(3)(i) of this section. Also, I bears the economic risk of loss for the full amount of liability 1 because I would be obligated to make a net contribution to the partnership of $70,000 with respect to liability 1 if the partnership constructively liquidated immediately after incurring that liability. Accordingly, liabilities 1 and 2 are recourse liabilities of the partnership, I and J share liability 2 equally, and I is allocated the entire amount of liability 1. See paragraph (d)(1) and (2) of this section.

Example (10). (i) K and L form a limited partnership. K, the general partner, and L, the limited partner, contribute $20,000 and $80,000, respectively, in cash to the partnership. The partnership purchases depreciable personal property for $250,000, using the $100,000 in cash contributed by the partners and a $150,000 recourse loan from a commercial bank. To provide additional security for the loan, the bank obtains an indemnification from L. Under the indemnification agreement, if the partnership defaults on the loan, L has agreed to pay the bank the portion, if any, of the outstanding balance of the loan that it is unable to recover from the partnership. L has no obligation, however, to make any payment pursuant to the indemnification agreement until the bank has exhausted its legal remedies against the partnership. The partnership agreement provides that capital accounts will be determined and maintained for the partners in accordance with §1.704-1(b)(2)(iv), distributions in liquidation of the partnership (or any partner's interest) are to be made in accordance with the partners' positive capital account balances (as set forth in §1.704-1(b)(2)(ii)(*b*)(*2*)), and K is obligated to restore to the partnership any deficit balance in K's capital account following the liquidation of K's interest (as set forth in §1.704-1(b)(2)(ii)(*b*)(*3*)). L has no obligation to contribute additional capital to the partnership. The partnership agreement also provides that partnership taxable income and loss will be allocated 20 percent to K and 80 percent to L, except that partnership taxable loss will be allocated solely to K after the partners' capital accounts are reduced to zero and partnership taxable income must be allocated first to eliminate any deficit balances in the partner's capital accounts.

(ii) The indebtedness represented by the loan obtained by the partnership to purchase the depreciable personal property is a partnership liability. See paragraph (g) of this section. If the partnership constructively liquidated (within the meaning of paragraph (d)(3)(iii) of this section), K, as the only partner that has any obligation to contribute additional capital to the partnership, would be obligated to make a contribution to the partnership of the funds needed to pay the outstanding balance of the loan, and K would not be entitled to seek reimbursement for this contribution from L (K is not a beneficiary of the indemnification agreement). Consequently, K would be obligated to make a net contribution of $150,000 with respect to the partnership liability for the loan if the partnership constructively liquidated. See paragraph (d)(3)(ii)(B) of this section. Therefore, under paragraph (c) of this section, K bears the economic risk of loss for the full amount of the partnership liability for the loan, and that liability is a recourse liability that is allocated entirely to K.

(iii) Under the indemnification agreement, L's obligation to make a payment to the bank arises only if the bank cannot recover its loan from the partnership. Consequently, if the partnership constructively liquidated, L would not be obligated to make a payment to the bank under the indemnification agreement unless K failed to discharge K's obligation to contribute additional capital to the partnership. Under paragraph (d)(3)(ii)(D)(*2*) of this section, however, the partners are generally treated as if they actually discharge their obligations to make contributions to the partnership or payments to a creditor or other person for purposes of applying paragraph (d)(3)(ii) of this section. Therefore, since K is assumed to satisfy K's obligation to contribute additional capital to the partnership, L is not considered to have an obligation to make a payment to the bank under the indemnification agreement.

Example (11). (i) The facts are the same as in example (10), except that K is a corporation that is a member of an affiliated group of corporations filing a consolidated return. K was formed by the parent of the consolidated group, P corporation, solely to acquire and hold its general partner interest. P corporation formed K to acquire an interest in the partnership both for investment purposes and for the tax losses it expected the partnership's property to generate. To limit its monetary exposure, however, P capitalized K only with the funds K needed to acquire its general partner interest.

(ii) These facts and circumstances, when considered together with L's indemnification agreement, indicate a plan to circumvent or avoid K's obligation to make a net contribution to the partnership. Therefore, under paragraph (d)(3)(ii)(D)(*3*) of this section, K's obligation to make a net contribution to the partnership is not recognized for purposes of applying the rules of paragraph (d)(3) this section, and the rules of this section must be applied as if that obligation did not exist. See paragraph (d)(3)(ii)(D)(*2*) of this section. Accordingly, if the partnership constructively liquidated (within the meaning of paragraph (d)(3)(iii) of this section), the bank would not be able to recover any part its loan from the partnership, and L would be obligated pursuant to the indemnification agreement to pay the bank the outstanding balance of the loan. Under paragraph (d)(3)(i) of this section, L bears the economic risk of loss for the full amount of the partnership liability for the loan. Therefore, the partnership liability for the loan is a recourse liability that is allocated entirely to L. See paragraph (d)(1) and (2) of this section.

Example (12). (i) M and N form a general partnership to purchase an office building, each contributing $15,000 to the partnership. The partnership purchases an office building for $100,000 with the cash contributed by the partners and a $70,000 recourse loan from a commercial bank. In connection with the purchase of the building, M contributes an additional $45,000 to the partnership. These funds are deposited in a special escrow account of the partnership that is to be used solely for purposes of making payments on the loan. The partnership pledges the escrow account to the bank as security for the loan. The partnership agreement provides that the partners will share partnership taxable income and loss equally, except that interest income from the escrow account is to be allocated 95 percent to M and 5 percent to N. The partnership agreement also provides that capital accounts will be determined and maintained for the partners in accordance with §1.704-1(b)(2)(iv), distributions in liquidation of the partnership (or any partner's interest) are to be made in accordance with the partners' positive capital account balances (as set forth in §1.704-1(b)(2)(ii)(*b*)(*2*)), and any partner with a deficit balance in the partner's capital account following the liquidation of the partner's interest must restore that deficit to the partnership (as set forth in §1.704-1(b)(2)(ii)(*b*)-(*3*)). The partnership has no income, gain, loss, deduction, or credit for the period prior to the acquisition of the building.

(ii) The indebtedness represented by the loan obtained by the partnership to purchase the office building is a partnership liability. See paragraph (g) of this section. If the partnership is deemed to constructively liquidate (within the meaning of paragraph (d)(3)(iii) of this section) immediately after purchasing the building, the partnership is treated as if the building became worthless, the loan became due and payable in full, and the partnership disposed of the building in a fully taxable exchange for no consideration. In addition, the partnership is deemed to transfer the funds held in escrow to the bank in partial satisfaction of the loan. The escrowed funds are not deemed to be worthless because those funds, which were contributed to the partnership by M, are used in the partnership's activities solely to secure the payment of the loan from the bank. See paragraph (d)(3)(iii)(A)(*1*) and (d)(3)(ii)(A)(*2*)(*ii*) of this section. Under paragraph (d)(3)(ii)(A)(*2*)(*ii*) of this section, the partnership's obligation to use the escrowed funds that M contributed to the partnership to discharge the loan is treated as an obligation of M to make a payment to a creditor or other person with respect to the partnership liability for the loan.

(iii) On the disposition of its office building for no consideration, the partnership would incur a taxable loss of $100,000, which would be allocated equally between the partners. Thus, if the partnership constructively liquidated immediately after purchasing the building, the partners' capital accounts would appear as follows:

	M	*N*
Capital accounts on formation	$60,000	$15,000
Less: loss	(50,000)	(50,000)
Capital accounts after constructive liquidation	$10,000	($35,000)

M's positive capital account balance would entitle M to a $10,000 distribution from the partnership. Because M would not have been entitled to any distribution from the partnership if M had not provided the escrowed funds to the partnership, M's right to this distribution constitutes a right to be reimbursed by the partnership for the escrowed funds that M is considered obligated to pay to the bank under paragraph (d)(3)(ii)(A)(*2*)(*ii*) of this section. Thus, under paragraph (d)(3)(ii)(A) of this section, M would be obligated to make a net payment of $35,000 ($45,000 less $10,000) to a creditor or other person with respect to the partnership liability for the loan if the partnership constructively liquidated.

(iv) N's $35,000 deficit capital account balance constitutes an obligation to make a net contribution to the partnership. Under paragraph (d)(3)(ii)(B)(*1*) of this section, this obligation will be allocated to the partnership liability for the loan only to the extent that it does not exceed the outstanding partnership indebtedness with respect to that liability. Under paragraph (d)(3)(ii)(B)(*4*) of this section, the outstanding partnership indebtedness with respect to that liability equals $35,000 (the amount of such liability ($70,000), reduced by the excess of (1) the amount M's obligation to make a payment to a creditor or other person with respect to such liability ($45,000) over (2) the reimbursement that M is entitled to receive from the partnership with respect to that liability ($10,000)). Therefore, if the partnership constructively liquidated, N would be obligated to make a net contribution of $35,000 to the partnership with respect to the partnership liability for the loan.

(v) Under paragraph (d)(3)(i) of this section, M and N each bear the economic risk of loss for $35,000 of the partnership liability for the loan. Accordingly, the liability is a recourse liability that M and N share equally.

Example (13). (i) O and P contribute $125,000 and $25,000 in cash, respectively, to form a calendar year general partnership on December 31, 1988. P also contributes a promissory note for $100,000 to the partnership. The promissory note is payable on the fifth anniversary of the partnership's formation and bears interest at a rate of 12 percent, compounded annually. On the date of its formation, the partnership purchases improved real property for its $150,000 of capital and a $850,000 nonrecourse loan from a commercial bank. The nonrecourse loan is secured by a mortgage on the real property and a pledge of P's promissory note. The partnership agreement provides that the partners will share partnership taxable income and loss equally. The partnership agreement also provides that capital accounts will be determined and maintained for the partners in accordance with §1.704-1(b)(2)(iv), distributions in liquidation of the partnership (or any partner's interest) are to be made in accordance with the partners' positive capital account balances (as set forth in §1.704-1(b)(2)(ii)(*b*)(*2*)), and any partner with a deficit balance in the partner's capital account following the liquidation of the partner's interest must restore that deficit to the partnership (as set forth in §1.704-1(b)(2)(ii)(*b*)(*3*)), except that P is not obligated to restore the first $100,000 of any deficit balance in P's capital account prior to the maturity of P's promissory note. For 1988, the partnership has no income, gain, loss, deduction, or credit. Assume that the Federal mid-term rate for December 1988 is 10 percent, compounded semi-annually.

(ii) The indebtedness represented by the nonrecourse loan obtained by the partnership to purchase the improved real property is a partnership liability. See paragraph (g) of this section. To determine whether any partner bears the economic risk of loss for that liability at the end of 1988, the partnership must be treated as if it constructively liquidated (within the meaning of paragraph (d)(3)(iii) of this section) at that time. If the partnership is deemed to constructively liquidate at the end of 1988, the following events are deemed to occur: (1) the partnership's improved real property becomes worthless, (2) the nonrecourse loan becomes due and payable, (3) the partnership disposes of its improved real property in a fully taxable exchange (involving the transfer of that property to the bank), and (4) the partnership allocates its taxable income or loss to the partners for the partnership taxable year ending on the date of the constructive liquidation and liquidates the partners' interests. In the constructive liquidation, the partnership is treated as if it received consideration in the form of relief from liability upon the hypothetical disposition of its improved real property to the extent that the nonrecourse loan is a liability for which the creditor's right to repayment is limited to one or more assets of the partnership. See paragraph (d)(3)(iii)(A)(*3*) of this section. Under paragraph (d)(3)(ii)(B)(*4*)(*ii*) of this section, the nonrecourse loan constitutes a liability for which the creditor's right to repayment is limited to one or more assets of the partnership to the extent, but only to the extent, that the outstanding balance of the loan exceeds the aggregate amount of the contributions that the partners would be obligated to make to the partnership to discharge that loan if the partnership constructively liquidated. P's promissory note (as a result of the pledge of that note to the bank to secure the nonrecourse loan) constitutes the only obligation that the partners have to make a contribution to the partnership in order to discharge the nonrecourse loan. Under paragraph (d)(3)(ii)(E) of this section, P's obligation to make a contribution to the partnership pursuant to the promissory note is recognized only to the extent of the value of that note because the note is not required to be paid by the later of (1) the end of the partnership taxable year in which N's interest is liquidated or (2) within 90 days after the date of such liquidation. At the time of the constructive liquidation (*i.e.*, at end of 1988), however, P's promissory note is deemed to have a value equal to the outstanding balance of the note at that time ($100,000) because the promissory note bears interest at a rate that equals or exceeds the applicable Federal rate at that time (i.e., the Federal mid-term rate for December 1988). See paragraph (d)(3)(ii)(E)(*2*) of this section. Accordingly, $750,000 of the nonrecourse loan ($850,000 less $100,000) constitutes a liability for which the creditor's right to repayment is limited to one or more assets of the partnership, and the partnership is deemed to receive consideration of $750,000 in relief from such liability upon the hypothetical disposition of its improved real property. Because the adjusted basis of the partnership's real property equals $1,000,000 at the end of 1988, the partnership would recognize a taxable loss of $250,000 on this disposition ($1,000,000 less $750,000 of consideration). This loss would be allocated equally between the partners for the partnership taxable year ending on the date of the constructive liquidation.

	O	*P*
Capital accounts on formation	$125,000	$25,000
Less: loss	(125,000)	(125,000)
Capital accounts after constructive liquidation . . .	$0	($100,000)

(iii) P's obligation to restore the $100,000 deficit balance in P's capital account is governed by the terms of P's promissory note. As stated above, P's obligation to make a contribution to the partnership pursuant to the promissory note is recognized to the extent of the outstanding balance of that note at the time of the constructive liquidation because the note bears interest at a rate that equals or exceeds the applicable Federal rate at that time. Thus, P would be obligated to make a net contribution to the partnership of $100,000 as a result of the constructive liquidation. Under paragraph (d)(3)(ii)(B)-(*1*) of this section, the net contributions that the partners would be obligated to make to the partnership if the partnership constructively liquidated can be allocated to a partnership liability only to the extent of the outstanding partnership indebtedness with respect to that liability. The outstanding partnership indebtedness with respect to the liability for the nonrecourse loan equals $100,000 (the amount of such liability ($850,000) reduced by the portion of such liability for which the creditor's right to repayment from the partnership is limited to one or more assets of the partnership ($750,000)). See paragraph (d)(3)(ii)(B)(*4*) of this section. Thus, under paragraph (d)(3)(ii)(B)(*1*) of this section, the full amount of the $100,000 net contribution that P would be obligated to make to the partnership if it constructively liquidated at the end of 1988 will be allocated to the partnership liability for the nonrecourse loan.

(iv) At the end of 1988, P bears the economic risk of loss for $100,000 of the partnership liability for the nonrecourse loan, and no partner bears the economic risk of loss for the other $750,000 of that liability. See paragraph (d)(3)(i) of this section. Accordingly, the liability is treated as a recourse liability to the extent that P bears the economic risk of loss for such liability and as a nonrecourse liability to the extent of the excess. See paragraph (j)-(2) of this section. Under paragraph (d)(1) of this section, all $100,000 of the recourse liability is allocated to P. Under paragraph (e)(1)(iii) of this section, the nonrecourse liability is allocated between the partners in proportion to their equal interests in partnership profits. At the end of 1988, O and P are thus each allocated $375,000 of the nonrecourse liability of the partnership.

Example (14). (i) Q, the general partner, and R, the limited partner, form a limited partnership with cash contributions of $10,000 each. Q and R share partnership profits and losses equally. The partnership purchases residential rental property for its $20,000 of capital and an $80,000 nonrecourse loan from a commercial bank. The nonrecourse loan is secured by a mortgage on the rental property. Q also provides the bank with a guarantee that the loan will be repaid. If the partnership defaults on the loan, Q is liable to the bank for the difference between the value of the property and the outstanding balance of the loan. In connection with Q's guarantee, Q and R enter into an indemnification agreement whereby R agrees to reimburse Q for 50 percent of any payment that Q is required to make pursuant to the guarantee.

(ii) The indebtedness represented by nonrecourse loan obtained by the partnership to purchase the residential rental property is a partnership liability. See paragraph (g) of this section. Upon a constructive liquidation (within the meaning of paragraph (d)(3)(iii) of this section), the partnership is treated as if its residential rental property becomes worthless and the nonrecourse loan becomes due and payable because of the partnership's failure to make the required payments on the loan. If these events occurred, Q would be obligated to pay the outstanding balance of the nonrecourse loan to the bank under the guarantee. Under the indemnification agreement, however, Q would be entitled to be reimbursed by R for 50 percent of any payment made to the bank pursuant to the guarantee. Thus, Q and R would each be obligated to make a net payment to a creditor or other person of 50 percent of the liability for the nonrecourse loan if the partnership constructively liquidated. See paragraph (d)(3)(ii)(A) of this section. Under paragraph (d)-(3)(i) of this section, Q and R each bear the economic risk of loss for 50 percent of the partnership liability for the nonrecourse loan. Accordingly, the liability is a recourse liability that the partners share equally. See paragraph (d)(1) and (2) of this section.

Example (15). (i) S and T form a limited partnership at the beginning of 1989 solely to acquire and lease depreciable personal property. S, the general partner, and T, the limited partner, each contribute $10,000 in cash to the partnership. In 1989, the partnership purchases depreciable personal property for $20,000 in cash and a recourse purchase money note for $80,000. For 1989, the partnership has a taxable loss of $10,000, consisting of $17,000 gross rental income, $7,000 of interest expense, and a depreciation deduction of $20,000. The partnership agreement provides that the partners will share the taxable income and loss of the partnership equally. In addition, the partnership agreement provides that capital accounts will be determined and maintained for the partners in accordance with §1.7041(b)(2)(iv) and distributions in liquidation of the partnership (or any partner's interest) will be made in accordance with the partners' positive capital account balances (as set forth in §1.704-1(b)(2)(ii)(*b*)(*2*)). The partnership agreement also provides that any partner with a deficit balance in the partner's capital account following the liquidation of the partner's interest must restore that deficit to the partnership. While S is required to restore any deficit balance in S's capital account following the liquidation of S's interest within 90 days of such liquidation, T is not required to restore any deficit balance in T's capital account following the liquidation of T's interest for 2 years following the date of such liquidation (and any deficit balance in T's capital account at the time of any such liquidation will not bear interest during that two-year period). The partnership makes $10,000 of principal payments on the promissory note during 1989, and the outstanding balance of the promissory note at the end of 1989 is $70,000. Assume that the Federal short-term rate for December 1989 is 10 percent, compounded semiannually.

(ii) The indebtedness represented by the purchase money note is a partnership liability. See paragraph (g) of this section. Under paragraph (d)(3)(i) of this section, the partners bear the economic risk of loss for that liability at the end of 1989 to the extent that they would be obligated to make a net payment to a creditor or other person or a net contribution to the partnership with respect to such liability if the partnership constructively liquidated (within the meaning of paragraph (d)(3)(iii) of this section) at that time. If the partnership constructively liquidated at the end of 1989, the partnership would recognize a taxable loss of $80,000 on the disposition of its depreciable property for no consideration. This would result in a partnership net taxable loss of $90,000 for the partnership taxable year ending on the date of the constructive liquidation ($80,000 loss on the deemed disposition plus a $10,000 operating loss). This loss would be allocated to the partners as follows:

	S	*T*
Capital accounts on formation	$10,000	$10,000
Less: loss	(45,000)	(45,000)
Capital accounts after constructive liquidation . .	($35,000)	($35,000)

Accordingly, if the partnership constructively liquidated at the end of 1989, S and T would each be obligated to make a net contribution of $35,000 to the partnership to restore the deficit balances in their capital accounts following the liquidation of their partnership interests. Under paragraph (d)(3)-(ii)(E) of this section, however, T's obligation to make a contribution to the partnership pursuant to T's deficit restoration obligation is recognized only to the extent of the fair market value of that obligation at the time of the constructive liquidation because T is not required to satisfy that obligation by the later of (1) the end of the partnership taxable year in which T's interest is liquidated or (2) within 90 days after the date of such liquidation.

(iii) Because T's obligation to restore the deficit balance in T's capital account does not bear interest, the fair market value of the deficit restoration obligation that T would have if the partnership constructively liquidated is deemed to equal the imputed principal amount of that obligation under section 1274(b). See paragraph (d)(3)(ii)(E)(*2*)(*ii*)-(*B*) of this section. The imputed principal amount of T's deficit restoration obligation is computed by treating that obligation as a debt instrument to which section 1274 applies and by assuming that the sale or exchange in which such debt instrument was given as consideration occurred at the time of the constructive liquidation. Under section 1274(b), the imputed principal amount of a debt instrument equals the present values of all payments due under the debt instrument. The present value of a payment is determined as of the date of the sale or exchange by using a discount rate equal to the applicable Federal rate (within the meaning of section 1274(d)), compounded semiannually. The applicable Federal rate with respect to T's deficit restoration obligation is 10 percent, compounded semiannually (*i.e.*, the Federal short-term rate for December 1989). Using this discount rate, the present value of the $35,000 payment that T would be required to make two years after the constructive liquidation to restore the deficit balance in T's capital account equals $28,795. Thus, under paragraph (d)(3)(ii)(B)(*1*) of this section, T would be obligated to make a net contribution of $28,795 to the partnership with respect to the partnership liability for the purchase money note if the partnership constructively liquidated at the end of 1989. Under paragraph (d)(3)(ii)(D)(*2*) of this section, T is treated as if T actually discharges that obligation at the time of the constructive liquidation.

(iv) To the extent that T's deficit restoration obligation is not recognized, paragraph (d)(3)(ii) of this section is applied by assuming that T's obligation to make a contribution to the partnership did not exist. See paragraph (d)(3)(ii)(D)(*2*) of this section. In that case, S, as the sole general partner, would be obligated by operation of law to contribute an additional $6,205 of capital to the partnership to make up the shortfall. Accordingly, if the partnership constructively liquidated at the end of 1989, S would be obligated to make a net contribution of $41,205 ($35,000 plus $6,205) to the partnership with respect to the partnership liability for the purchase money note. See paragraph (d)(3)(ii)-(B) of this section.

(v) At the end of 1989, S and T bear the economic risk of loss for $41,205 and $28,795, respectively, of the partnership liability for the purchase money note. See paragraph (d)(3)(i) of this section. Therefore, that liability is a recourse liability that the partners share according to the economic risk of loss borne by each of them. See paragraph (d)(1) and (2) of this section.

Example (16). (i) U and V form a general partnership with cash contributions of $25,000 each. U and V share partnership profits and losses equally. The partnership purchases an apartment building for its $50,000 of capital and a $200,000 nonrecourse loan from a commercial bank. The nonrecourse loan is secured by a mortgage on the building. The loan documents provide that the partnership will be liable for the outstanding balance of the loan on a recourse basis to the extent of any decrease in the value of the apartment building resulting from the partnership's failure to properly maintain the property.

(ii) The indebtedness represented by the nonrecourse loan obtained by the partnership to purchase the apartment building is a partnership liability. See paragraph (g) of this section. If the partnership constructively liquidated (within the meaning of paragraph (d)(3)(iii) of this section), the apartment building would become worthless, the nonrecourse loan would become due and payable because of the partnership's failure to make the required payments on the loan, and the partnership would dispose of the apartment building in a fully taxable exchange involving the transfer of the building to the bank. Since under this example there are no facts that establish with reasonable certainty the existence of any liability on the part of the partnership (and its partners) for damages resulting from the partnership's failure to properly maintain the building, the obligations of the partnership with respect to the nonrecourse loan would be extinguished on the transfer of the apartment building to the bank, and the partners would not have any obligation to contribute additional funds to the partnership to discharge the liability for the nonrecourse loan. See paragraph (d)(3)(ii)(D)(*1*) of this section. In addition, neither U nor V would be obligated to make a payment to a creditor or other person with respect to that liability if the partnership constructively liquidated. Therefore, under paragraph (d)(3)(i) of this section, no partner bears the economic risk of loss for the partnership liability for the nonrecourse loan, and the liability constitutes a nonrecourse liability within the meaning of paragraph (e)(2) of this section. Under paragraph (e)(1) of this section, the partners share this nonrecourse liability equally because they share all partnership profits and losses equally.

Example (17). (i) W and X form a general partnership with cash contributions of $50,000 each. The partners share all partnership profits and losses equally. On January 1, 1990, the partnership purchases raw land for $100,000 on which it plans to construct an office building. The partnership obtains a nonrecourse construction loan commitment of $900,000 from a commercial bank to finance the construction of the office building. The construction loan is secured by a mortgage on the property and a completion guarantee from W. Under the completion guarantee, W agrees to provide the funds necessary to complete the construction of building to the extent construction costs exceed $900,000. At the end of 1990, the partnership has borrowed $500,000 under the construction loan commitment.

(ii) The indebtedness represented by the outstanding balance of the construction loan is a partnership liability. See paragraph (g) of this section. Under paragraph (d)(3)(i) of this section, no partner bears the economic risk of loss for that liability because no partner would be obligated to make a contribution to the partnership or a payment to a creditor or other person with respect to the partnership liability for the construction loan if the partnership constructively liquidated (within the meaning of paragraph (d)(3)(iii) of this section). See paragraph (d)(3)(ii)(A) and (B) of this section. Upon a constructive liquidation of the partnership, the construction loan is deemed to be due and payable in full because of the partnership's failure to make the required payments on the loan. See paragraph (d)(3)(iii)(A)(*2*) of this section. Under the completion guarantee, W would not be obligated to make any payments in satisfaction of the construction loan as a result of the partnership's default because W's liability under the completion guarantee is limited to bearing cost overruns.

(iii) Under paragraph (e)(2) of this section, the construction loan is a nonrecourse liability of the partnership because no partner bears the economic risk of loss for that loan. Under paragraph (e)(1) of this section, the partners share this nonrecourse liability equally because they share all partnership profits and losses equally.

Example (18). (i) Y and Z, a corporation, each contribute $100,000 to form a general partnership to acquire a hotel. The partners agree to share partnership profits and losses equally. The partnership purchases a hotel for its $200,000 of capital and a nonrecourse loan of $1,800,000 from VW, a commercial bank that is a wholly-owned subsidiary of Z. To secure its loan, VW takes a mortgage on the hotel and obtains a guarantee from Y. Under the guarantee, Y agrees to pay VW an amount equal to 50 percent of any loss that VW incurs on the loan. Y has no right to seek reimbursement from the partnership or Z for any amount that it pays to VW under the guarantee.

(ii) The indebtedness represented by the loan obtained by the partnership to purchase the hotel is a partnership liability. See paragraph (g) of this section. If the partnership constructively liquidated (within the meaning of paragraph (d)(3)(iii) of this section), VW would incur a loss equal to the outstanding balance of its loan to the partnership, and Y would be liable for 50 percent of that loss pursuant to the guarantee. Thus, Y bears the economic risk of loss for 50 percent of the partnership liability for the loan from VW. See paragraph (d)(3)-(i) of this section.

(iii) Z and VW are related persons (within the meaning of paragraph (h) of this section). Under paragraph (d)(3)(i)(B) of this section, a partner bears the economic risk of loss with respect to a partnership liability to the extent that the partner (or a person related to such partner) is the owner of the liability, and but for that paragraph, the liability would be treated as a nonrecourse liability under paragraph (e)(2) of this section. If this section were applied without regard to paragraph (d)(3)(i)(B) of this section, 50 percent of the partnership liability for the loan from VW would be a nonrecourse liability because no partner would bear the economic risk of loss for that portion of the liability. Accordingly, since Z and VW are related persons, Z bears the economic risk of loss for 50 percent of the liability for the loan from VW under paragraph (d)(3)-(i)(B) of this section. Because Z owns a one-half interest in the partnership, the de minimis rule set forth in paragraph (d)(3)(vii) of this section is inapplicable.

(iv) Under paragraph (d) of this section, the partnership liability for the loan from VW is a recourse liability, and the partners share that liability equally.

Example (19). (i) AB and CD form a general partnership with cash contributions of $30,000 each. AB and CD share all partnership profits and losses equally. The partnership purchases an apartment building from AB for its $60,000 in cash and a nonrecourse purchase money note for $240,000 that is secured by the building. The purchase money note given to AB by the partnership "wraps around" a $200,000 underlying nonrecourse note issued by AB to an unrelated person in connection with AB's acquisition of the building. The underlying nonrecourse note is also secured by the building.

(ii) The indebtedness represented by the purchase money note is a partnership liability. See paragraph (g) of this section. Under paragraph (d)(3)(i)(B) of this section, AB bears the economic risk of loss for only $40,000 of the liability for the purchase money note because AB is not considered to be the creditor with respect to that liability to the extent it reflects the debt on the underlying nonrecourse note. See the fourth sentence of paragraph (d)(3)(i) of this section. Therefore, under paragraph (d) of this section, $40,000 of the partnership liability for the purchase money note is a recourse liability that is allocated to AB. The remaining portion of the partnership liability is a nonrecourse liability because no partner bears the economic risk of loss for that liability. See paragraphs (e)(2) and (j)(2) of this section. Under, paragraph (e)(1) of this section, AB's and CD's shares of the nonrecourse liability are $100,000 each because they share all partnership profits and losses equally.

Example (20). (i) EF and GH, a widely held corporation, form a limited partnership to purchase and lease computer equipment. EF, the general partner, contributes $200,000 to the partnership, and GH, the limited partner, contributes $800,000 to the partnership. The partnership agreement provides that partnership profits and losses will be allocated 20 percent to EF and 80 percent to GH. GH invests in the partnership, in part, to obtain significant tax losses that EF has indicated would be available from an investment in the partnership. The partnership purchases computer equipment subject to a two-year lease for $10,000,000. To purchase the equipment, the partnership obtained a $9,000,000 nonrecourse loan, with a five-year term, from a commercial bank. Upon making the loan, the bank acquired a security interest in the computer equipment. Furthermore, in order to induce the bank to make a nonrecourse loan to the partnership, EF agreed to lease the computer equipment from the partnership under a master lease. The master lease is pledged to the bank as additional security. The rental payments due under the master lease will provide the partnership with sufficient cash flow to make the principal and interest payments due on the loan. EF's obligation to make the rental payments required under master lease is unconditional. EF must make those payments even if it is unable to sublease the equipment (after the existing two-year lease expires) or the equipment is damaged or destroyed. EF is also responsible for all costs associated with maintaining the equipment. Unless the loan that the partnership used to purchase the computer equipment is treated as a nonrecourse liability for purposes of section 752 and the regulations thereunder, GH will not be able to claim the tax losses that EF indicated would be available from an investment in the partnership.

(ii) The indebtedness represented by the nonrecourse loan the partnership obtained to purchase the computer equipment is a partnership liability. See paragraph (g) of this section. Under the general rule of paragraph (d)(3)(i) of this section, no partner bears the economic risk of loss for that liability. If no partner bears the economic risk of loss for the partnership liability, the liability will be treated as nonrecourse liability that EF and GH will share in accordance with their general profit sharing ratios. See paragraph (e) of this section. Paragraph (d)(3)(iv) of this section, however, provides that if one or more partners (or persons related to such partners) (1) undertake contractual obligations in order to acquire a loan, (2) those obligations eliminate substantially all the risk that the partnership will not satisfy its obligations under the loan (assuming that such partners (or related persons) satisfy their obligations), and (3) one of the principal purposes of the arrangement is to permit other partners to include a portion of such liability in the basis of their partnership interests, the partners that undertake such contractual obligations are considered to bear the economic risk of loss for that liability. Under the facts of this example, it must be concluded that one of the principal purposes for the master lease was to permit GH to include a portion of the nonrecourse loan in the basis of GH's partnership interest. Therefore, under paragraph (d)(3)(iv) of this section, EF bears the economic risk of loss for the partnership liability for the nonrecourse loan. Accordingly, for purposes of this section, the liability is a recourse liability that is allocated entirely to EF. See paragraph (d)(1) and (2) of this section.

Example (21). (i) KL and MN form a general partnership to purchase a shopping center. The partners each contribute $500,000 to the partnership and agree to share partnership profits and losses equally. On January 1, 1991, the partnership obtains a $4,000,000 nonrecourse loan, and purchases the shopping center for $5,000,000. The nonrecourse loan is secured by a mortgage on the shopping center. The interest on the nonrecourse loan accrues at a 15 percent annual rate and is payable on December 31 of each year. The principal amount of the nonrecourse loan is payable in a lump sum on December 31, 2005. MN guarantees the payment of all interest due on the nonrecourse loan. Under the guarantee, MN is unconditionally obligated to pay the nonrecourse lender any interest payment that the partnership fails to make in a timely manner. MN is not entitled to be reimbursed for any payments made to the lender pursuant to the guarantee.

(ii) The indebtedness represented by the nonrecourse loan obtained by the partnership to acquire the shopping center is a partnership liability. See paragraph (g) of this section. Under paragraph (d)(3)(i) of this section, no partner bears the economic risk of loss for that liability because the constructive liquidation of the partnership would not obligate any partner to make a payment to a creditor or other person or a net contribution to the partnership with respect to the liability for the nonrecourse loan. Under paragraph (d)(3)(v) of this section, however, MN's economic risk of loss for that liability must be increased by an amount equal to the sum of the present values of the remaining interest payments on the nonrecourse loan that MN would be obligated to make pursuant to the guarantee if the partnership does not make those payments. The present value of each interest payment due on the nonrecourse loan is computed by using a discount rate equal to the rate at which interest accrues on the loan (15 percent, compounded annually). At the time the partnership obtains the nonrecourse loan, the sum of the present values of all interest payments due on the loan equals $3,508,422, and MN therefore bears the economic risk of loss for $3,508,422 of the partnership liability for the $4,000,000 loan. Accordingly, at the time the partnership obtains the nonrecourse loan, $3,508,422 of the partnership liability for that loan constitutes a recourse liability that must be allocated entirely to MN. See paragraph (d)(1) and (2) of this section. Only $491,578 of the $4,000,000 loan constitutes a nonrecourse liability that will be allocated equally between the partners under paragraph (e) of this section.

Example (22). (i) OP and QR form a limited partnership to acquire and operate a commercial office building. OP, the general partner, contributes $20,000, and QR, the limited partner, contributes $180,000 to the partnership. The partnership obtains an $800,000 nonrecourse loan and purchases the building on leased land for $1,000,000. The nonrecourse loan is secured only by the building, and no principal payments are due for five years. The partnership agreement provides that the partners' capital accounts will be determined and maintained in accordance with §1.704-1(b)(2)(iv), distributions in liquidation of the partnership (or any partner's interest) will be made in accordance with partners' positive capital account balances (as set forth in §1.704-1(b)(2)(ii)(*b*)(*2*)), and any partner with a deficit balance in the partner's capital account following the liquidation of the partner's interest must restore that deficit to the partnership (as set forth in §1.704-1(b)(2)(*ii*)(*b*)(*3*)). The partnership agreement also contains a minimum gain chargeback (in accordance with §1.704-1T(b)(4)(iv)(*e*)). The partnership agreement provides that, except as otherwise required by its minimum gain chargeback provision, (1) all partnership items will be allocated 10 percent to OP and 90 percent to QR until the partnership has recognized items of income and gain that exceed the items of loss and deduction it has recognized over its life, and (2) all further partnership items will be allocated equally between OP and QR. Finally, the partnership agreement specifies that OP and QR have equal interests in partnership profits for purposes of determining the partners' shares of the nonrecourse liabilities of the partnership (which is consistent with the equal division of all partnership income and gain that is required after the partnership has recognized items of income and gain that exceed the items of loss and deduction that it has recognized over its life). At the time the partnership agreement is entered into, there is a reasonable likelihood that over the partnership's life it will recognize amounts of income and gain (the allocation of which will have substantial economic effect) significantly in excess of the amounts of loss and deduction allowed to the partnership.

(ii) In each of the partnership's first 2 taxable years, it generates rental income of $95,000, operating expenses (including land lease payments) of $10,000, interest expense of $80,000, and a depreciation deduction of $90,000, resulting in a taxable loss of $85,000 in each of those years. The partnership agreement allocates 10 percent of these losses to OP and 90 percent to QR, and this allocation has substantial economic effect. If the partnership were to dispose of the building in full satisfaction of the nonrecourse loan at the end of year 1 or 2, the partnership would not realize any gain because the adjusted basis of the building exceeds the outstanding balance of the nonrecourse loan at the end of each of those years. Thus, at the end of years 1 and 2, there is no partnership minimum gain. See §1.704-1T(b)(4)(iv)(*c*). In its third taxable year, the partnership again generates rental income of $95,000, operating expenses of $10,000, interest expense of $80,000, and a depreciation deduction of $90,000, resulting in a taxable loss of $85,000. If the partnership were to dispose of the building in full satisfaction of the nonrecourse loan at the end of that year, it would realize $70,000 of gain ($800,000 amount realized less $730,000 adjusted tax basis). Because the amount of partnership minimum gain at the end of that year (and the net increase in partnership minimum gain during the year) is $70,000, the amount of partnership nonrecourse deductions for the year is $70,000, consisting of depreciation deductions allowable with respect to the building of $70,000. See §1.704-1T(b)(4)(iv)(*b*) and (*c*). Pursuant to the partnership agreement, all partnership items comprising the taxable loss of $85,000, including the $70,000 of nonrecourse deductions, are allocated 10 percent to OP and 90 percent to QR. The allocation of these items, other than the nonrecourse deductions, has substantial economic effect.

	OP	*QR*
Capital account on formation	$20,000	$180,000
Less: loss in years 1 and 2	(17,000)	(153,000)
Less: loss in year 3 (without non-recourse deductions)	(1,500)	(13,500)
Less: nonrecourse deductions in year 3	(7,000)	(63,000)
Capital account at end of year 3	($5,500)	($49,500)

This allocation of the $70,000 of nonrecourse deductions 10 percent to OP and 90 percent to QR is deemed to be made in accordance with the partners' interest in the partnership under §1.704-1T(b)(4)(iv)(d). See §1.704-1T(b)(5) (example 20 (i)). At the end of the partnership's third taxable year, OP's and QR's shares of partnership minimum gain are $7,000 and $63,000, respectively. See §1.704-1T(b)(4)(iv)(*f*)

(iii) The indebtedness represented by the nonrecourse loan obtained by the partnership to purchase the office building is a partnership liability. See paragraph (g) of this section. Under paragraph (d)(3)(i) of this section, no partner bears the economic risk of loss for that liability. Therefore, under paragraph (e)(2) of this section, the liability is a nonrecourse liability that the partners will share in the manner prescribed under paragraph (e)(1) of this section. At the end of years 1 and 2, the nonrecourse liability is allocated equally between the partners under paragraph (e)(1)(iii) of this section. The partners share the nonrecourse liability equally because the partnership agreement specifies that, for purposes of determining the partners' shares of the nonrecourse liabilities of the partnership, each partner has a 50 percent interest in partnership profits, which is consistent with allocations (which have substantial economic effect) of some significant item of partnership income or gain. See paragraph (e)(3)(ii)(C) of this section. Thus, at the end of years 1 and 2, each partner's share of the nonrecourse liability is $400,000.

(iv) At the end of year 3, there is partnership minimum gain, and OP's and QR's shares of partnership minimum gain are $7,000 and $63,000, respectively. Under paragraph (e)(1)(i) of this section, the nonrecourse liability is allocated to the partners first according to their shares of partnership minimum gain, and any excess is allocated equally between the partners under paragraph (e)(1)(iii) of this section. See paragraph (e)(3)(ii) (A) and (B) of this section. Therefore, at the end of year 3, OP's and QR's shares of the nonrecourse liability are $372,000 ($7,000 share of partnership minimum gain plus $365,000 share of the excess) and $428,000 ($63,000 share of partnership minimum gain plus $365,000 share of the excess), respectively.

Example (23). (i) ST and UV form a general partnership to own and operate residential rental property. UV contributes $500,000 to the partnership that it uses to purchase residential rental property. ST contributes an apartment building with a $1,200,000 fair market value and $520,000 adjusted tax basis. The apartment building contributed by ST is subject to a $700,000 nonrecourse loan. ST and UV share all partnership profits and losses equally.

(ii) The indebtedness represented by the nonrecourse loan is a partnership liability. See §1.752-2T regarding the treatment of liabilities to which contributed or distributed property is subject. Under paragraph (e)(2) of this section, this liability is a nonrecourse liability because no partner bears the economic risk of loss for such liability. See paragraph (d)(3)(i) of this section. Under paragraph (e)(1)(ii) of this section, ST is allocated $180,000 of the partnership liability for the nonrecourse loan because ST would be allocated taxable gain of $180,000 under section 704(c) if the partnership disposed of (in a taxable transaction) the apartment building in full satisfaction of the nonrecourse liability. The remainder of the nonrecourse liability is allocated between the partners in proportion to their equal interests in partnership profits. See paragraph (e)(1)(iii) of this section. Accordingly, ST's and UV's shares of the nonrecourse liability are $440,000 ($180,000 share of section 704(c) minimum gain and $260,000 share of the excess of the nonrecourse liability over the section 704(c) minimum gain) and $260,000 (which equals UV's $260,000 share of the excess of the nonrecourse liability over the section 704 (c) minimum gain), respectively.

§1.752-2T Liabilities to which contributed or distributed property is subject (temporary).

(a) *In general.* For purposes of section 752 and the regulations thereunder, if property is contributed by a partner to the partnership or distributed by the partnership to a partner and such property is subject to a liability of the transferor (within the meaning of §1.752-1T(f)(2), (g), and (j)(1)), the transferee shall be considered to have assumed such liability to the extent of the amount of such liability that does not exceed the fair market value of the property at the time of the contribution or distribution. See section 752(c).

(b) *Examples.* The following examples illustrate the application of the rules of this section :

Example (1). A contributes property with an adjusted basis of $1,000 to a general partnership in exchange for a one-third interest in partnership. At the time of contribution, the property is subject to recourse debt of $150 and has a fair market value in excess of $150. The recourse debt to which the property is subject is a liability of A within the meaning of §1.752-1T(g). Under this section, the partnership is considered to have assumed the liability to which the property is subject upon A's contribution of the property to the partnership (without regard to whether the partnership assumes such liability within the meaning of §1.752-1T(f)). As a result of this assumption, A's individual liabilities decrease by $150. At the same time, however, A's share of the liabilities of the partnership increases by $150, assuming that, after the contribution, A bears the economic risk of loss (within the meaning of §1.752-1T(d)(3)) for the entire amount of such liability because A remains personally liable to the creditor. Only the net increase or decrease in the sum of A's share of the liabilities of the partnership and A's individual liabilities is taken into account in applying section 752. See §1.752-1T(j)(3) (relating to increase and decrease in share of liabilities resulting from same transaction). Accordingly, since there is no net change in the sum of A's share of the liabilities of the partnership and A's individual liabilities, A will not be considered to have made a contribution of money to the partnership or to have received a distribution of money from the partnership under §1.752-1T(b) or (c) Therefore, A's basis for A's partnership interest is $1,000 (A's basis for the contributed property of $1,000).

Example (2). B contributes property with an adjusted basis of $1,000 to partnership AB in exchange for a one-half interest in the partnership. At the time of contribution, the property is subject to nonrecourse debt of $2,500 and has a fair market value in excess of $2,500. The nonrecourse debt to which the property is subject is a liability of B within the meaning of §1.752-1T(g). In addition, to the extent that the liability is assumed by the partnership, the liability will be treated as a nonrecourse liability of the partnership under §1.752-1T(e)(2) because no partner will bear the economic risk of loss for such liability. Under this section, the partnership is considered to have assumed the liability to which the property is subject upon B's contribution of the property to the partnership. As a result of this assumption, B's individual liabilities decrease by $2,500. At the same time, however, B's share of the liabilities of the partnership increases by $2,000 (the $1,500 of gain that would be allocated to B under section 704 (c) if the partnership disposed of the property (in a taxable transaction) in full satisfaction of the nonrecourse debt encumbering such property, and B's $500 (one-half) share of the amount by which the nonrecourse liability exceeds that gain). See §1.752-1T(e)(1) (relating to a partner's share of nonrecourse liabilities). Only the net decrease of $500 in the sum of B's share of the liabilities of the partnership and B's individual liabilities is taken into account in applying section 752. See §1.752- 1T(j)(3) (relating to increase and decrease in share of liabilities resulting from same transaction). Therefore, under §1.752-1T(c), B will be treated as receiving a distribution of money in the amount of $500. Because the basis of B's partnership interest is $1,000 (the basis of the property contributed by him), the distribution to B of $500 does not result in the realization of any gain under section 731(a). B's basis for B's partnership interest is $500 (B's basis for the contributed property of $1,000 reduced by $500, the amount of the distribution under §1.752-1T(c)).

§1.752-3T Sale or exchange of partnership interest (temporary).

For purposes of determining the amount of any gain or loss realized on a sale, exchange, or other disposition of an interest in a partnership, liabilities shall be treated in the same manner as liabilities in connection with the sale, exchange, or other disposition of property not associated with partnerships. For example, if a partner whose share of partnership liabilities is $250 sells the partner's interest in the partnership for $750 cash and at the same time transfers to the purchaser the partner's $250 share of partnership liabilities, the amount realized by the selling partner on the sale is $1,000.

§1.752-4T Effective dates and transition rules (temporary).

(a) *In general.* Except as otherwise provided in this section, §§1.752-1T, -2T, and -3T shall apply to any liability incurred or assumed by a partnership on or after January 30, 1989, unless such liability is incurred or assumed by the partnership pursuant to a written binding contract in effect prior to December 29, 1988 and at all times thereafter.

(b) *Partner loans and guarantees.* If at any time on or after March 1, 1984, a partner bears the economic risk of loss (within the meaning of §1.752-1T(d)(3)) for a partnership liability that is nonrecourse for purposes of §1.1001-2 as a result of guaranteeing the payment of all or part of such liability or holding an interest in such liability as a creditor, the rules of §§1.752-1T, -2T, and -3T shall apply to such liability beginning on the later of—

(1) March 1, 1984; or

(2) The first date on which such partner bears the economic risk of loss with respect to the liability as a result of such guarantee or as a result of holding an interest in such liability as a creditor.

A guarantee made, or an interest in a liability as a creditor acquired, pursuant to a written binding contract in effect prior to March 1, 1984, and at all times thereafter, shall be disregarded for purposes of the preceding sentence. For purposes of this paragraph (b), the determination of whether a partner bears the economic risk of loss with respect to a partnership liability shall be made in accordance with the rules of §1.752-1T(d)(3).

(c) *Election*—(1) *In general.* Notwithstanding anything to the contrary in this section, a partnership may elect to apply the provisions of §§1.752-1T, -2T, and -3T to all of its liabilities as of the beginning of the first taxable year of such partnership ending after December 29, 1988.

(2) *Time and manner of election.* An election under this paragraph (c) is made by attaching a written statement to the partnership return for the first taxable year of such partnership ending after December 29, 1988. A written statement required pursuant to this paragraph (c)(2) must include the name, address, and taxpayer identification number of the partnership making such statement and contain a declaration that an election is being made under this paragraph (c).

(d) *Coordination with amendments to section 704(b) regulations.* If all or part of a partnership liability is treated as one or more partner nonrecourse debts under §1.704-1T(b)(4)(iv)(*h*) and, but for this paragraph (d), §§1.752-1T, -2T, and -3T would not apply to such liability, then the partnership may treat such liability as a liability to which §§1.752-1T, -2T, and -3T apply to the extent of the partners' shares (if any) of the minimum gain attributable to any such partner nonrecourse debts (within the meaning of §1.704-1T(b)(4)(iv)(*h*)(*5*)). If both §1.704-1(b)(4)(iv) and §§1.752-1T, -2T, and -3T apply to a taxable year of a partnership, any reference included in §§1.752-1T, -2T, and -3T to §1.704-1T(b)(4)(iv) shall be treated as a reference to the appropriate provision of §1.704-1(b)(4)(iv) for purposes of applying §§1.752-1T, -2T, and -3T to such partnership for such taxable year. See §§1.704-1(b)(4)(iv)(*h*) and 1.704-1T(b)-(4)(iv)(*m*) for rules regarding the effective dates of §§1.704-1(b)(4)(iv) and 1.704-1T (b)(4)(iv).

(e) *Cross reference.* For the rules applicable to liabilities of a partnership that are not subject to §§1.752-1T, -2T, and -3T, see 26 CFR 1.752-1.

Par. 4. A new §1.704-1T is added to read as follows:

§1.704-1T Partner's distributive share.

(a)[Reserved.]

(b) *Determination of partner's distributive share*—(0) Cross-references.

Heading	Section
Cross-references	1.704-1T(b)(0)
[Reserved.]	1.704-1T(b)(1)
[Reserved.]	1.704-1T(b)(2)
[Reserved.]	1.704-1T(b)(3)
Special rules	1.704-1T (b)(4)
[Reserved.]	1.704-1T(b)(4)(i)
[Reserved.]	1.704-1T(b)(4)(ii)
[Reserved.]	1.704-1T(b)(4)(iii)
Allocations attributable to nonrecourse liabilities	1.704-1T(b)(4)(iv)
In general	1.704-1T(b)(4)(iv)(*a*)
Allocation of nonrecourse deductions	1.704-1T(b)(4)(iv)(*a*)(*1*)
Allocation of minimum gain	1.704-1T(b)(4)(iv)(*a*)(2)
Determination of nonrecourse deductions	1.704-1T(b)(4)(iv)(*b*)
Partnership minimum gain	1.704-1T(b)(4)(iv)(*c*)
Requirements to be satisfied	1.704-1T(b)(4)(iv)(*d*)
Minimum gain chargeback	1.704-1T(b)(4)(iv)(*e*)
In general	1.704-1T(b)(4)(iv)(*e*)(*1*)
Allocations required pursuant to minimum gain chargeback	1.704-1T(b)(4)(iv)(*e*)(2)
Coordination with paragraph (b)(2)(ii) of this section	1.704-1T(b)(4)(iv)(*e*)(*3*)
Partner's share of partnership minimum gain	1.704-1T(b)(4)(iv)(*f*)
Distribution of nonrecourse liability proceeds allocable to an increase in minimum gain.	1.704-1T(b)(4)(iv)(*g*)
In general	1.704-1T(b)(4)(iv)(*g*)(*1*)
Allocation of net increase in partnership minimum gain	1.704-1T(b)(4)(iv)(*g*)(2)
Carryover to immediately succeeding taxable year	1.704-1T(b)(4)(iv)(*g*)(*3*)
Distribution allocable to proceeds of nonrecourse liability	1.704-1T(b)(4)(iv)(*g*)(*4*)
Nonrecourse debt of the partnership where a partner bears the economic risk of loss	1.704-1T(b)(4)(iv)(*h*)
In general	1.704-1T(b)(4)(iv)(*h*)(*1*)
Allocation of losses, deductions, and expenditures attributable to partner nonrecourse debt	1.704-1T(b)(4)(iv)(*h*)(2)
Determination of partner nonrecourse deductions	1.704-1T(b)(4)(iv)(*h*)(*3*)
Chargeback of items of income and gain	1.704-1T(b)(4)(iv)(*h*)(*4*)
Partner's share of minimum gain attributable to partner nonrecourse debt	1.704-1T(b)(4)(iv)(*h*)(*5*)
Net increase (or decrease) in minimum gain attributable to partner nonrecourse debt	1.704-1T(b)(4)(iv)(*h*)(*6*)

(1) [Reserved.]

(2) [Reserved.]

(3) [Reserved.]

(4) *Special rules*—(i)[Reserved.]

(ii) [Reserved.]

(iii) [Reserved.]

(iv) *Allocations attributable to nonrecourse liabilities*—*(a) In general*—*(1) Allocation of nonrecourse deductions.* An allocation of an item of loss, deduction, or section 705(a)(2)(B) expenditure attributable to nonrecourse liabilities of the partnership (''nonrecourse deduction'') cannot have economic effect because, in the event there is an economic burden that corresponds to such an allocation, the creditor alone bears that burden. Thus, nonrecourse deductions must be allocated in accordance with the partners' interests in the partnership. Paragraph (b)(4)(iv)(*d*) of this section, however, provides a test under which certain allocations of nonrecourse deductions will be deemed to be in accordance with the partners' interests in the partnership. If that test is not satisfied, the partners' distributive shares of nonrecourse deductions will be determined, under §1.704-1(b)(3), according to the partners' overall economic interests in the partnership. See also paragraph (b)(4)(iv)(*h*) of this section for special rules regarding the allocation of deductions attributable to nonrecourse debt with respect to which a partner bears the economic risk of loss.

(2) Allocation of minimum gain. To the extent that the amount of a nonrecourse liability encumbering an item of partnership property exceeds the adjusted tax basis of such property (or book value of such property if the property is properly reflected on the books of the partnership at a value that differs from its adjusted tax basis), a disposition of such property will generate gain in an amount that is at least equal to such excess (''partnership minimum gain''). See paragraph (b)(4)(iv)(*c*) of this section for rules regarding the computation of partnership minimum gain. An increase in partnership minimum gain may be attributable to items of partnership loss, deduction, or section 705(a)(2)(B) expenditure that decrease the adjusted tax basis (or book value) of property subject to a nonrecourse liability of the partnership or a nonrecourse borrowing by the partnership that exceeds the adjusted tax basis (or book value) of the partnership property encumbered by such liability. To the extent that an increase in partnership minimum gain is attributable to items of partnership loss, deduction, or section 705(a)(2)(B) expenditure, such items are treated as nonrecourse deductions under paragraph (b)(4)(iv)(*b*) of this section. Although an allocation of nonrecourse deductions cannot have economic effect, the amount of nonrecourse deductions allocated to any partner decreases such partner's capital account. Similarly, although the allocation to a partner of partnership minimum gain that is attributable to nonrecourse deductions claimed by the partnership increases the partner's capital account, the allocation cannot have economic effect because the minimum gain merely offsets nonrecourse deductions previously claimed by the partnership and does not necessarily bear any relationship to the value of partnership property. Thus, minimum gain that is attributable to nonrecourse deductions claimed by the partnership must be allocated to the partners that were allocated such nonrecourse deductions to prevent such gain from impairing the economic effect of other partnership allocations. In addition, if an increase in partnership minimum gain is attributable to a nonrecourse borrowing that is used to make a distribution to the partners, then such minimum gain represents the unrecognized gain of which the distributee-partners have effectively reaped the economic benefit through the use of nonrecourse debt. An allocation of such minimum gain can have economic effect only if the allocation is made to the partners that received the economic benefit of that gain. Accordingly, under paragraph (b)(4)(iv)-(*e*) of this section, minimum gain attributable to nonrecourse deductions claimed by the partnership or the proceeds of a nonrecourse liability distributed to the partners by the partnership must be allocated to the partners that were allocated such deductions or received such distributions.

(b) Determination of nonrecourse deductions. The amount of nonrecourse deductions for a partnership taxable year equals the excess, if any, of the net increase in the amount of partnership minimum gain during such year, over the aggregate amount of any distributions during such year of proceeds of a nonrecourse liability that are allocable to an increase in partnership minimum gain. See examples (20)(i) and (vi), (21), and (22) of paragraph (b)(5) of this section. The nonrecourse deductions for a partnership taxable year shall consist first of depreciation or cost recovery deductions with respect to items of partnership property subject to one or more nonrecourse liabilities of the partnership to the extent of the increase in minimum gain attributable to the nonrecourse liabilities to which each such item of property is subject (or if such depreciation or cost recovery deductions exceed the amount of nonrecourse deductions for the year,

then a proportionate share of each such deduction shall constitute a nonrecourse deduction), and the remainder of such nonrecourse deductions, if any, shall consist of a pro rata portion of other items of partnership loss, deduction, and section 705(a)(2)(B) expenditure for that year. See example (23) of paragraph (b)-(5) of this section. In addition, if the amount of nonrecourse deductions for a partnership taxable year exceeds the total amount of the items of partnership loss, deduction, and section 705(a)(2)(B) expenditure for such year, then an amount of the net increase in partnership minimum gain for such year equal to that excess shall, for purposes of this paragraph (b)(4)(iv), be treated as an increase in partnership minimum gain for the immediately succeeding partnership taxable year for purposes of determining whether there is a net increase or a net decrease in partnership minimum gain during such taxable year. For example, if a partnership encumbers partnership property with a nonrecourse liability that results in a net increase in partnership minimum gain for the taxable year, but the partnership does not distribute any proceeds of the liability during the year and the amount of such net increase in minimum gain exceeds the partnership's losses, deductions, and section 705(a)-(2)(*b*) expenditures for such year, then the partnership will have a net increase in partnership minimum gain for the taxable year that cannot be allocated either to distributions or to losses, deductions, or section 705(a)(2)(B) expenditures, thereby leaving the partnership with excess nonrecourse deductions for the year. See example (20)(vi) of paragraph (b)(5) of this section. For purposes of this paragraph (b)(4)(iv)(*b*), the items of partnership loss, deduction, and section 705(a)(2)(B) expenditure for a partnership taxable year are determined without regard to any item that is treated as a partner nonrecourse deduction under paragraph (b)(4)(iv)(*h*)(*3*) of this section.

(c) *Partnership minimum gain.* The amount of partnership minimum gain is determined by computing, with respect to each nonrecourse liability of the partnership, the amount of gain (of whatever character), if any, that would be realized by the partnership if it disposed of (in a taxable transaction) the partnership property subject to such liability in full satisfaction thereof (and for no other consideration), and by then aggregating the amounts so computed. See examples (20)(i) and (iv), (21), and (22) of paragraph (b)(5) of this section. For purposes of determining the amount of such gain, (*1*) the adjusted tax basis of partnership property subject to two or more liabilities of equal priority shall be allocated among such liabilities in proportion to the respective outstanding balances of such. liabilities, and (*2*) the adjusted tax basis of partnership property subject to two or more liabilities of unequal priority shall be allocated to the liabilities of an inferior priority (in accordance with subdivision (*1*) of this paragraph (b)(4)(iv)-(*c*)) only to the extent of the excess, if any, of the adjusted tax basis of such property over the aggregate outstanding balance of the liabilities of superior priority. Only the portion of the property's adjusted tax basis that is allocated to nonrecourse liabilities of the partnership shall be used in computing minimum gain. See example (20)(v) and (vii) of paragraph (b)(5) of this section. If partnership property subject to one or more nonrecourse liabilities of the partnership is, under §1.704-1(b)(2)(iv)(*d*), (*f*), or (*r*), properly reflected on the books of the partnership at a book value that differs from the adjusted tax basis of such property, then the determinations under this paragraph (b)(4)(iv) shall be made with reference to such book value. See example (22) of paragraph (b)(5) of this section. For purposes of this paragraph (b)(4)(iv), in determining the net increase or decrease in partnership minimum gain during any partnership taxable year in which the capital accounts of the partners are increased pursuant to §1.704-1(b)(2)(iv)(*f*) or (*r*) to reflect a revaluation of partnership property subject to one or more nonrecourse liabilities of the partnership, any decrease in partnership minimum gain attributable to each such revaluation shall be added back to the net decrease or increase otherwise determined. See example (22)(iii) of paragraph (b)(5) of this section.

(*d*) *Requirements to be satisfied.* Allocations of nonrecourse deductions are deemed to be made in accordance with the partners' interests in the partnership if and only if—

(*1*) Throughout the full term of the partnership, requirements (*1*) and (*2*) of §1.704-1(b)(2)(ii)(*b*) are satisfied;

(*2*) Beginning in the first taxable year in which there are nonrecourse deductions and thereafter throughout the full term of the partnership, the partnership agreement provides for allocations of nonrecourse deductions among the partners in a manner that is reasonably consistent with allocations, which have substantial economic effect, of some other significant partnership item attributable to the property securing nonrecourse liabilities of the partnership;

(*3*) Beginning in the first taxable year of the partnership in which the partnership has nonrecourse deductions or makes a distribution of proceeds of a nonrecourse liability that are allocable to an increase in minimum gain and thereafter throughout the full term of the partnership, the partnership agreement contains a provision that complies with the requirements of paragraph (b)(4)(iv)(*e*) of this section (''minimum gain chargeback''); and

(*4*) All other material allocations and capital account adjustments under the partnership agreement are recognized under §1.704-1 (b) (without regard to whether allocations of adjusted tax basis and amount realized under section 613A(c)(7)(D) are recognized under §1.704-1(b)(4)(v)).

(*e*) *Minimum gain chargeback*—(*1*) *In general.* If there is a net decrease in partnership minimum gain for a partnership taxable year, the partners must be allocated items of partnership income and gain in accordance with this paragraph (b)(4)(iv)(*e*) (''minimum gain chargeback'').

(*2*) *Allocations required pursuant to minimum gain chargeback.* If a minimum gain chargeback is required for a partnership taxable year, then each partner must be allocated items of income and gain for such year (and, if necessary, for subsequent years) in proportion to, and to the extent of, an amount equal to the greater of—

(i) The portion of such partner's share of the net decrease in partnership minimum gain during such year that is allocable to the disposition of partnership property subject to one or more nonrecourse liabilities of the partnership; or

(*ii*) The deficit balance in such partner's capital account at the end of such year (determined before any allocation of partnership income, gain, loss, deduction, or section 705(a)(2)(B) expenditure for such year and excluding from such deficit capital account balance any amount that such partner is obligated to restore under §1.704-1(b)(2)(ii)(*c*), as well as any addition thereto pursuant to the next to last sentences of paragraph (b)(4)(iv)(*f*) and (*h*)(*5*) of this section after taking into account thereunder any changes during such year in partnership minimum gain and in the minimum gain attributable to any partner nonrecourse debt), provided that if requirements (*1*) and (*2*) of §1.704-1(b)(2)(ii)(*b*) have not been satisfied throughout the full term of the partnership, the amount determined under this paragraph (b)(4)(iv)(*e*)(*2*)(*ii*) shall equal zero and the amount of any allocation in addition to that required under paragraph (b)(4)(iv)(*e*)(*2*)(*i*) of this section that must be made to such partner in connection with the net decrease in partnership minimum gain during such year shall be determined in accordance with the partner's interest in the partnership under §1.704-1(b)(3).

See examples (20)(i) and (22)(v) of paragraph (b)(5) of this section. For purposes of this paragraph(b)(4)(iv)(*e*)(*2*), the partners' capital accounts shall be reduced by the items described in §1.704-1(b)(2)(ii)(*d*)(*4*), (*5*), and (*6*). See paragraph (b)(4)(iv)(*f*) of this section for rules regarding the determination of a partner's share of a net decrease in partnership minimum gain. The portion of a partner's share of any net decrease in partnership minimum gain for a partnership taxable year that is allocable to the disposition of partnership property subject to one or more nonrecourse liabilities of the partnership equals the amount determined by multiplying the partner's share of the net decrease in partnership minimum gain for the year by a fraction, the numerator of which is the portion of the net decrease in partnership minimum gain for the year that is allocable to the disposition of partnership property subject to one or more nonrecourse liabilities of the partnership and the denominator of which is the net decrease in partnership minimum gain for the year. For purposes of the preceding sentence, a net decrease in partnership minimum gain for a partnership taxable year is allocable to the disposition of partnership property subject to one or more nonrecourse liabilities of the partnership to the extent of any decrease in partnership minimum gain during such year that resulted from the disposition of any such property. Any minimum gain chargeback required for a partnership taxable year shall consist first of gains recognized from the disposition of items of partnership property subject to one or more nonrecourse liabilities of the partnership to the extent of the decrease in minimum gain attributable to the disposition of such items of property (or if such gains exceed the amount of the minimum gain chargeback required for such taxable year, the minimum gain chargeback shall consist of a proportion share of each such gain), and the remainder of such minimum gain chargeback shall consist of a pro rata portion of the other items of partnership income and gain for that year. An allocation of items of income or gain required for a partnership taxable year pursuant to a minimum gain chargeback shall be deemed to be in accordance with the partners' interests in the partners and shall be made before any other allocation of partnership items is made under section 704 (b) for such year.

(3) *Coordination with §1.704-1(b)(2)(ii).* For purposes of §1.704-1(b)(2)(ii)(*d*)(*6*), offsetting increases to a partner's capital account taken into account under that paragraph do not include items of partnership income and gain that are expected to be allocated to that partner pursuant to this paragraph (b)(4)(iv)(*e*), provided that any subsequent distributions that are expected to be made to such partner of proceeds of a nonrecourse liability that are allocable to an increase in partnership minimum gain shall be deemed to be offset by increases to the partner's capital account for purposes of that section.

(f) *Partner's share of partnership minimum gain.* A partner's share of partnership minimum gain at the end of any partnership taxable year equals the excess (if any) of—

(*1*) The sum of the nonrecourse deductions allocated to such partner (and such partner's predecessors in interest) up to that time and the aggregate distributions to such partner (and such partner's predecessors in interest) up to that time of proceeds of a nonrecourse liability that are allocable to an increase in partnership minimum gain; over

(*2*) The sum of such partner's (and such partner's predecessors in interest) aggregate share of the net decreases in partnership minimum gain up to that time and such partner's (and such partner's predecessors in interest) aggregate share of the decreases up to that time in partnership minimum gain resulting from revaluations of partnership property subject to one or more nonrecourse liabilities of the partnership.

A partner's share of the net decrease in partnership minimum gain during a partnership taxable year equals an amount that bears the same relation to the net decrease in partnership minimum gain during such year as such partner's share of partnership minimum gain at the end of the immediately preceding taxable year of the partnership (or, if later, the time immediately following the last time that the capital accounts of the partners are increased pursuant to §1.704-1(b)(2)(iv)(*f*) or (*r*) to reflect a revaluation of partnership property subject to one or more nonrecourse liabilities of the partnership) bears to the amount of partnership minimum gain at the end of such preceding taxable year (or such later date). See examples (20)(i) and (iv) and (21) of paragraph (b)(5) of this section. A partner's share of any decrease in partnership minimum gain resulting from a revaluation of partnership property equals the amount of the increase in such partner's capital account attributable to such revaluation to the extent of the reduction in minimum gain caused by such revaluation. See example (22)(i) of paragraph (b)(5) of this section. For purposes of §1.704-1(b)(2)(ii)(*d*), the amount of a partner's share of partnership minimum gain shall be added to the limited dollar amount, if any, of the deficit balance in such partner's capital account that such partner is obligated to restore. See examples (20)(i) and (22)(i) of paragraph (b)(5) of this section.

(*g*) *Distribution of nonrecourse liability proceeds allocable to an increase in minimum gain*—(*1*) *In general.* If during a partnership taxable year a partnership makes a distribution to the partners that is allocable to the proceeds of any nonrecourse liability of the partnership such distribution is allocable to an increase in partnership minimum gain to the extent of the amount of the net increase, if any, in partnership minimum gain for such taxable year that is allocated to such nonrecourse liability under paragraph (b)(4)(iv)(*g*)(*2*) of this section.

(*2*) *Allocation of net increase in partnership minimum gain.* A net increase in partnership minimum gain for a taxable year is allocated to a nonrecourse liability of the partnership under this paragraph (b)(4)(iv)(*g*)(*2*) to the extent of the amount of any increase in partnership minimum gain for such year that arose as a result of incurring such nonrecourse liability (that is, the amount of any increase in partnership minimum gain for such year that arose as a result of encumbering partnership property with a nonrecourse liability that exceeds its adjusted tax basis or book value, as the case may be). See example (20)(vi) of paragraph (b)(5) of this section. If an amount of the net increase in partnership minimum gain for a partnership taxable recourse liability of the partnership pursuant to the first sentence of this paragraph (b)(4)(iv)(*g*)(*2*) and the sum of the amounts so allocated exceeds the total amount of such net increase, then the amount of such net increase that shall be allocated to each such liability equals the amount determined by multiplying the total amount of such net increase by the fraction obtained by dividing—

(*i*) The amount of such net increase that would be allocated to such liability under the first sentence of this paragraph (b)(4)(iv)(*g*)(2); by

(*ii*) The sum of the amounts of such net increase that would be allocated to all such liabilities under the first sentence of this paragraph (b)(4)(iv)(*g*)(*2*).

(*3*) *Carryover to immediately succeeding taxable year.* If the amount of the net increase in partnership minimum gain for a taxable year of the partnership that is allocated to a nonrecourse liability of the partnership under paragraph (d)(4)(iv)-(*g*)(*2*) of this section exceeds the aggregate amount of the distributions to the partners during such year that are allocable to the proceeds of such liability ("excess allocable amount") and all or part of the net increase in partnership minimum gain for such year is treated as an increase in partnership minimum gain during the immediately succeeding taxable year under paragraph (b)(4)(iv)(*b*) of this section, then an amount of such deemed increase in partnership minimum gain equal to such excess allocable amount (or, if less, the amount of such deemed increase) shall be treated as an increase in partnership minimum gain that arose as a result of incurring the nonrecourse liability to which such excess allocable amount is attributable for purposes of applying paragraph (b)-(4)(iv)(*g*)(*2*) of this section in such succeeding taxable year. See example (20)-(vi) of paragraph (b)(5) of this section. If for a partnership taxable year there is an excess allocable amount with respect to more than one nonrecourse liability of the partnership and the sum of such excess allocable amounts exceeds the amount of the net increase in partnership minimum gain for such year that is treated as an increase in partnership minimum gain during the immediately succeeding taxable year, then the amount of such deemed increase in partnership minimum gain which is treated as an increase in partnership minimum gain that arose as a result of incurring any such nonrecourse liability shall equal the amount determined by multiplying the amount of such deemed increase by the fraction obtained by dividing—

(*i*) The excess allocable amount for such year with respect to such nonrecourse liability; by

(*ii*) The sum of the excess allocable amounts for such year with respect to all nonrecourse liabilities.

(*4*) *Distribution allocable to proceeds of nonrecourse liability.* The determination of whether a distribution by the partnership to one or more partners is allocable to proceeds of a nonrecourse liability may be made under any reasonable method. For purposes of the preceding sentence, the rules prescribed under §1.163-8T for allocating debt proceeds among expenditures (applying those rules to the partnership as if it were an individual) constitutes a reasonable method for determining (*i*) whether the proceeds of a nonrecourse liability have been distributed to the partners and (*ii*) the partners to whom such proceeds have been distributed.

(*h*) *Nonrecourse debt of the partnership where a partner bears economic risk of loss*—(*1*) *In general.* The rationale for the special rule contained in this paragraph (b)(4)(iv) is that, in the event there is an economic burden that corresponds to the nonrecourse deductions, none of the partners will bear that burden. Accordingly, for purposes of this paragraph (b)(4)(iv)—

(*i*) A nonrecourse liability of the partnership is a liability of the partnership (or portion thereof) for which no partner bears the economic risk of loss (within the meaning of paragraph (b)(4)(iv)(*k*)(*1*) of this section); and

(*ii*) The rules of this paragraph (*h*) govern the allocation of items of partnership income, gain, loss, deduction, or section 705(a)(2)(B) expenditure that must be made (and are considered in accordance with the partners' interests in the partnership) in connection with any nonrecourse debt (within the meaning of paragraph (b)(4)(iv)(*k*)(*2*) of this section) of the partnership for which any partner bears the economic risk of loss ("partner nonrecourse debt").

(*2*) *Allocation of losses, deductions, and expenditures attributable to partner nonrecourse debt.* Any item of partnership loss, deduction, or section 705(a)(2)(B) expenditure that is attributable to a partner nonrecourse debt ("partner nonrecourse deduction") must be allocated to the partner that bears the economic risk of loss for such debt. If more than one partner bears the economic risk of loss for a partner nonrecourse debt, any partner nonrecourse deduction attributable to such debt must be allocated among such partners in accordance with the ratios in which the partners share the economic risk of loss for such partner nonrecourse debt.

(*3*) *Determination of partner nonrecourse deductions.* For any partnership taxable year, the amount of partner nonrecourse deductions with respect to a partner nonrecourse debt equals the excess, if any, of the amount of the net increase during such year in the amount of minimum gain attributable to such partner nonrecourse debt, over the aggregate amount of any distributions during such year to the partner that bears the economic risk of loss for such debt of proceeds of such debt that are allocable to an increase in the minimum gain attributable to such debt. See example (20)(viii) and (ix) of paragraph (b)(5) of this section. The determination of which items of partnership loss, deduction, and section 705(a)(2)(B) expenditure constitute the partner nonrecourse deductions with respect to a partner nonrecourse debt for a partnership taxable year must be made in a manner that is consistent with the principles of paragraph (b)(4)(iv)(*b*) of this section. If the amount of partner nonrecourse deductions with respect to a partner nonrecourse debt for a partnership taxable year exceeds the total amount of items of partnership loss, deduction, and section 705(a)(2)(B) expenditure for such year that are treated as partner nonrecourse deductions with respect to such debt, then an amount of the net increase during such year in the minimum gain attributable to such partner nonrecourse debt equal to that excess shall be treated as an increase during the immediately succeeding partnership taxable year in the minimum gain attributable to such debt for purposes of determining the net increase or decrease during such succeeding taxable year in the minimum gain attributable to such debt. The determination of which items of partnership loss, deduction, and section 705(a)(2)(B) expenditure constitute partner nonrecourse deductions for a partnership taxable year must be made before the determination of which items constitute nonrecourse deductions for the taxable year under paragraph (b)(4)(iv)(*b*) of this section.

(*4*) *Chargeback of items of income and gain.* If there is a net decrease during a partnership taxable year in the minimum gain attributable to a partner nonrecourse debt, then any partner with a share of the minimum gain attributable to such debt at the beginning of such year must be allocated items of partnership income and gain for such year (and, if necessary, for subsequent years) in proportion to, and to the extent of, an amount equal to the greater of—

(*i*) The portion of such partner's share of the net decrease in the minimum gain attributable to such partner nonrecourse debt that is allocable to the disposition of partnership property subject to such debt; or

(*ii*) The deficit balance in such partner's capital account at the end of such year (determined before any allocation of partnership income, gain, loss, deduction, or section 705(a)(2)(B) expenditure for such year and excluding from such deficit capital account balance any amount that such partner is obligated to restore under §1.704-1(b)(2)(ii)(*c*), as well as any addition thereto pursuant to the next to last sentences of paragraph (b)(4)(iv)(*f*) and (*h*)(*5*) of this section after taking into account thereunder any changes during such year in partnership minimum gain and in the minimum gain attributable to any partner nonrecourse debt), provided that if requirements (*1*) and (*2*) of §1.704-1(b)(2)(ii)(*b*) have not been satisfied throughout the full term of the partnership, the amount determined under this paragraph (b)(4)(iv)-(*h*)(*4*)(*ii*) shall equal zero and the amount of any allocation in addition to that required under paragraph (b)(4)-(iv)(*h*)(*4*)(*i*) of this section that must be made to such partner in connection with the net decrease during such year in the minimum gain attributable to such partner nonrecourse debt shall be determined in accordance with the partner's interest in the partnership under §1.704-1(b)(3).

See paragraph (b)(4)(iv)(*h*)(*5*) of this section for rules regarding the determination of a partner's share of a net decrease in the minimum gain attributable to a partner nonrecourse debt. For purposes of this paragraph (b)(4)(iv)(*h*)(*4*), the determination of whether the partners have deficit balances in their capital accounts shall be made by reducing the partners' capital accounts by the items described in §1.704-1(b)(2)(ii)(*d*)(*4*), (*5*), and (*6*). The portion of a partner's share of any net decrease during a partnership taxable year in the minimum gain attributable to a partner nonrecourse debt that is allocable to the disposition of partnership property subject to such debt equals the amount determined by multiplying the partner's share of the net decrease in the minimum gain attributable to such debt for the year by a fraction, the numerator of which is the portion of the net decrease in the minimum gain attributable to such debt for the year that is allocable to the disposition of partnership property subject to such debt and the denominator of which is the net decrease in the minimum gain attributable to such debt for the year. For purposes of the preceding sentence, a net decrease during a partnership taxable year in the minimum gain attributable to a partner nonrecourse debt is allocable to the disposition of partnership property subject to such debt to the extent of any decrease during such year in the minimum gain attributable to such debt that resulted from the disposition of any such property. The determination of which items of partnership income and gain must be allocated pursuant to this paragraph (b)(4)(iv)(*h*)(*4*) for any partnership taxable year shall be made in a manner that is consistent with the principles of paragraph (b)(4)(iv)(*e*)(*2*) of this section. For purposes of this paragraph (b)(4)(iv)-(*h*)(*4*), the items of partnership income and gain for a partnership taxable year do not include any item of income or gain that is allocated pursuant to a minimum gain chargeback for such year under paragraph (b)(4)(iv)(*e*) of this section. Any allocation of items of partnership income and gain required to be made pursuant to this paragraph (b)(4)-(iv)(*h*)(*4*) for a partnership taxable year must be made before any other allocation (other than a minimum gain chargeback pursuant to paragraph (b)(4)(iv)(*e*) of this section) of partnership items is made under section 704(b) for such year. For purposes of §1.704-1(b)(2)(ii)(*d*)(*6*), offsetting increases in a partner's capital account taken into account under that paragraph do not include items of partnership income and gain that are expected to be allocated to that partner under this paragraph (b)(4)(iv)(*h*)(*4*), provided that any subsequent distributions that are expected to be made to such partner of proceeds of any partner nonrecourse debt (with respect to which such partner will bear the economic risk of loss at the time of distribution) that are allocable to an increase in the minimum gain attributable to such debt shall be deemed to be offset by increases to the partner's capital account for purposes of that section.

(*5*) *Partner's share of minimum gain attributable to partner nonrecourse debt.* For purposes of this paragraph (b)(4)(iv)-(*h*), a partner's share of the minimum gain attributable to a partner nonrecourse debt at the end of any partnership taxable year equals the excess (if any) of—

(*i*) The sum of the partner nonrecourse deductions attributable to such debt that have been allocated to such partner (and such partner's predecessors in interest) up to that time and the aggregate amount of distributions made to such partner (and such partner's predecessors in interest) up to that time of proceeds of such debt that are allocable to an increase in the minimum gain attributable to such debt (but only if such partner (or such partner's predecessor in interest) bears the economic risk of loss for that debt at the time of any such distribution); over

(*ii*) The sum of such partner's (and such partner's predecessors in interest) aggregate share of the net decreases in the minimum gain attributable to such partner nonrecourse debt up to that time and such partner's (and such partner's predecessors in interest) aggregate share of the decreases up to that time in the minimum gain attributable to such partner nonrecourse debt resulting from revaluations of partnership property subject to such debt.

A partner's share of the net decrease in the minimum gain attributable to a partner nonrecourse debt for a partnership taxable year equals an amount that bears the same relation to the net decrease in the minimum gain attributable to such debt for such year as such partner's share of the minimum gain attributable to such debt at the end of the immediately preceding taxable year of the partnership (or, if later, the time immediately following the last time that the capital accounts of the partners are increased pursuant to §1.704-1(b)(2)(iv)(*f*) or (*r*) to reflect a revaluation of partnership property subject to such partner nonrecourse debt) bears to the amount of minimum gain attributable to such debt at the end of such preceding taxable year (or such later date). A partner's share of a decrease in the minimum gain attributable to a partner nonrecourse debt resulting from a revaluation of partnership property subject to such debt equals the amount of the increase in such partner's capital account that is attributable to such revaluation to the extent of the reduction in the minimum gain attributable to such debt caused by such revaluation. See paragraph (b)(4)(iv)(*f*) of this section for similar rules relating to partnership minimum gain. For purposes of §1.704-1 (b)-(2)(ii)(*d*), the amount of a partner's share of the minimum gain attributable to any partner nonrecourse debt shall be added to the limited dollar amount, if any, of the deficit balance in such partner's capital account that such partner is obligated to restore, and a partner shall not otherwise be considered to have an obligation to restore a deficit balance in such partner's capital account as a result of bearing the economic risk of loss for any partner nonrecourse debt. See example (20)(viii) of paragraph (b)(5) of this section.

(*6*) *Net increase (or decrease) in minimum gain attributable to partner nonrecourse debt.* For purposes of this paragraph (b)(4)(iv)(*h*), the net increase (or decrease) in the minimum gain for a partnership taxable year that is attributable to a partner nonrecourse debt equals the sum of—

(*i*) Any increase (or decrease) in the net increase in partnership minimum gain during such year that would result if such partner nonrecourse debt were treated as a nonrecourse liability of the partnership; and

(*ii*) Any decrease (or increase) in the net decrease in partnership minimum gain during such year that would result if such partner nonrecourse debt were treated as a nonrecourse liability of the partnership.

In addition, for purposes of this paragraph (b)(4)(iv)(*h*), the amount of a decrease in the minimum gain attributable to a partner nonrecourse debt resulting from a revaluation of partnership property subject to such debt equals the excess of the aggregate amount of gain that would be realized by the partnership immediately prior to such revaluation, over the aggregate amount of gain that would be realized by the partnership immediately after such revaluation if the partnership had, at each such time, disposed of (in a taxable transaction) the partnership property subject to such debt in full satisfaction thereof (and for no other consideration). Only the portion of the adjusted tax basis or book value, as the case may be, of the partnership property subject to such debt that is allocable to such debt under the principles of paragraph (b)(4)(iv)(*c*)(*1*) and (*2*) of this section shall be used in computing such gain.

(*7*) *Distribution of proceeds of partner nonrecourse debt allocable to an increase in the minimum gain attributable to such debt.* If a partnership makes a distribution to the partners during a partnership taxable year that is allocable to the proceeds of a partner nonrecourse debt, the amount of such distribution that is allocable to an increase in the minimum gain attributable to such debt equals the amount of the net increase during such year in the minimum gain attributable to such debt that arose as a result of incurring such debt or distributing proceeds of such debt. The rules of this paragraph (b)(4)(iv)(*h*)(*7*) shall be applied in a manner that is consistent with the principles of paragraph (b)(4)(iv)(*g*) of this section.

(*8*) *Debt with respect to which more than one partner bears the economic risk of loss.* If more than one partner bears the economic risk of a loss for different portions of a nonrecourse debt of the partnership, then each such portion shall be treated as a separate partner nonrecourse debt for purposes of this paragraph (b)(4)(iv).

(*i*) [Reserved.]

(*j*) *Tiered partnerships.* If a partnership (the "upper-tier partnership") is a partner in another partnership (the "subsidiary partnership"), then for purposes of applying this paragraph (b)(4)(iv) to the upper-tier partnership for any taxable year of the upper-tier partnership-

(*1*) The sum of—

(*i*) Any nonrecourse deductions of the subsidiary partnership allocated to the upper-tier partnership for such taxable year; and

(*ii*) Any distributions made during such taxable year to the upper-tier partnership by the subsidiary partnership of proceeds of a nonrecourse liability that are allocable to an increase in the partnership minimum gain of the subsidiary partnership;

shall be treated as an increase in the minimum gain of the upper-tier partnership that shall be taken into account in computing the net increase or decrease, as the case may be, in the partnership minimum gain of the upper-tier partnership for such taxable year;

(*2*) The upper-tier partnership's share for such taxable year of any net decrease in the partnership minimum gain of the subsidiary partnership shall be treated as a decrease in the minimum gain of the upper-tier partnership that shall be taken into account in computing the net increase or decrease, as the case may be, in the partnership minimum gain of the upper-tier partnership for such taxable year;

(*3*) The portion of the upper-tier partnership's share for such taxable year of any net decrease in the partnership minimum gain of the subsidiary partnership that is allocable to the disposition of property of the subsidiary partnership subject to one or more nonrecourse liabilities of the subsidiary partnership shall, for purposes of paragraph (b)(4)(iv)(*e*) of this section, be treated as a decrease during such year in the partnership minimum gain of the upper-tier partnership that resulted from the disposition of property of the upper-tier partnership that is subject to one or more nonrecourse liabilities of the upper-tier partnership;

(*4*) Any distributions made during such taxable year to the upper-tier partnership by the subsidiary partnership of proceeds of a nonrecourse liability that are allocable to an increase in the partnership minimum gain of the subsidiary partnership shall be treated as proceeds of a nonrecourse liability of the upper-tier partnership, and the increase in the minimum gain of the upper-tier partnership under paragraph (b)(4)(iv)(*j*)(*1*) of this section that is attributable to the receipt of such distributions shall, for purposes of paragraph (b)(4)(iv)(*g*) of this section, be treated as an increase in the minimum gain of the upper-tier partnership that arose as a result of encumbering property of the upper-tier partnership with such nonrecourse liability of the upper-tier partnership;

(*5*) Any nonrecourse deductions allocated to the upper-tier partnership by the subsidiary partnership for such taxable year shall, for purposes of paragraph (b)(4)(iv)(*b*) of this section, be treated as depreciation or cost recovery deductions with respect to an item of property of the upper-tier partnership subject to a nonrecourse liability of such partnership with respect to which the minimum gain increased during such year by the amount of such nonrecourse deductions; and

(*6*) Any liability of the subsidiary partnership (within the meaning of the regulations under section 752) that is treated as a liability of the upper-tier partnership under §1.752-1T(j)(1) shall be treated as a liability of the upper-tier partnership for purposes of applying paragraph (b)(4)(iv)(*h*) of this section, and rules incorporating the principles of subdivisions (*1*) through (*5*) of this paragraph (b)(4)(iv)(*j*) shall, to the extent appropriate, be applied to determine the allocations that the upper-tier partnership must make under paragraph (b)(4)(iv)(*h*) of this section with respect to any such liability that constitutes a nonrecourse debt for which one or more partners of the upper-tier partnership bear the economic risk of loss.

(*k*) *Meaning of certain terms.* For purposes of this paragraph (b)(4)(iv), the following terms have the meanings set forth below:

(*1*) *Economic risk of loss.* The determination of whether a partner bears the economic risk of loss with respect to any partnership liability shall be made in accordance with §1.752-IT(d)(3) (without regard to whether that section applies to such liability).

(*2*) *Nonrecourse debt.* The term "nonrecourse debt" means any partnership liability that is considered nonrecourse for purposes of §1.1001-2 (without regard to whether such liability is a recourse liability under paragraph §1.752-IT(d)(2)) and any partnership liability for which the creditor's right to repayment is limited to one or more assets of the partnership (within the meaning of §1.752-1T(d)(3)(ii)(B)(*4*)(*ii*)).

(*3*) *Nonrecourse liability.* The term "nonrecourse liability" means any partnership liability (or portion thereof) for which no partner bears the economic risk of loss.

(*4*) *Partner nonrecourse debt.* The term "partner nonrecourse debt" means any nonrecourse debt of the partnership for which any partner bears the economic risk of loss.

(*l*) [Reserved.]

(*m*) *Effective dates*—(*1*) *In general.* Except as otherwise provided in this paragraph (b)(4)(iv)(*m*), this paragraph (b)(4)(iv) shall apply for partnership taxable years beginning after December 29, 1988. For the rules applicable to taxable years beginning on or before December 29, 1988 see §1.704-1(b)(4)(iv). If a partnership agreement entered into on or before December 29, 1988 complied with the provisions of §1.704-1(b)(4)(iv)(*d*) on or before that date, the provisions of §1.704-1(b)(4)(iv)(*a*) through (*f*) shall continue to apply to such partnership for any taxable year beginning after that date (unless the partnership makes an election under paragraph (b)(4)(iv)(*m*)(*2*) of this section) and ending before any subsequent material modification to the partnership agreement.

(*2*) *Election.* A partnership may elect to apply the provisions of this paragraph (b)(4)(iv) to the first taxable year of such partnership ending after December 29, 1988. An election under this paragraph (b)(4)(iv)(*m*) is made by attaching a written statement to the partnership return for the first taxable year of such partnership ending after December 29, 1988. A written statement required pursuant to this paragraph (b)(4)(iv)(*m*)(*2*) must include the name, address, and taxpayer identification number of the partnership making such statement and contain a declaration that an election is being made under this paragraph (b)(4)(iv)(*m*).

(5) *Examples.* The operation of the rules of this paragraph is illustrated by the following examples:

Examples (1) through (19). [Reserved.]

Example (20). (i) RM and HB form a limited partnership to acquire and operate a commercial office building. RM, the limited partner, contributes $180,000, and HB, the general partner, contributes $20,000 to the partnership, which obtains an $800,000 nonrecourse loan and purchases the building (on leased land) for $1,000,000. The nonrecourse loan is secured only by the building, and no principal payments are due for 5 years. The partnership agreement provides that the partners' capital accounts will be determined and maintained in accordance with §1.704-1(b)(2)(iv), distributions in liquidation of the partnership (or any partner's interest) will be made in accordance with partners' positive capital account balances (as set forth in §1.704-1(b)(2)(ii)(*b*)(*2*)), HB will be required to restore any deficit balance in HB's capital account following the liquidation of HB's interest (as set forth in §1.704-1(b)(2)(ii)(*b*)(*3*)), and RM will not be required to restore any deficit balance in RM's capital account following the liquidation of RM's interest. The partnership agreement contains a qualified income offset (as defined in §1.704-1(b)(2)(ii)(*d*)), and, as of the end of each partnership taxable year discussed herein, the items described in §1.704-1(b)(2)(ii)(*d*)(*4*), (*5*), and (*6*) are not reasonably expected to cause or increase a deficit balance in RM's capital account. In addition, the agreement contains a minimum gain chargeback (in accordance with paragraph (b)(4)(iv)(*e*) of this section). The partnership agreement provides that, except as otherwise required by its qualified income offset and minimum gain chargeback provisions, (a) all partnership items will be allocated 90 percent to RM and 10 percent to HB until the first time when the partnership has recognized items of income and gain that exceed the items of loss and deduction it has recognized over its life, and (b) all further partnership items will be allocated equally between RM and HB. Finally, the partnership agreement provides that all distributions, other than distributions in liquidation of the partnership or of a partner's interest in the partnership, will be made 90 percent to RM and 10 percent to HB until a total of $200,000 has been distributed, and thereafter all such distributions will be made equally to RM and HB. In each of the partnership's first 2 taxable years, it generates rental income of $95,000, operating expenses (including land lease payments) of $10,000, interest expense of $80,000, and a cost recovery deduction of $90,000, resulting in a net taxable loss of $85,000 in each of those years. The allocations of these losses 90 percent to RM and 10 percent to HB have substantial economic effect.

	RM	*HB*
Capital account on formation	$180,000	$20,000
Less: net loss in years 1 and 2	(153,000)	(17,000)
Capital account at end of year 2	$27,000	$3,000

In the partnership's third taxable year, it again generates rental income of $95,000, operating expenses of $10,000, interest expense of $80,000, and a cost recovery deduction of $90,000, resulting in a net taxable loss of $85,000. If the partnership were to dispose of the building in full satisfaction of the nonrecourse liability at the end of that year, it would realize $70,000 of gain ($800,000 amount realized less $730,000 adjusted tax basis). Since the amount of partnership minimum gain at the end of that year (and the net increase in partnership minimum gain during the year) is $70,000 and the partnership did not distribute any proceeds of a nonrecourse liability that are allocable to an increase in partnership minimum gain, the amount of partnership nonrecourse deductions for that year is $70,000, consisting of cost recovery deductions allowable with respect to the building of $70,000. Pursuant to the partnership agreement all partnership items comprising the net taxable loss of $85,000, including the $70,000 nonrecourse deduction, are allocated 90 percent to RM and 10 percent to HB. The allocation of these items, other than the nonrecourse deductions, has substantial economic effect.

	RM	*HB*
Capital account at end of year 2	$27,000	$3,000
Less: net loss in year 3 (without non-recourse deduction)	(13,500)	(1,500)
Less: nonrecourse deduction in year 3	(63,000)	(7,000)
Capital account at end of year 3	($49,500)	($5,500)

This allocation of the $70,000 nonrecourse deduction, 90 percent to RM and 10 percent to HB, satisfies requirement (2) of paragraph (b)(4)(iv)(*d*) of this section because the allocation is consistent with allocations, which have substantial economic effect, of other significant partnership items attributable to the building. Since the remaining requirements of paragraph (b)(4)(iv)(*d*) of this section are satisfied, the allocation of nonrecourse deductions is deemed to be made in accordance with the partners' interests in the partnership. At the end of the partnership's third taxable year, RM's and HB's shares of partnership minimum gain are $63,000 and $7,000, respectively. Therefore, pursuant to the next to last sentence in paragraph (b)(4)(iv)(*f*) of this section, RM is treated as obligated to restore a deficit balance in RM's capital account of $63,000, so that in the succeeding year RM could be allocated up to an additional $13,500 of partnership deductions, losses, and section 705(a)(2)(B) expenditures that are not nonrecourse deductions, and that allocation would be considered to have economic effect under the alternate economic effect test contained in §1.704-1(b)(2)(ii)(*d*) even though such an allocation would increase a deficit capital account balance. If the partnership were to dispose of the building in full satisfaction of the nonrecourse liability at the beginning of the partnership's fourth taxable year (and had no other economic activity in that year), the partnership minimum gain would be decreased from $70,000 to zero. RM's and HB's shares of that net decrease would be $63,000 and $7,000, respectively. Upon such a disposition, the minimum gain chargeback would require (before any other allocation is made under section 704(b) with respect to partnership items for the partnership's fourth taxable year) that RM and HB be allocated $63,000 and $7,000, respectively, of the gain from that disposition.

(ii) Assume the same facts as originally stated in (i) except that the partnership agreement provides that all nonrecourse deductions of the partnership will be allocated equally between RM and HB. Furthermore, at the time the partnership agreement is entered into, there is a reasonable likelihood that over the partnership's life it will recognize amounts of income and gain significantly in excess of amounts of loss and deduction (other than nonrecourse deductions). The allocation of such excess equally between the partner's pursuant to the partnership agreement will have substantial economic effect. The allocation of all items, other than the nonrecourse deductions, 90 percent to RM and 10 percent to HB, has substantial economic effect.

	RM	*HB*
Capital account on formation	$180,000	$20,000
Less: net loss in years 1 and 2	(153,000)	(17,000)
Capital account at end of year 2	27,000	3,000
Less: net loss in year 3 (without nonrecourse deduction)	(13,500)	(1,500)
Less: nonrecourse deduction in year 3	(35,000)	(35,000)
Capital account at end of year 3	($21,500)	($33,000)

The allocation of the $70,000 nonrecourse deduction equally between RM and HB satisfies requirement (2) of paragraph (b)(4)(iv)(*d*) of this section because the allocation is consistent with allocations, which will have substantial economic effect, of other significant partnership items attributable to the building. Since the remaining requirements of paragraph (b)(4)(iv)(*d*) of this section are satisfied, the allocation of nonrecourse deductions is deemed to be made in accordance with the partners' interests in the partnership. The allocation of the nonrecourse deductions 75 percent to RM and 25 percent to HB (or in any other ratio between 90 percent to RM/10 percent to HB and 50 percent to RM/50 percent to HB) also would satisfy requirement (2) of paragraph (b)(4)(iv)(*d*) of this section.

(iii) Assume the same facts as originally stated in (i) except that the partnership agreement provides that RM will be allocated 99 percent, and HB 1 percent, of all nonrecourse deductions of the partnership. This allocation of the $70,000 nonrecourse deduction does not satisfy requirement (2) of paragraph (b)(4)(iv)(*d*) because it is not reasonably consistent with allocations, which have substantial economic effect, of any other significant partnership item attributable to the building. Therefore, the allocation of nonrecourse deductions will be disregarded, and the nonrecourse deductions of the partnership will be reallocated according to the partners' overall economic interests in the partnership, determined with reference to the factors set forth in §1.704-1(b)(3)(ii).

(iv) Assume the same facts as originally stated in (i) except that, at the beginning of the partnership's fourth taxable year, RM contributes $144,000 and HB contributes $16,000 of additional capital to the partnership, which the partnership uses to reduce the amount of its nonrecourse liability from $800,000 to $640,000. In addition, in the partnership's fourth taxable year, it again generates rental income of $95,000, operating expenses of $10,000, interest expense of $80,000, and a cost recovery deduction of $90,000, resulting in a net taxable loss of $85,000. If the partnership were to dispose of the building in full satisfaction of the nonrecourse liability at the end of that year, it would realize no gain ($640,000 amount realized less $640,000 adjusted tax basis). Therefore, the amount of partnership minimum gain at the end of the year is zero, which represents a net decrease in partnership minimum gain of $70,000 during the year. RM's and HB's shares of this net decrease are $63,000 and $7,000 respectively, so that at the end of the partnership's fourth taxable year, RM's and HB's shares of partnership minimum gain are zero. Therefore, pursuant to the next to last sentence in paragraph (b)(4)(iv)(*f*) of this section, RM is no longer treated as being obligated to rest.ore any deficit balance in RM's capital account. Assuming the sum of the reductions to RM's capital account described in §1.704-1(b)(2)(ii)(*d*)(*4*), (*5*), and (*6*) does not exceed $94,500, the minimum gain chargeback does not require that either RM or HB be allocated items of income and gain in the partnership's fourth taxable year even though there is a net decrease in partnership minimum gain during that year. This is true because (1) none of the net decrease in partnership minimum' gain for the partnership's fourth taxable year is allocable to the disposition of partnership property subject to nonrecourse liabilities of the partnership, (2) RM's capital account balance at the end of that year (before any allocation is made under section 704(b) to RM for such year) is $94,500 (RM's capital account balance at the end of the partnership's third taxable year increased by RM's $144,000 capital contribution), and (3) HB has a full deficit makeup obligation.

	RM	*HB*
Capital account at end of year 3	($49,500)	($5,500)
Plus: contribution	144,00	16,000
Less: net loss in year 4	(76,500)	(8,500)
Capital account at end of year 4	$18,000	$2,000

(v) Assume the same facts as originally stated in (i) except that the partnership incurred only a $700,000 nonrecourse loan and, in addition, incurred a $100,000 recourse loan, subordinate in priority to the nonrecourse loan, to which the partnership's building is also subject. Under paragraph (b)(4)(iv)(*c*) of this section, $700,000 of the adjusted basis of the building at the end of the partnership's third taxable year is allocated to the nonrecourse liability (with the remaining $30,000 allocated to the recourse liability) so that if the partnership disposed of the building in full satisfaction of the nonrecourse liability at the end of that year, it would realize no gain ($700,000 amount realized less $700,000 adjusted tax basis). Therefore, there is no minimum gain at the end of the partnership's third taxable year (and no increase in partnership minimum gain in such year). If, however, the $700,000 nonrecourse loan were subordinate in priority to the $100,000 recourse loan, under paragraph (b)(4)(iv)(*c*) of this section, only $630,000 of the adjusted basis of the building would be allocated to the $700,000 nonrecourse loan (the excess of the $730,000 adjusted tax basis of the building at the end of the partnership's third taxable year over the balance of the superior $100,000 recourse liability). In that case, the balance of the $700,000 nonrecourse liability would exceed the adjusted tax basis of the building so allocated by $70,000 so that there would be $70,000 of minimum gain (and a $70,000 increase in partnership minimum gain) in the partnership's third taxable year.

(vi) Assume the same facts as originally stated in (i) except that the partnership obtains a nonrecourse loan of $200,000 at the end of its fourth taxable year, which is secured by a second mortgage on the building, and distributes this cash to its partners at the beginning of its fifth taxable year. In addition, in its fourth and fifth taxable years, the partnership again generates rental income of $95,000, operating expenses of $10,000, interest expense of $80,000, and a cost recovery deduction of $90,000, resulting in a net taxable loss of $85,000. Also assume that the partnership has distributed its $5,000 of operating cash flow for each year ($95,000 of rental income less $10,000 of operating expense and $80,000 of interest expense) to RM and HB at the end of each such year. If the partnership were to dispose of the building in full satisfaction of the nonrecourse liabilities at the end of its fourth taxable year, the partnership would realize $360,000 of gain ($1,000,000 amount realized less $640,000 adjusted tax basis). Thus, the net increase in partnership minimum gain during the partnership's fourth taxable year is $290,000 ($360,000 of minimum gain at the end of the fourth year less $70,000 of minimum gain at the end of the third year). Because the partnership did not distribute any of the proceeds of the loan it obtained in its fourth year during that year, the amount of partnership nonrecourse deductions for that year is $290,000. Under paragraph (b)(4)(iv)(*b*) of this section, if the partnership had distributed the proceeds of that loan to its partners at the end of its fourth year, the partnership's nonrecourse deductions for that year would have been reduced by the amount of that distribution because the proceeds of that loan are allocable to an increase in partnership minimum gain under paragraph (b)(4)(iv)(*g*) of this section. Since the nonrecourse deductions for the partnership's fourth taxable year exceed its actual deductions for that year, all $180,000 of the partnership's deductions for that year are treated as nonrecourse deductions, and the $110,000 excess nonrecourse deductions will be treated as an increase in minimum gain in the partnership's fifth taxable year under paragraph (b)(4)(iv)(*b*) of this section.

	RM	*HB*
Capital account at end of year 3 (including cash flow distributions)	($63,000)	($7,000)
Plus: rental income in year 4	85,500	9,500
Less: nonrecourse deduction in year 4	(162,000)	(18,000)
Less: cash flow distributions in year 4	(4,500)	(500)
Capital account at end of year 4	($144,000)	($16,000)

At the end of the partnership's fourth taxable year, RM's and HB's shares of partnership minimum gain are $225,000 and $25,000, respectively, and is deemed to be obligated to restore a deficit balance of $225,000 in RM's capital account at the end of that year. If the partnership were to dispose of the building in full satisfaction of the nonrecourse liabilities at the end of its fifth taxable year, the partnership would realize $450,000 of gain ($1,000,000 amount realized less $550,000 adjusted tax basis). Therefore, the net increase in partnership minimum gain during the partnership's fifth taxable year is $200,000 ($110,000 deemed increase plus the $90,000 by which minimum gain at the end of the fifth year exceeds minimum gain at the end of the fourth year ($450,000 less $360,000)). At the beginning of its fifth year, the partnership distributed the $200,000 of loan proceeds. Under paragraph (b)(4)(iv)(g)(*3*) of this section, the first $110,000 of this distribution (an amount equal to the deemed increase in partnership minimum gain for the year) is considered allocable to an increase in partnership minimum gain for such year. As a result, the amount of nonrecourse deductions for the partnership's fifth taxable year is $90,000 ($200,000 net increase in minimum gain less $110,000 distribution of nonrecourse liability proceeds that are allocable to an increase in minimum gain), and such nonrecourse deductions consist solely of the $90,000 cost recovery deduction allowable with respect to the building. As a result of the distributions during the partnership's fifth taxable year, the total distributions to the partners over the partnership's life will equal $225,000. Therefore, the last $25,000 distributed to the partners during the fifth year will be divided equally between them under the partnership agreement. Thus, out of the $200,000 distribution of loan proceeds at the beginning of the partnership's fifth taxable year, the first $180,000 is distributed 90 percent to RM and 10 percent to HB, and the last $20,000 is divided equally between them.

	RM	HB
Capital account at end of year 4	($144,000)	($16,000)
Plus: net income in year 5 (without nonrecourse deduction)	4,500	500
Less: nonrecourse deduction in year 5	(81,000)	(9,000)
Less: distribution of loan proceeds	(172,000)	(28,000)
Less: cash flow distribution in year 5	(2,500)	(2,500)
Capital account at end of year 5	($395,000)	($55,000)

At the end of the partnership's fifth taxable year, RM's share of partnership minimum gain is $405,000 ($225,000 share of minimum gain at the end of the fourth year plus $81,000 of nonrecourse deductions for the fifth year and a $99,000 distribution of nonrecourse liability proceeds that are allocable to an increase in minimum gain) and HB's share of partnership minimum gain is $45,000 ($25,000 share of minimum gain at the end of the fourth year plus $9,000 of nonrecourse deductions for the fifth year and an $11,000 distribution of nonrecourse liability proceeds that are allocable to an increase in minimum gain). Accordingly, RM is considered obligated to restore a deficit balance of $405,000 in RM's capital account at the end of that year.

(vii) Assume the same facts as originally stated in (i) except that RM and HB personally guarantee the "first" $100,000 of the $800,000 nonrecourse loan (*i.e.*, only if the building is worth less than $100,000 will they be called upon to make up any deficiency). Under paragraph (b)(4)(iv)(*c*) of this section, only $630,000 of the adjusted tax basis of the building is allocated to the $700,000 nonrecourse portion of the loan because the collateral will be applied first to satisfy the $100,000 guaranteed portion, in effect making it superior in priority to the remainder of the loan. On the other hand, if RM and HB were to guarantee the "last" $100,000 (i.e., if the building is worth less than $800,000, they will be called upon to make up the deficiency up to $100,000), $700,000 of the adjusted tax basis of the building would be allocated to the $700,000 nonrecourse portion of the loan because the guaranteed portion in effect would be inferior in priority to it.

(viii) Assume the same facts as originally stated in (i) except that the $800,000 loan is made by RM, the limited partner. Under paragraph (b)(4)(iv)(*h*) of this section, the $800,000 obligation does not constitute a nonrecourse liability of the partnership for purposes of this paragraph (b)(4)(iv) because RM, a partner, bears the economic risk of loss for that loan within the meaning of §1.752-1T(c)(3). The $800,000 loan does, however, constitute a partner nonrecourse debt since that obligation is a nonrecourse debt (within the meaning of paragraph (b)(4)(iv)(*k*)(*2*) of this section) for which a partner bears the economic risk of loss. In the partnership's third taxable year, partnership minimum gain would have increased by $70,000 if such debt were a nonrecourse liability of the partnership. Thus, under paragraph (b)(4)(iv)-(*h*)(*6*) of this section, there is a net increase of $70,000 in the minimum gain attributable to the $800,000 partner nonrecourse debt for the partnership's third taxable year, and $70,000 of the $90,000 cost recovery deduction from the building for the partnership's third taxable year constitutes a partner nonrecourse deduction with respect to such debt. See paragraph (b)(4)(iv)(*h*)(*3*) of this section. Under paragraph (b)(4)(iv)(*h*)(*2*) of this section, this partner nonrecourse deduction must be allocated to RM, the partner that bears the economic risk of loss for that liability, and RM will, as a result of this allocation, be considered obligated to restore a deficit balance in RM's capital account of $70,000. See paragraph (b)(4)(iv)(*h*)(*5*) of this section.

(ix) Assume the same facts as in (viii) except that the $800,000 loan from RM to the partnership is a purchase money loan that "wraps around" a $700,000 underlying nonrecourse note (also secured by the building) issued by RM to an unrelated person in connection with RM's acquisition of the building. Under these circumstances, RM bears the economic risk of loss with respect to only $100,000 of the liability within the meaning of §1.752-1T(c)(3). See §1.752-1T(j) (example (18)). Therefore, for purposes of paragraph (b)(4)(iv) of this section, the $800,000 liability will be treated as a $700,000 nonrecourse liability of the partnership and a $100,000 partner nonrecourse debt (inferior in priority to the $700,000 liability) of the partnership for which RM bears the economic risk of loss. Under paragraph (b)(4)(iv)(*h*) of this section, $70,000 of the $90,000 cost recovery deduction realized in the partnership's third taxable year constitutes a partner nonrecourse deduction that must be allocated to RM.

Example (21). (i) RD and PK form a general partnership to acquire and operate residential real properties. Each partner contributes $150,000 to the partnership. The partnership obtains a $1,500,000 nonrecourse loan and purchases 3 apartment buildings (on leased land) for $720,000 ("Property A"), $540,000 ("Property B"), and $540,000 ("Property C") , respectively. The nonrecourse loan is secured only by the 3 buildings, and no principal payments are due for 5 years. In each of the partnership's first 3 taxable years, it generates rental income of $225,000, operating expenses (including land lease payments) of $50,000, interest expense of $175,000, and cost recovery deductions on the 3 properties of $150,000 ($60,000 on Property A, $45,000 on Property B, and $45,000 on Property C), resulting in a net taxable loss of $150,000 in each of those years. If the partnership were to dispose of the 3 apartment buildings in full satisfaction of its nonrecourse liability at the end of its third taxable year. it would realize $150,000 of gain ($1,500,000 amount realized less $1,350,000 adjusted tax basis). Since the amount of partnership minimum gain at the end of that year (and the net increase in partnership minimum gain during that year) is $150,000 and the partnership did not distribute any proceeds of a nonrecourse liability that are allocable to an increase in partnership minimum gain, the amount of partnership nonrecourse deductions for that year is $150,000, consisting of cost recovery deductions allowable with respect to the 3 apartment buildings of $150,000. The result would be the same if the partnership obtained 3 separate nonrecourse loans that were "cross-collateralized" (*i.e.*, if each separate loan were secured by all 3 of the apartment buildings).

(ii) Assume the same facts as originally stated in (i) and that at the beginning of the partnership's fourth taxable year, the partnership (with the permission of the nonrecourse lender) disposes of Property A for $835,000 and uses a portion of the proceeds to repay $600,000 of the nonrecourse liability, reducing the balance to $900,000. As a result of the disposition, the partnership recognizes gain of $295,000 ($835,000 amount realized less $540,000 adjusted tax basis). Also during the partnership's fourth taxable year it generates rental income of $135,000, operating expenses of $30,000, interest expense of $105,000, and cost recovery deductions of $90,000 ($45,000 on each remaining building). if the partnership were to dispose of the remaining two buildings in full satisfaction of its nonrecourse liability at the end of the partnership's fourth taxable year, it would realize gain of $180,000 ($900,000 amount realized less $720,000 aggregate adjusted tax basis), which represents the amount of partnership minimtim gain at the end of such year. Since the amount of partnership minimum gain increased from $150,000 to $180,000 during the partnership's fourth taxable year, the amount of partnership nonrecourse deductions for such year is $30,000, consisting of cost recovery deductions allowable with respect to the two remaining apartment buildings. No minimum gain chargeback is required for the taxable year, even though the partnership disposed of one of the properties subject to the nonrecourse liability during the year, because there is no net decrease in partnership minimum gain for the year.

Example (22). (i) OC and DR form a limited partnership to acquire and lease machinery that is 5-year recovery property. The partnership elects under section 48(q)(4) to reduce the amount of investment tax credit in lieu of adjusting the tax basis of such machinery. OC, the limited partner, and DR, the general partner, contribute $100,000 each to the partnership, which obtains an $800,000 nonrecourse loan and purchases the machinery for $1,000,000. The nonrecourse loan is secured only by the machinery. The principal amount of the loan is to be repaid $50,000 per year during each of the partnership's first 5 taxable years, with the remaining $550,000 of unpaid principal due on the first day of the partnership's sixth taxable year. The partnership agreement provides that the partners' capital accounts will be determined and maintained in accordance with §1.704-1(b)(2)(iv), distributions in liquidation of the partnership (or any partner's interest) will be made in accordance with the partners' positive capital account balances (as set forth in §1.704-1(b)(2)(ii)(*b*)(*2*)), DR will be required to restore any deficit balance in DR's capital account following the liquidation of DR's interest (as set forth in §1.704-1(b)(2)(ii)(*b*)(*3*)), and OC will not be required to restore any deficit balance in his capital account following the liquidation of his interest. The partnership agreement contains a qualified income offset (as defined in §1.704-1(b)(2)(ii)(*d*)), and, as of the end of each partnership taxable year discussed herein, the items described in §1.704-1(b)(2)(ii)(*d*)(*4*), (*5*), and (*6*) are not reasonably expected to cause or increase a deficit balance in OC's capital account. In addition, the agreement contains a minimum gain chargeback (in accordance with paragraph (b)(4)(iv)(*e*) of this section). The partnership agreement provides that, except as otherwise required by its qualified income offset and minimum gain chargeback provisions, all partnership items will be allocated equally between OC and DR. Finally, the partnership agreement provides that all distributions, other than distributions in liquidation of the partnership or of a partner's interest in the partnership, will be made equally between OC and DR. In the partnership's first taxable year it generates rental income of $130,000 interest expense of $80,000, and a cost recovery deduction of $150,000, resulting in a net taxable loss of $100,000. In addition, the partnership repays $50,000 of the nonrecourse liability, reducing that liability to $750,000. Allocations of these losses ually between OC and DR have substantial economic effect.

	OC	DR
Capital account on formation	$100,000	$100,000
Less: net loss in year 1	(50,000)	(50,000)
Capital account at end of year 1	$ 50,000	$ 50,000

In the partnership's second taxable year, it generates rental income of $130,000, interest expense of $75,000, and a cost recovery deduction of $220,000 resulting in a net taxable loss of $165,000. In addition, the partnership repays $50,000 of the nonrecourse liability, reducing that liability to $700,000, and distributes $2,500 of cash to each partner. If the partnership were to dispose of the machinery in full satisfaction of the nonrecourse liability at the end of that year, it would realize $70,000 of gain ($700,000 amount realized less $630,000 adjust tax basis). Therefore, the amount of partnership minimum gain at the end of that year (and the net increase in partnership minimum gain during the year) is $70,000, and the amount of partnership nonrecourse deductions for the year is $70,000 since the partnership did not distribute any proceeds of a nonrecourse liability to the partners during that year. The partnership nonrecourse deductions for its second taxable year consist of $70,000 of the cost recovery deductions allowable with respect to the machinery. Pursuant to the partnership agreement, all partnership items comprising the net taxable loss of $165,000, including the $70,000 nonrecourse deduction, are allocated equally between OC and DR. The allocation of these items, other than the nonrecourse deductions, has substantial economic effect.

	OC	DR
Capital account at end of year 1	$50,000	50,000
Less: net loss in year 2 (without nonrecourse deduction)	(47,500)	(47,500)
Less: nonrecourse deduction in year 2	(35,000)	(35,000)
Less: distribution	(2,500)	(2,500)
Capital account at end of year 1	($35,000)	($35,000)

This allocation of the $70,000 nonrecourse deduction equally between OC and DR satisfies requirement (2) of paragraph (b)(4)(iv)(*d*) of this section because the allocation is consistent with allocations, which have substantial economic effect, of other significant partnership items attributable to the machinery. Since the remaining requirements of paragraph (b)(4)(iv)(*d*) of this section are satisfied, the allocation of nonrecourse deductions is deemed to be made in accordance with the partners' interests in the partnership. At the end of the partnership's second taxable year, OC's and DR's shares of partnership minimum gain are $35,000 each. Therefore, pursuant to the next to the last sentence in paragraph (b)(4)(iv)(*f*) of this section, OC is treated as obligated to restore a deficit balance in his capital account of $35,000. If the partnership were to dispose of the machinery in full satisfaction of the nonrecourse liability at the beginning of the partnership's third taxable year (and had no other economic activity in that year), the partnership minimum gain would be decreased from $70,000 to zero. OC's and DR's shares of that net decrease would be $35,000 each. Upon such a disposition, the minimum gain chargeback would require that OC and DR each be allocated $35,000 of that gain (before any other allocation is made under section 704(b) with respect to partnership items for the partnership's third taxable year).

(ii) Assume the same facts as originally stated in (i) and that DT is admitted to the partnership at the beginning of the partnership's third taxable year. At the time of DT's admission, the fair market value of the machinery is $900,000. DT contributes $100,000 to the partnership (the partnership invests $95,000 of this in undeveloped land and holds the other $5,000 in cash) in exchange for an interest in the partnership. In connection with DT's admission to the partnership, the partnership's machinery is revalued on the partnership's books to reflect its fair market value of $900,000. Pursuant to §1.704-1(b)(2)(iv)(*f*), the capital accounts of OC and DR are adjusted upwards to $100,000 each to reflect the revaluation of the partnership's machinery. This adjustment reflects the manner in which the partnership gain of $270,000 ($900,000 fair market value minus $630,000 adjusted tax basis) would be shared if the machinery were sold for its fair market value immediately prior to DT's admission to the partnership.

	OC	DR
Capital account before DT's admission	($35,000)	($35,000)
Deemed sale adjustment	135,000	135,000
Capital account adjusted for DT's admission	$100,000	$100,000

The partnership agreement is modified to provide that, except as otherwise required by its qualified income offset and minimum gain chargeback provisions, partnership income, gain, loss, and deduction, as computed for book purposes, will be allocated equally among the partners, and such allocations will be reflected in the partners' capital accounts. The partnership agreement also is modified to provide that depreciation and gain or loss, as computed for tax purposes, with respect to the machinery will be shared among the partners in a manner that takes account of the variation between such property's $630,000 adjusted tax basis and its $900,000 book value, in accordance with §1.704-1(b)(2)(iv)(*f*) and the special rule contained in §1.704-1(b)(4)(i). Finally, the partnership agreement is modified to provide that DT will not be required to restore any deficit balance in DT's capital account following the liquidation of DT's interest. Since the requirements of §1.704-1(b)(2)(iv)(*g*) are satisfied, the capital accounts of the partners (as adjusted) continue to be maintained in accordance with §1.704-1(b)(2)(iv). If the partnership were to dispose of the machinery in full satisfaction of the nonrecourse liability immediately following the revaluation of the machinery, it would realize no book gain ($700,000 amount realized less $900,000 book value). Thus, as a result of the revaluation of the machinery upward by $270,000, the partnership minimum gain is reduced from $70,000 immediately prior to such revaluation to zero. Under paragraph (b)(4)(iv)(*f*) of this section, OC's and DR's shares of that decrease are $35,000 each.

(iii) Assume the same facts as in (ii) and that also during the partnership's third taxable year the partnership generates rental income of $130,000, interest expense of $70,000, a cost recovery deduction of $210,000, and a book depreciation deduction (attributable to the machinery) of $300,000. As a result the partnership has a net taxable loss of $150,000 and net book loss of $240,000. In addition, the partnership repays $50,000 of the nonrecourse liability (after the date of DT's admission), reducing the liability to $650,000, and distributes $5,000 of cash to each partner. If the partnership were to dispose of the machinery in full satisfaction of the nonrecourse liability at the end of the year, $50,000 of book gain would result ($650,000 amount realized less $600,000 book value). Therefore, the amount of partnership minimum gain at the end of the year is $50,000, which represents a net decrease in partnership minimum gain of $20,000 during the year. (This is so even though there would be an increase in partnership minimum gain in the partnership's third taxable year if minimum gain were computed with reference to the adjusted tax basis of the machinery.) Nevertheless, pursuant to the next to the last sentence of paragraph (b)(4)(iv)(*c*) of this section, the amount of nonrecourse deductions of the partnership for its third taxable year is $50,000 (the net increase in partnership minimum gain during the year determined by adding back the $70,000 decrease in partnership minimum gain attributable to the revaluation of the machinery to the $20,000 net decrease in partnership minimum gain during the year). The $50,000 of partnership nonrecourse deductions for the year consist of book depreciation deductions allowable with respect to the machinery of $50,000. Pursuant to the partnership agreement all partnership items comprising the net book loss of $240,000 including the $50,000 nonrecourse deduction, are allocated equally among the partners. The allocation of these items, other than the nonrecourse deductions, has substantial economic effect. Consistent with the special partners' interests in the partnership rule contained in §1.704-1(b)(4)(i), the partnership agreement provides that the $210,000 cost recovery deduction for the partnership's third taxable year is, in accordance with section 704(c) principles, shared $55,000 to OC, $55,000 to DR, and $100,000 to DT.

	OC		DR		DT	
	Tax	*Book*	*Tax*	*Book*	*Tax*	*Book*
Capital account at end of year 2	($35,000)	$100,000	($35,000)	$100,000	$100,000	$100,000
Less: nonrecourse deduction	(9,166)	(16,666)	(9,166)	(16,666)	(16,666)	(16,666)
Plus: items other than nonrecourse deduction in year 3	(25,834)	(63,334)	(25,834)	(63,334)	(63,334)	(63,334)
Less: distribution	(5,000)	(5,000)	(5,000)	(5,000)	(5,000)	(5,000)
Capital account at end of year 3	($75,000)	$15,000	($75,000)	$15,000	$15,000	$15,000

The allocation of the $50,000 nonrecourse deduction equally among OC, DR, and DT satisfies requirement (2) of paragraph (b)(4)(iv)(*d*) of this section because the allocation is consistent with allocations, which have substantial economic effect, of other significant partnership items attributable to the machinery. Since the remaining requirements of paragraph (b)(4)(iv)(*d*) of this section are satisfied, such allocation is deemed to be made in accordance with the partners' interests in the partnership. At the end of the partnership's third taxable year, OC's, DR's, and DT's shares of partnership minimum gain are $16,666 each.

(iv) Assume the same facts as in (iii) and that during the partnership's fourth taxable year the partnership generates rental income of $130,000, interest expense of $65,000, a cost recovery deduction of $210,000, and a book depreciation deduction (attributable to the machinery) of $300,000. As a result, the partnership has a net taxable loss of $145,000 and a net book loss of $235,000. In addition, the partnership repays $50,000 of the nonrecourse liability, reducing that liability to $600,000, and distributes $5,000 of cash to each partner. If the partnership were to dispose of the machinery in full satisfaction of the nonrecourse liability at the end of the year, $300,000 of book gain would result ($600,000 amount realized less $300,000 book value). Therefore, the amount of partnership minimum gain as of the end of the year is $300,000, which represents a net increase in partnership minimum gain during the year of $250,000. Thus, since the partnership did not distribute any proceeds of a nonrecourse liabilty that are allocable or to an increase in partnership minimum gain, the amount of partnership nonrecourse deductions for that year equals $250,000, consisting of book depreciation deductions of $250,000. Pursuant to the partnership agreement, all partnership items comprising the net book loss of $235,000, including the $250,000 nonrecourse deductions, are allocated equally among the partners. That allocation of all items, other than the nonrecourse deductions, has substantial economic effect. Consistent with the special partners' interests in the partnership rule contained in §1.704-1(b)(4)(i), the partnership agreement provides that the $210,000 cost recovery deduction for the partnership's fourth taxable year is, in accordance with section 704(c) principles, shared $55,000 to OC, $55,000 to DR, and $100,000 to DT.

	OC		*DR*		*DT*	
	Tax	*Book*	*Tax*	*Book*	*Tax*	*Book*
Capital account at end of year 3 ...	($75,000)	$15,000	($75,000)	$15,000	$15,000	$15,000
Less: nonrecourse deduction.......	(45,833)	(83,333)	(83,333)	(83,333)	(83,333)	(83,333)
Plus: items other than nonrecourse deduction in year 4	(12,499)	5,000	12,499	5,000	5,000	5,000
Less: distribution................	(5,000)	(5,000)	(5,000)	(5,000)	(5,000)	(5,000)
Capital account at end of year 4 ...	($113,334)	($68,333)	($113,333)	($68,333)	($68,333)	($68,333)

The allocation of the $250,000 nonrecourse deduction equally among OC, DR, and DT satisfies requirement (2) of paragraph (b)(4)(iv)(*d*) of this section. Since the remaining requirements of paragraph (b)(4)(iv)(*d*) of this section are satisfied, such allocation is deemed to be made in accordance with the partners' interests in the partnership. At the end of the partnership's third taxable year, OC's, DR'S, and DT's shares of partnership minimum gain are $100,000 each.

(v) Assume the same facts as (iv) and that at the beginning of the partnership's fifth taxable year it sells the machinery for $650,000 (using $600,000 of the proceeds to repay the nonrecourse liability), resulting in a taxable gain of $440,000 (650,000 amount realized less $210,000 adjusted tax basis) and a book gain of $350,000 (650,000 amount realized less $300,000 book basis). The partnership has no other items of income, gain, loss, or deduction for such year. As a result of the sale, partnership minimum gain is reduced from $300,000 to zero, reducing OC's, DR's, and DT's shares of partnership minimum gain to zero from $100,000 each. The minimum gain chargeback requires that OC, DR, and DT each be allocated $100,000 of that gain (an amount equal to each partner's share of the net decrease in partnership minimum gain resulting from the sale) before any allocation is made to them under section 704(b) with respect to partnership items for the partnership' s fifth taxable year. Thus, the allocation of the first $300,000 of book gain $100,000 to each of the partners is deemed to be made in accordance with the partners' interests in the partnership under paragraph (b)(4)(iv)(*e*) of this section. The allocation of the remaining $50,000 of book gain equally among the partners has substantial economic effect. Consistent with the special partners' interests in the partnership rule contained in §1.704-1(b)(4)(i), the partnership agreement provides that the $440,000 taxable gain is, in accordance with section 704(c) principles, shared $161,667 to OC, $161,667 to DR, and $116,666 to DT.

	OC		*DR*		*DT*	
	Tax	*Book*	*Tax*	*Book*	*Tax*	*Book*
Capital account at end of year 4 ...	($113,334)	($68,333)	($113,334)	($68,333)	($68,333)	($68,333)
Plus: minimum gain chargeback....	138,573	100,000	138,573	100,000	100,000	100,000
Plus: additional gain	23,094	16,666	23,094	16,666	16,666	16,666
Capital account before liquidation ..	$48,333	$48,333	$48,333	$48,333	$48,333	$48,333

Example (23). (i) A partnership owns 4 properties, each of which is subject to a nonrecourse liability of the partnership. During a taxable year of the partnership, the following events take place. First, the partnership generates a cost recovery deduction (for both book and tax purposes) with respect to Property W of $10,000 and repays $5,000 of the nonrecourse liability secured only by that property, resulting in an increase in minimum gain with respect to that liability of $5,000. Second, the partnership generates a cost recovery deduction (for both book and tax purposes) with respect to Property X of $10,000 and repays none of the nonrecourse liability secured by that property, resulting in an increase in minimum gain with respect to that liability of $10,000. Third, the partnership generates a cost recovery deduction (for both book and tax purposes) of $2,000 on Property Y and repays $11,000 of the nonrecourse liability secured only by that property, resulting in a decrease in minimum gain with respect to that liability of $9,000 (although at the end of that year, there remains minimum gain with respect to that liability). Finally, the partnership borrows $5,000 on a nonrecourse basis, giving as the only security for that liability Property Z, which is a parcel of undeveloped land with an adjusted tax basis (and book value) of $2,000, resulting in a net increase in minimum gain with respect to that liability of $3,000. The net increase in partnership minimum gain during that year is $9,000, so that the amount of nonrecourse deductions of the partnership for that taxable year is $9,000. Those nonrecourse deductions consist of $3,000 of cost recovery deductions with respect to Property W and $6,000 of cost recovery deductions with respect to Property X. The amount of nonrecourse deductions consisting of cost recovery deductions is determined as follows. With respect to the nonrecourse liability secured by Property Z, with respect to which there is no cost recovery deduction, the amount of cost recovery deductions that constitutes nonrecourse deductions is zero. Similarly, with respect to the nonrecourse liability secured by Property Y, for which there is no increase in minimum gain, the amount of cost recovery deductions that constitutes nonrecourse deductions is zero. With respect to each of the nonrecourse liabilities secured by Properties W and X, which are (i) secured by property with respect to which there are cost recovery deductions and (ii) for which there is an increase in minimum gain, the amount of cost recovery deductions that constitutes nonrecourse deductions equals the product obtained by multiplying the net increase in partnership minimum gain ($9,000) times a fraction, the numerator of which is the total cost recovery deductions with respect to the partnership property securing that particular liability to the extent of the increase in minimum gain with respect to that liability and the denominator of which is the sum of the numerators for each such liability. Thus, for the liability secured by Property W, the amount is $9,000 times $5,000/$15,000. For the liability secured by Property X, the amount is $9,000 times $10,000/$15,000. (If one depreciable property secured 2 partnership nonrecourse liabilities, the amount of cost recovery or book depreciation with respect to that property would be allocated among such liabilities in accordance with the method by which adjusted basis is allocated under §1.704-1(b)(2)(iv)(*c*)).

(ii) Assume the facts as in (i) except that the loan secured by Property Z is $15,000 (rather than $5,000), resulting in a net increase in minimum gain with respect to that liability of $13,000. Thus, the net increase in partnership minimum gain is $19,000, and the amount of nonrecourse deductions of the partnership for that taxable year is $19,000. Those nonrecourse deductions consist of $5,000 of cost recovery deductions with respect to Property W, $10,000 of cost recovery deductions with respect to Property X, and a pro rata portion of the partnership's other items of deduction, loss, and section 705(a)(2)(B) expenditure for that year. The method for computing the amounts of cost recovery deductions that constitute nonrecourse deductions is the same as in (i) for the liabilities secured Properties Y and Z. With respect to each of the nonrecourse liabilities secured by Properties W and X, the amount of cost recovery deductions that constitutes nonrecourse deductions equals the total cost recovery deductions with respect to the partnership property securing that particular liability to the extent of the increase in minimum gain with respect to that liability.

Par. 5. Section 1.704-1 is amended as follows:

1. Paragraph (b)(0) is amended by removing the words "Nonrecourse liabilities of the partnership where a person related to a partner has economic risk of loss.... 1.704-1(b)(4)(iv)(*h*)" from the table and adding, in their place, the words "Effective date and cross reference.... 1.704-1(b)(4)(iv)(*h*)."

2. Paragraph (b)(2)(ii)(*c*) is amended by adding the following new sentence to the end thereof: "For purposes of this paragraph (b)(2), if a partner contributes a promissory note to the partnership during a partnership taxable year beginning after December 29, 1988, and the maker of such note is a person related to such partner (within the meaning of §1.752-1T(h), but without regard to subdivision (4) of that section), then such promissory note shall be treated as a promissory note of which such partner is the maker.

3. Paragraph (b)(2)(ii)(*h*) is amended by adding the following new sentence to the end thereof: "For purposes of the preceding sentence, sections 267 (b) and 707(b)(1) shall be applied for partnership taxable years beginning after December 29, 1988 by (*1*) substituting "80 percent or more" for "more than 50 percent" each place it appears in such sections, (2) excluding brothers and sisters from the members of a person's family, and (*3*) disregarding section 267(f)(1)(A)."

4. Paragraph (b)(2)(ii)(*d*)(*6*) is amended by removing from the last parenthetical the words "under paragraph (b)(4)(iv)(*e*) of this section."

5. Paragraph (b)(4)(iv)(*h*) is revised to read as follows:

(*h*) *Effective date and cross reference.* The rules of this paragraph (b)(4)(iv) generally are effective only for partnership taxable years beginning on or before December 29, 1988. See §1.704-1T(b)(4)(iv)(*m*) for transition rules. For the rules generally applicable to allocations attributable to nonrecourse liabilities for partnership taxable years beginning after December 29, 1988, see §1.704-1T(b)(4)(iv). See paragraph (b)(1)(ii) of this section for additional rules regarding the effective date of this section.

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 6. The authority for Part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 7. Section 602.101(c) is amended by inserting the following in the appropriate places in the table:

1. "1.752-4T...[1545 1090]."

2. "1.704-1T(b)(4)(iv)(*m*)(*2*)...[1545 1090]."

* * * * * *

There is a need for immediate guidance with respect to the provisions contained in this Treasury decision. For this reason, it is found impracticable to issue it with notice ond public procedure under subsection (b) of section 553 of title 5 of the United States Code or subject to the effective date limitation of subsection (d) of that section.

Lawrence B. Gibbs,
Commissioner of Internal Revenue.

Approved December 2, 1988.

O. Donaldson Chapoton,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on December 29, 1988, 8:45 a.m., and published in the issue of the Federal Register for December 30, 1988, 53 F.R. 53140)

Subchapter L.—Insurance Companies
Part I.—Life Insurance Companies
Subpart A.—Tax Imposed

Section 801.—Tax Imposed

Whether the Service will rule as to whether the liquidation of a life insurance subsidiary pursuant to either section 334(b)(2) (pre-TEFRA) or section 338 (added by TEFRA) is a termination under section 815(d)(2) (as in effect before the Tax Reform Act of 1984) causing a distribution from the subsidiary's policyholders surplus account. See Rev. Proc. 89-36, page 919.

Subpart C.—Life Insurance Deductions

Section 805.—General Deductions

Whether the Service will rule as to whether a portion of the purchase price of the stock of the life insurance company is properly allocable to insurance in force. See Rev. Proc. 89-36, page 919.

Subpart D.—Accounting, Allocation, and Foreign Provisions

Section 811.—Accounting Provisions

Whether the Service will rule as to whether the difference between the face value of bonds held by a life insurance subsidiary liquidating under section 334(b)(2) (pre-TEFRA) or section 338 (added by TEFRA) and the amount allocable to such bonds pursuant to the liquidation is market discount and need not be accrued. See Rev. Proc. 89-36, page 919.

Section 815.—Distribution to Shareholders From Pre-1984 Policyholders Surplus Account

26 CFR 1.815-2: Distributions to shareholders.

Whether the Service will rule as to whether the liquidation of a life insurance subsidiary pursuant to section 334(b)(2) (pre-TEFRA) or section 338 (added by TEFRA) is a termination requiring the application of section 801(c) or section 802(b)(3) as in effect before the enactment of the Tax Reform Act of 1984. See Rev. Proc. 89-36, page 919.

Subpart E.—Definitions and Special Rules

Section 816.—Life Insurance Company Defined

Whether the Service will rule as to whether the life insurance reserves acquired in the liquidation of a life insurance subsidiary qualify as unsecured liabilities assumed by the acquiring corporation for purposes of section 334(b)(2) (pre-TEFRA) and section 338(added by TEFRA). See Rev. Proc. 89-36, page 919.

26 CFR 1.801-4: Life insurance reserves.

Insurance; life insurance reserves. Certain reserves set aside for a level premium, guaranteed renewable, group long-term care policy that provides indemnity benefits for an impaired individual qualify as life insurance reserves under section 816(b) of the Code.

Rev. Rul. 89-43

ISSUE

If a policy provides coverage for long-term care in the event an individual becomes chronically impaired, do certain reserves set aside for the policy qualify as life insurance reserves under section 816(b) of the Internal Revenue Code?

FACTS

IC, a life insurance company as defined in section 816(a) of the Code, issues level premium, guaranteed renewable, group long-term care policies (Policies). The Policies provide indemnity benefits for the cost of some or all of the necessary diagnostic, preventive, therapeutic, rehabilitative, and maintenance or personal care services required by an individual in the event the individual becomes chronically impaired. The Policies do not contain any nonforfeiture provisions.

The Policies are guaranteed renewable by class, and no individual may be singled out for cancellation or a rate increase. Rate increases may be made only for all insureds belonging to a class, based upon actual and anticipated experience of the class. These adjustments may not reflect increases in morbidity risks due merely to the advancing age of insured members of the class.

Each individual covered by the Policies is issued a certificate evidencing such coverage. Although *IC* may not cancel the Policies, it may end enrollment of new members at any time. If a policyholder terminates the Policies or if the plan sponsor terminates its sponsorship of the Policies in a situation where the plan sponsor is not the policyholder, *IC* guarantees each certificate holder the right to continue the coverage provided under the Policies without the individual providing evidence of insurability.

If a certificate holder leaves the group covered by the Policies or otherwise terminates his or her relationship with the plan sponsor, *IC* guarantees that individual the right to continue the coverage provided under the Policies without providing evidence of insurability. The premiums for the continued coverage will remain level and are based on the insured individual's age at the time that individual became covered under the original Policies. These premiums may only be changed on a class basis for all covered persons in the same class as determined by *IC*. No premium change may be made on an individual basis. The continued coverage provides benefits as similar to those under the original Policies as allowed by state law. All time limits on certain defenses and pre-existing-condition periods run from the date of the insured individual's coverage under the original Policies.

IC maintains an active lives reserve, in addition to the unearned premium reserve, to cover its obligation to renew the Policies at level premiums notwithstanding the increasing age of the insureds. Other reserves that *IC* maintains with regard to the Policies include a waiver of premium reserve, a group conversion guaranteed insurability reserve, and a disability disabled lives reserve covering the liability for losses that were incurred on or before the valuation date and that have not accrued as of the valuation date. These reserves are set aside to mature or liquidate future unaccrued claims arising out of the Policies. As morbidity experience tables for these types of Policies have not been developed, *IC* computes reserves other than the unearned premium reserve using either a recognized morbidity table reasonably adjusted to reflect the Policies' risks that are not otherwise taken into account or a morbidity table based on *IC*'s experience (provided *IC* has adequate experience upon which to construct a reasonable table). In addition, these reserves are based on assumed interest rates and a recognized mortality table. All of the above reserves are required by law.

LAW AND ANALYSIS

Section 816(b) of the Code defines the term ''life insurance reserves'' as amounts that are computed or estimated on the basis of recognized mortality or morbidity tables and assumed rates of interest and that are set aside to mature or liquidate, either by payment or reinsurance, future unaccrued claims arising from life insurance, annuity, and noncancellable accident and health insurance contracts (including life insurance or annuity contracts combined with noncancellable accident and health insurance) involving at the time with respect to which the reserve is computed, life, accident or health contingencies. Section 816(e) provides that guaranteed renewable life, accident, and health insurance shall be treated in the same manner as noncancellable life, accident, and health insurance policies.

Section 1.801-4(a) of the regulations under the predecessor of section 816 of the Code defines the term ''life insurance reserves'' to mean those amounts—(1) which are computed or estimated on the basis of recognized mortality or morbidity tables and assumed rates of interest; (2) which are set aside to mature or liquidate, either by payment or reinsurance, future unaccrued claims arising from life insurance, annuity, and noncancellable health and accident insurance contracts (including life insurance or annuity contracts combined with noncancellable health and accident insurance) involving, at the time with respect to which the reserve is computed, life, health, or accident contingencies; and (3) which are required by law. Because the language of section 816 is similar to that in former section 801 of the Code, the definition in section 1.801-4 provides guidance for the interpretation of the current provision. *See* H.R. Rep. No. 432, Part 2, 98th Cong., 2d Sess. 1401 (1984); Senate Comm. on Finance, 98th Cong., 2d Sess., *Deficit Reduction Act of 1984: Explanation of the Provision Approved by the Committee on March 21, 1984,* at 524 (Comm. Print 1984).

To qualify under section 816(b) of the Code, life insurance reserves must be computed or estimated ''on the basis of recognized mortality or morbidity tables.'' Although neither the Code nor the regulations define the term ''recognized mortality or morbidity tables,'' the legislative history of the term provides useful guidance. The Revenue Act of 1942 substituted the term ''recognized mortality or morbidity tables'' for the term ''recognized experience tables'' in prior law. The Senate Finance Committee Report accompanying the Act indicates that the change was designed to expand rather than to restrict the types of mortality or morbidity tables that would qualify. *See* S. Rep. No. 1631, 77th Cong., 2d Sess. 142 (1942), 1942-2 C.B. 510, 610. There was no intent to exclude a table that is based on a company's experience *Cf.* section 807(d)(5)-(C) (special rule, for contracts where standard tables are not available, requiring that the amount of life insurance reserves for purposes other than section 816 be determined using the mortality and morbidity tables specified in the regulations). *See also* section 1.807-1T of the temporary Income Tax Regulations (allowing adjustments to mortality and morbidity tables to reflect risks not otherwise taken into account). Accordingly, the term ''recognized mortality or morbidity tables'' in section 816(b) includes a table based on an insurance company's experience (provided the company has adequate experience upon which to construct a reasonable table) or a recognized table reasonably adjusted to reflect policy risks not otherwise taken into account. Tax reserves, however, must be computed as provided in section 807.

Rev. Rul. 70-460, 1970-2 C.B. 135, provides that the additional required reserve under guaranteed renewable health and accident contracts qualifies as a life insurance reserve within the meaning of the predecessor of section 816(b) of the Code if the reserve is computed or estimated on the basis of recognized mortality or morbidity tables and an assumed rate of interest, and is set aside to mature or liquidate unaccrued claims under such contracts.

In Rev. Rul. 70-190, 1970-1 C.B. 150, *clarified in* Rev. Rul. 80-115, 1980-1 C.B. 138, an insurance company issued noncancellable policies providing life insurance benefits payable at the death of the insured combined with disability income and waiver of premium benefits. Prior to an insured becoming disabled, the company set aside a disability active lives reserve for its obligation to pay the disability income and waiver of premium benefits. When an insured became disabled and entitled to the disability income and waiver of premium benefits, the company established a disability disabled lives reserve in an amount actuarially computed to provide these benefits during the period of disability. The ruling concludes that the disability disabled lives reserve qualifies as a life insurance reserve under the predecessor of section 816(b) of the Code. *Cf.* section 807(e)(3)(special rules for determining the amount of life insurance reserves attributable to certain supplemental benefits, including guaranteed insurability benefits, accidental death and disability benefits, convertibility benefits, disability waiver benefits, and any other de minimis benefit prescribed by the regulations).

An additional reserve for excess mortality under group conversion contracts was present in Rev. Rul. 77-451, 1977-2 C.B. 224. The ruling concludes that the additional reserve did not qualify as a life insurance reserve because the company had used gross premiums in computing the reserve. The reserve, therefore, was not computed or estimated on the basis of recognized mortality or morbidity tables and assumed rates of interest as required by the predecessor of section 816(b) of the Code. *Cf.* section 807(e)(3).

IC's active lives, waiver premium, group conversion and disability disabled lives reserves under the Policies are established to liquidate "future unaccrued claims arising from life insurance, annuity, and noncancellable accident and health insurance contracts (including life insurance or annuity contracts combined with noncancellable accident and health insurance) involving, at the time with respect to which the reserve is computed, life, accident, or health contingencies." Section 816(b)(1)(B) of the Code. These reserves are computed or estimated on the basis of assumed rates of interest and recognized mortality or morbidity tables. The reserves also are required by law. These reserves, therefore, qualify as life insurance reserves under section 816(b) of the Code.

HOLDING

The active lives, waiver of premiums, group conversion, and disability disabled lives reserves set aside for the Policies qualify as life insurance reserves under section 816(b) of the Code.

APPLICATION

The above holding applies to policies issued either to an individual or to a group.

A characterization of policies or of the insurance company's reserves for purposes of subchapter L does not characterize for federal income tax purposes the benefits received by the insureds. For example, if policies provide annuity benefits, those benefits are taxable under section 72 of the Code notwithstanding any other benefits provided under the policies. Additionally, a characterization of policies or of the underlying reserves does not determine whether the insureds or their employers are allowed any exclusion or deduction for amounts paid to purchase the policies.

Section 817.—Treatment of Variable Contracts

26 CFR 1.817-5: Diversification requirements for variable annuity, endowment, and life insurance contracts.

T.D. 8242

TITLE 26-INTERNAL REVENUE.—CHAPTER 1— INTERNAL REVENUE SERVICE, DEPARTMENT OF THE TREASURY, SUBCHAPTER A—INCOME TAX; PART I—INCOME TAX; TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1953

Diversification Requirements for Variable Annuity, Endowment, and Life Insurance Contracts

AGENCY: Internal Revenue Service, Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to the diversification requirements for variable annuity, endowment, and life insurance contracts. Changes to the applicable law were made by the Tax Reform Act of 1984. The regulations affect issuers and policyholders of variable contracts and provide them with guidance concerning the tax treatment of those contracts.

DATES: The regulations apply to variable annuity, endowment, and life insurance contracts for taxable years beginning after December 31, 1983, except as follows: See 1.817-5(i)(2).

SUPPLEMENTARY INFORMATION:

BACKGROUND

This document amends the Income Tax Regulations (26 CFR Part 1) to provide rules under section 817(h) of the Internal Revenue Code of 1986, relating to diversification requirements for variable annuity, endowment, and life insurance contracts. Section 817(h) was added to the Code by section 211(a) of the Tax Reform Act of 1984 (Pub. L. 98-369, 98 Stat. 750) [1984-3 C.B. (Vol. 1) 1]. On September 15, 1986, the Federal Register published amendments (T.D. 8101; 51 FR 32633) [1986-2 C.B. 97] to the Income Tax Regulations (26 CFR Part 1) to provide temporary regulations under section 817(h). The same issue of the Federal Register also published proposed amendments (51 FR 32664) [LR-295-84, 1986-2 C.B. 801] to the Income Tax Regulations and the Table of OMB Control Numbers based on those temporary regulations. This document supersedes the temporary regulations under section 817(h) and adopts final regulations based on the notice of proposed rulemaking published on September 15, 1986.

Before adopting the final regulations, the Internal Revenue Service solicited comments and held a public hearing on the proposed amendments. Fourteen written comments responding to the notice of proposed rulemaking were received. In addition, seven persons provided oral comments at the hearing held on July 1, 1987. After consideration of all comments received, the proposed amendments are adopted as revised by this Treasury decision.

PUBLIC COMMENTS

Several commentators argued that if a segregated asset account fails the diversification requirement, any contract invested in such account should fail to qualify as an annuity, endowment, or life insurance contract only for the period during which the account was not adequately diversified. The Internal Revenue Service believes that, in general, failing the diversification requirements should result in disqualification of contracts for all periods. Section 817(h) provides that a variable contract shall not be treated as an annuity, endowment, or life insurance contract for purposes of subchapter L, section 72, and section 7702(a) for any period (and any subsequent period) for which the investments made by a segregated asset account underlying the contract are not adequately diversified. The statutory language indicates that contracts should remain disqualified for periods subsequent to the period for which the investments are not adequately diversified. With respect to prior periods, section 7702 required that, for a life insurance or endowment contract, any income on the contract for all prior taxable years be treated as income received or accrued by the policyholder if the contract ceases to meet the definition of a life insurance contract. An annuity contract is treated in the same manner under these regulations.

Various commentators suggested that if a failure to diversify is inadvertent and the failure is promptly corrected, contracts based on such an account should continue to qualify as life insurance, endowment, or annuity contracts during all periods. The Internal Revenue Service agrees that variable contracts based upon a segregated asset account that inadvertently becomes nondiversified should be treated as remaining qualified, provided that the issuer or holder of the contract agrees to pay such amounts as may be required by the Commissioner. The amounts required by the Commissioner to be paid will be based on the amount of tax the policyholders would have been required to pay if they were treated as receiving the income on the contract during the period of nondiversification. Although based on the amount of tax described in the preceding sentence, it is anticipated that, in determining the amount of the payment, the absence of a policyholder basis adjustment and other relevant factors will be taken into account.

Several commentators disagreed with the treatment in the proposed regulations of all government securities as securities of a single issuer. This rule has been revised to conform to section 817(h)(6), as added by section 6080 of the Technical and Miscellaneous Revenue Act of 1988.

The proposed regulations provide that the members of an affiliated group, within the meaning of section 1504(a), ordinarily are treated as a single issuer. The final regulations delete this provision.

Various comments relating to the start-up period rules under paragraph (c)(2) of the proposed regulations were received. The proposed regulations provide that the start-up period rules apply only if no more than 30 percent of the amount allocated to a segregated asset account as of any date is attributable to premium and investment income received more than one year prior to such date. A commentator suggested that amounts transferred from a previously diversified account and amounts transferred as a result of a tax-free exchange of an unaffiliated company's contract do not constitute an abuse of the start-up period rules, even if such amounts were received more than one year prior to the test date. In addition, the commentator noted that it is burdensome for companies to trace premium and investment income as of any date. Accordingly, the final regulations provide that if more than 30 percent of the amount allocated to a segregated asset account as of the last day of a calendar quarter is attributable to contracts entered into more than one year before such date, the start-up period rules do not apply. Any amount transferred to the account from a diversified account or any amount transferred as a result of an exchange pursuant to section 1035 with an unaffiliated company is not treated as an amount attributable to contracts entered into more than one year before such date.

Several commentators requested clarification of the rules relating to the aggregation of multiple accounts or funds. The final regulations restate these rules and provide additional clarifying examples.

The final regulations extend the look-through rules applicable to underlying investment companies or trusts all of the interests in which (with certain exceptions) are held by segregated asset accounts to underlying partnerships all of the interests in which are held by such persons. The final regulations clarify that this look-through rule is available to a segregated asset account (notwithstanding ownership of interests in the underlying entity by the public) if all the assets of the segregated asset account are attributable to (i) premium payments made by policyholders prior to September 26, 1981, (ii) premium payments made in connection with a qualified pension or retirement plan, or (iii) any combination of such premium payments. Additionally the final regulations clarify that the return on an interest in an underlying entity held by the general account of a life insurance company must be computed in the same manner as the return for the related variable contracts prior to deducting expenses related to the variable contracts.

The final regulations include an additional look-through rule for trusts, substantially all of the assets of which are Treasury securities. Under this rule, Treasury securities are still treated as such, even though they are held through a custodial arrangement that is treated as a grantor trust.

Several commentators requested that the regulations clarify whether purchased put and call options on Treasury securities, interest rate futures contracts on Treasury securities, and options on such contracts are classified as Treasury securities under the regulations. The final regulations clarify that such options and futures contracts are not Treasury securities because their direct obligor is not the U.S. Treasury.

The proposed regulations require that in order to qualify as a real property account, an account must have 40 percent of its assets invested in real property or interests in real property on the first anniversary of the date premium income is first received. A commentator requested that this period be increased to 18 months, because of the extensive time needed to identify and buy real property for investment. Accordingly, the final regulations provide that, if on or before the first anniversary of the account, the issuer has stated an intention to invest the assets of the account primarily in real property or interests in real property, the account will be permitted 18 months to invest at least 40 percent of its assets in such items.

SPECIAL ANALYSES

The Commissioner of Internal Revenue has determined that this rule is not a major rule as defined in Executive Order 12291. Accordingly, a Regulatory Impact Analysis is not required. Although a notice of proposed rulemaking that solicited public comment was issued, the Internal Revenue Service concluded when the notice was issued that the regulations are interpretative and that the notice and public procedure requirements of 5 U.S.C. 553 did not apply. Accordingly, the final regulations do not co stitute regulations subject to the Regulatory Flexibility Act (5 U.S.C. chapter 6).

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Adoption of amendments to the regulations

For the reasons set out in the preamble, Chapter I Subchapter A, Part I of Title 26 of the Code of Federal Regulations is amended as follows:

INCOME TAX REGULATIONS
(26 CFR Part 1)

Paragraph 1. The authority for Part 1 is amended by adding the following citation and by removing "Section 1.817-5T also issued under 26 U.S.C. 817(h)":

Authority: 26 U.S.C. 7805. * * * Section 1.817-5 also issued under 26 U.S.C. 817(h).

Par. 2. 26 CFR Part 1 is amended by removing §1.817-5T.

Par. 3. The following new §1.817-5 is added to read as follows:

§1.817-5 Diversification requirements for variable annuity, endowment, and life insurance contracts.

(a) *Consequences of nondiversification*—(1) *In general.* Except as provided in paragraph (a)(2) of this section, for purposes of subchapter L, section 72, and section 7702(a), a variable contract (as defined in section 817(d)), other than a pension plan contract (as defined in section 818(a)), which is based on one or more segregated asset accounts shall not be treated as an annuity, endowment, or life insurance contract for any calendar quarter period for which the investments of any such account are not adequately diversified. For this purpose, a variable contract shall be treated as based on a segregated asset account for a calendar quarter period if amounts received under the contract (or earnings thereon) are allocated to the segregated asset account at any time during the period. In addition, a variable contract that is not treated as an annuity, endowment, or life insurance contract for any period by reason of this paragraph (a)(1) shall not be treated as an annuity, endowment, or life insurance contract for any subsequent period even if the investments are adequately diversified for such subsequent period. If a variable contract which is a life insurance or endowment contract under other applicable (e.g., State or foreign) law is not treated as a life insurance or endowment contract under section 7702(a), the income on the contract for any taxable year of the policyholder is treated as ordinary income received or accrued by the policyholder during such year in accordance with section 7702(g) and (h). Likewise, if a variable contract is not treated as an annuity contract under section 72, the income on the contract for any taxable year of the policyholder shall be treated as ordinary income received or accrued by the policyholder during such year in the same manner as a life insurance or endowment contract under section 7702(g) and (h).

(2) *Inadvertent failure to diversify.* The investments of a segregated asset account shall be treated as satisfying the requirements of paragraph (b) of this section for one or more periods, provided the following conditions are satisfied—

(i) The issuer or holder must show the Commissioner that the failure of the investments to satisfy the requirements of paragraph (b) of this section for such period or periods was inadvertent,

(ii) The investments of the account must satisfy the requirements of paragraph (b) of this section within a reasonable time after the discover of such failure, and

(iii) The issuer or holder of the variable contract must agree to make such adjustments or pay such amounts as may be required by the Commissioner with respect to the period or periods during which the investments of the account did not satisfy the requirements of paragraph (b) of this section. The amount required by the Commissioner to be paid shall be an amount based upon the tax that would have been owed by the policyholders if they were treated as receiving the income on the contract (as defined in section 7702(g)(1)(B), without regard to section 7702(g)(1)(C)) for such period or periods.

(b) *Diversification of investments*—(1) *In general.* (i) Except as otherwise provided in this paragraph and paragraph (c) of this section, the investments of a segregated asset account shall be considered adequately diversified for purposes of this section and section 817(h) only if—

(A) No more than 55% of the value of the total assets of the account is represented by any one investment;

(B) No more than 70% of the value of the total assets of the account is represented by any two investments;

(C) No more than 80% of the value of the total assets of the account is represented by any three investments; and

(D) No more than 90% of the value of the total assets of the account is represented by any four investments.

(ii) For purposes of this section—

(A) All securities of the same issuer, all interests in the same real property project, and all interests in the same commodity are each treated as a single investment; and

(B) In the case of government securities, each government agency or instrumentality shall be treated as a separate issuer.

(iii) See paragraph (f) of this section for circumstances in which a segregated asset account is treated as the owner of assets held indirectly through certain pass-through entities and corporations taxed under subchapter M, chapter 1 of the Code.

(2) *Safe harbor.* A segregated asset account will be considered adequately diversified for purposes of this section and section 817(h) if—

(i) The account meets the requirements of section 851(b)(4) and the regulations thereunder; and

(ii) No more than 55% of the value of the total assets of the account is attributable to cash, cash items (including receivables), government securities, and securities of other regulated investment companies.

(3) *Alternative diversification requirements for variable life insurance contracts.* (i) A segregated asset account with respect to variable life insurance contracts will be considered adequately diversified for purposes of this section and section 817(h) if the requirements of paragraph (b)(1) or (b)(2) of this section are satisfied or if the assets of such account, other than Treasury securities, satisfy the percentage limitations prescribed in paragraph (b)(1) of this section increased by the product of (A) .5 and (B) the percentage of the value of the total assets of the account that is represented by Treasury securities. In determining whether the assets of an account, other than Treasury securities, satisfy the increased percentage limitations, such limitations are applied as if the Treasury securities were not included in the account (*i.e.*, the increased percentage limitations are not applied to Treasury securities and the value of the total assets of the account is reduced by the value of the Treasury securities).

(ii) The provisions of this paragraph (b)(3) may be illustrated by the following examples:

Example (1). On the last day of a quarter of a calendar year, a segregated asset account with respect to variable life insurance contracts holds assets having a total value of $100,000. The assets of the account are represented by Treasury securities having a total value of $90,000 and securities of Corporation A having a total value of

$10,000. The 55% limit described in paragraph (b)(1)(i) of this section would be increased by 45% (0.5 × 90%) to 100%, and would then be applied to the assets of the account other than Treasury securities. Because no more than 100% of the value of the assets other than Treasury securities is represented by securities of Corporation A, the investments of the account will be considered adequately diversified.

Example (2). On the last day of a quarter of a calendar year, a segregated asset account with respect to variable life insurance contracts holds assets having a total value of $100,000. The assets of the account are represented by Treasury securities having a total value of $60,000, securities of Corporation A having a total value of $30,000, and securities of Corporation B having a total value of $10,000. The 55% and 70% limits described in paragraph (b)(1)(i) of this section would be increased by 30% (0.5 × 60%) to 85% and 100%, respectively, and would then be applied to the assets of the account other than Treasury securities. Securities of Corporation A represent 75%, and securities of Corporation B represent 25%, of the value of the assets of the account other than Treasury securities. Because no more than 85% of the value of the assets other than Treasury securities is represented by securities of Corporation A or B and no more than 100% of the value of the assets other than Treasury securities is represented by securities of Corporations A and B, the investments of the account will be considered adequately diversified.

(c) *Periods for which an account is adequately diversified*—(1) *In general.* A segregated asset account that satisfies the requirements of paragraph (b) of this section on the last day of a quarter of a calendar year (*i.e.*, March 31, June 30, September 30, and December 31) or within 30 days after such last day shall be considered adequately diversified for such quarter.

(2) *Start-up period.* (i) Except as provided in paragraph (c)(2)(iv) of this section, a segregated asset account that is not a real property account on its first anniversary shall be considered adequately diversified until such first anniversary.

(ii) Except as provided in paragraph (c)(2)(iv) of this section, a segregated asset account that is a real property account on its first anniversary shall be considered adequately diversified until the earlier of its fifth anniversary or the anniversary on which the account ceases to be a real property account.

(iii) For purposes of paragraph (c)(2)(i) and (ii) of this section, the anniversary of a segregated asset account is the anniversary of the date on which any amount received under a life insurance or annuity contract, other than a pension plan contract (as defined in section 818 (a)), is first allocated to the account.

(iv) If more than 30 percent of the amount allocated to a segregated asset account as of the last day of a calendar quarter is attributable to contracts entered into more than one year before such date, paragraph (c)(2)(i) of this section shall not apply to the segregated asset account for any period after such date. Similarly, if more than 30 percent of the amount allocated to a segregated asset account as of the last day of a calendar quarter is attributable to contracts entered into more than 5 years before such date, paragraph (c)(2)(ii) of this section shall not apply to the segregated asset account for any period after such date. For purposes of this paragraph (c)(2), amounts transferred to the account from a diversified account (determined without regard to this paragraph (c)(2)) or as a result of an exchange pursuant to section 1035 in which the issuer of the contract received in the exchange is not related in a manner specified in section 267(b) to the issuer of the contract transferred in the exchange are not treated as—

(A) Amounts attributable to contracts entered into more than one year before such date, in the case of accounts subject to paragraph (c)(2)(i) of this section, or

(B) Amounts attributable to contracts entered into more than five years before such date, in the case of accounts subject to paragraph (c)(2)(ii) of this section.

(3) *Liquidation period.* A segregated asset account that satisfies the requirements of paragraph (b) of this section on the date a plan of liquidation is adopted shall be considered adequately diversified for—

(i) The one-year period beginning on the date the plan of liquidation is adopted if the account is not a real property account on such date; or

(ii) The two-year period beginning on the date the plan of liquidation is adopted if the account is a real property account on such date.

(d) *Market fluctuations.* A segregated asset account that satisfies the requirements of paragraph (b) of this section at the end of any calendar quarter (or within 30 days after the end of such calendar quarter) shall not be considered nondiversified in a subsequent quarter because of a discrepancy between the value of its assets and the diversification requirements unless such discrepancy exists immediately after the acquisition of any asset and such discrepancy is wholly or partly the result of such acquisition.

(e) *Segregated asset account.* For purposes of section 817(h) and this section, a segregated asset account shall consist of all assets the investment return and market value of each of which must be allocated in an identical manner to any variable contract invested in any of such assets. See paragraph (9) for examples illustrating the application of this paragraph (e).

(f) *Look-through rule for assets held through certain investment companies, partnerships, or trusts*—(1) *In general.* If this paragraph (f) applies, a beneficial interest in a regulated investment company, a real estate investment trust, a partnership, or a trust that is treated under sections 671 through 679 as owned by the grantor or another person ("investment company, partnership, or trust") shall not be treated as a single investment of a segregated asset account. Instead, a pro rata portion of each asset of the investment company, partnership, or trust shall be treated, for purposes of this section, as an asset of the segregated asset account. For purposes of this section, the ratable interest of a partner in a partnership's assets shall be determined in accordance with the partner's capital interest in the partnership.

(2) *Applicability*—(i) *Certain investment companies, partnerships, and trusts.* This paragraph (f) shall apply to an investment company, partnership, or trust if—

(A) All the beneficial interests in the investment company, partnership, or trust (other than those described in paragraph (f)(3) of this section) are held by one or more segregated asset accounts of one or more insurance companies; and

(B) Public access to such investment company, partnership, or trust is available exclusively (except as otherwise permitted in paragraph (f)(3) of this section) through the purchase of a variable contract. Solely for this purpose, the status of a contract as a variable contract will be determined without regard to section 817(h) and this section.

(ii) *Nonregistered partnerships.* This paragraph (f) shall also apply to a partnership interest if the partnership interest is not registered under a Federal or State law regulating the offering or sale of securities.

(iii) *Trusts holding Treasury securities.* This paragraph (f) shall also apply to a trust that is treated under section 671 through 679 as owned by the grantor or another person if substantially all of the assets of the trust are represented by Treasury securities.

(3) *Interests not held by segregated asset accounts.* Satisfaction of the requirements of paragraph (f)(2)(i) of this section shall not be prevented by reason of beneficial interests in the investment company, partnership, or trust that are—

(i) Held by the general account of a life insurance company or a corporation related in a manner specified in section 267(b) to a life insurance company, but only if the return on such interests is computed in the same manner as the return on an interest held by a segregated asset account is computed (determined without regard to expenses attributable to variable contracts), there is no intent to sell such interests to the public, and a segregated asset account of such life insurance company also holds or will hold a beneficial interest in the investment company, partnership, or trust;

(ii) Held by the manager, or a corporation related in a manner specified in section 267(b) to the manager, of the investment company, partnership, or trust, but only if the holding of the interests is in connection with the creation or management of the investment company, partnership, or trust, the return on such interest is computed in the same manner as the return on an interest held by a segregated asset account is computed (determined without regard to expenses attributable to variable contracts), and there is no intent to sell such interests to the public;

(iii) Held by the trustee of a qualified pension or retirement plan; or

(iv) Held by the public, or treated as owned by policyholders pursuant to Rev. Rul. 81-225, 1981-2 C.B. 12, but only if (A) the investment company, partnership, or trust was closed to the public in accordance with Rev. Rul. 82-55, 1982-1 C.B. 12, or (B) all the assets of the segregated asset account are attributable to premium payments made by policyholders prior to September 26, 1981, to premium payments made in connection with a qualified pension or retirement plan, or to any combination of such premium payments.

(g) *Examples.* The provisions of paragraphs (e) and (f) of this section may be illustrated by the following examples.

Example (1). (i) The assets underlying variable contracts issued by a life insurance company consist of two groups of assets: (a) a diversified portfolio of debt securities and (b) interests in P, a partnership that is publicly registered. All of the beneficial interests in P are held by one or more segregated asset accounts of one or more insurance companies and public access to P is available exclusively through the purchase of a variable contract. The variable contracts provide that policyholders may specify which portion of each premium is to be invested in the debt securities and which portion is to be invested in P interests. The portfolio of debt securities and the assets of P, considered separately, each satisfy the diversification requirements of paragraph (b) of this section.

(ii) As a result of the ability of policyholders to allocate premiums among the two groups of assets, the investment return and market value of the interests in P and the debt securities may be allocated to different variable contracts in a non-identical manner. Accordingly, under paragraph (e) of this section, the interests in P are treated as part of a single segregated asset account ("Account 1") and the debt securities are treated as part of a different segregated asset account ("Account 2").

(iii) Since P is described in paragraph (f)(2)(i) of this section, interests in P will not be treated as a single investment of Account 1. Rather, Account 1 is treated as owning a pro rata portion of the assets of P.

(iv) Since Account 1 and Account 2 each satisfy the requirements of paragraph (b) of this section, variable contracts that are based on either or both accounts are treated as annuity, endowment, or life insurance contracts.

Example (2). The facts are the same as in example (1) except that some of the beneficial interests in P are held by persons not described in paragraph (f)(3) of this section. Since P is not described in paragraph (f)(2) of this section, interests in P will be treated as a single investment of Account 1. As a result, Account 1 does not satisfy the requirements of paragraph (b) of this section. Variable contracts based in whole or in part on Account 1 are not treated as annuity, endowment, or life insurance contracts. Variable contracts that are not based on Account 1 at any time during the period in which such account fails to satisfy the requirements of paragraph (b) of this section (*i.e.*, contracts based entirely on Account 2), are treated as annuity, endowment, or life insurance contracts. See paragraph (a)(1).

Example (3). The facts are the same as in example (2) except that P is not publicly registered. Since P is described in paragraph (e)(2)(ii) of this section, the result is the same as in example (1).

Example (4). The facts are the same as in example (2) except that the variable contracts do not permit policyholders to allocate premiums between or among the debt securities and interests in P Thus, the investment return and market value of the interests in P and the debt securities must be allocated to the same variable contracts and in an identical manner. Under paragraph (e) of this section, the interests in P and the debt securities are treated as part of a single segregated asset account. If the interests in P and the debt securities, considered together, satisfy the requirements of paragraph (b) of this section, contracts based on this segregated asset account will be treated as annuity, endowment, or life insurance contracts.

(h) *Definitions.* The terms defined below shall, for purposes of this section, have the meanings set forth in such definitions:

(1) *Government security*—(i) *General rule.* The term "government security" shall mean any security issued or guaranteed or insured by the United States or an instrumentality of the United States; or any certificate of deposit for any of the foregoing. Any security or certificate or deposit insured or guaranteed only in part by the United States or an instrumentality thereof is treated as issued by the United States or its instrumentality only to the extent so insured or guaranteed, and as issued by the direct obligor to the extent not so insured or guaranteed. For purposes of this paragraph (h)(1), an instrumentality of the United States shall mean any person that is treated for purposes of 15 U.S.C. 80a-2-(16), as amended, as a person controlled or supervised by and acting as an instrumentality of the Government of the United States pursuant to authority granted by the Congress of the United States.

(ii) *Example.* A segregated asset account purchases a certificate of deposit in the amount of $150,000 from bank A. Deposits in bank A are insured by the Federal Deposit Insurance Corporation, an instrumentality of the United States, to the extent of $100,000 per depositor. The certificate of deposit is treated as a government security to the extent of the $100,000 insured amount and is treated as a security issued by bank A to the extent of the $50,000 excess of the value of the certificate of deposit over the insured amount.

(2) *Treasury security*—(i) *General rule.* For purposes of paragraph (b)(3) of this section and section 817(h)(3), the term "Treasury security" shall mean a security the direct obligor of which is the United States Treasury.

(ii) *Example.* A segregated asset account purchases put and call options on U.S. Treasury securities issued by the Options Clearing Corporation. The options are not Treasury securities for purposes of paragraph (b)(3) and section 817(h)(3) because the direct obligor of the options is not the United States Treasury.

(3) *Real property.* The term "real property" shall mean any property that is treated as real property under 1.856-3(d) except that it shall not include interests in real property.

(4) *Real property account.* A segregated asset account is a real property account on an anniversary of the account (within the meaning of paragraph (c)(2)-(iii) of this section) or on the date a plan of liquidation is adopted if not less than the applicable percentage of the total assets of the account is represented by real property or interests in real property on such anniversary or date. For this purpose, the applicable percentage is 40% for the period ending on the first anniversary of the date on which premium income is first received, 50% for the year ending on the second anniversary, 60% for the year ending on the third anniversary, 70% for the year ending on the fourth anniversary, and 80% thereafter. A segregated asset account will also be treated as a real property account on its first anniversary if on or before such first anniversary the issuer has stated in the contract or prospectus or in a submission to a regulatory agency, an intention that the assets of the account will be primarily invested in real property or interests in real property, provided that at least 40% of the total assets of the account are so invested within six months after such first anniversary.

(5) *Commodity.* The term "commodity" shall mean any type of personal property other than a security.

(6) *Security*. The term "security" shall include a cash item and any partnership interest registered under a Federal or State law regulating the offering or sale of securities. The term shall not include any other partnership interest, any interest in real property, or any interest in a commodity.

(7) *Interest in real property*. The term "interest in real property" shall include the ownership and co-ownership of land or improvements thereon and leaseholds of land or improvements thereon. Such term shall not, however, include mineral, oil, or gas royalty interests, such as a retained economic interest in coal or iron ore with respect to which the special provisions of section 631(c) apply. The term "interest in real property" also shall include options to acquire land or improvements thereon, and options to acquire leaseholds of land or improvements thereon.

(8) *Interest in a commodity*. The term "interest in a commodity" shall include the ownership and co-ownership of any type of personal property other than a security, and any leaseholds thereof. Such term shall include mineral, oil, and gas royalty interests, including any fractional undivided interest therein. Such term also shall include any put, call, straddle, option, or privilege on any type of personal property other than a security.

(9) *Value*. The term "value" shall mean, with respect to investments for which market quotations are readily available, the market value of such investments; and with respect to other investments, fair value as determined in good faith by the managers of the segregated asset account.

(10) *Terms used in section 851*. To the extent not inconsistent with this paragraph (h) all terms used in this section shall have the same meaning as when used in section 851.

(i) *Effective date*—(1) *In general*. This section is effective for taxable years beginning after December 31, 1983.

(2) *Exceptions*. (i) If, at all times after December 31, 1983, an insurance company would be considered the owner of the assets of a segregated asset account under the principles of Rev. Rul. 81-225, 1981-2 C.B. 12, this section will not apply to such account until December 15, 1986.

(ii) This section will not apply to any variable contract to which Rev. Rul. 77-85, 1977-1 C.B. 12, or Rev. Rul. 81-225, 1981-2 C.B. 12, did not apply by reason of the limited retroactive effect of such rulings.

(iii) In determining whether a segregated asset account is adequately diversified for any calendar quarter ending before July 1, 1988, debt instruments that are issued, guaranteed, or insured by the United States or an instrumentality of the United States shall not be treated as government securities if such debt instruments are secured by a mortgage on real property (other than real property owned by the United States or an instrumentality of the United States) or represent an interest in a pool of debt instruments secured by such mortgages.

(iv) This section shall not apply until January 1, 1989, with respect to a variable contract (as defined in section 817(d)) that (1) provides for the payment of an immediate annuity (as defined in section 72(u)(4)); (2) was outstanding on September 12, 1986; and (3) the segregated asset account on which it was based was, on September 12, 1986, wholly invested in deposits insured by the Federal Deposit Insurance Corporation or the Federal Savings and Loan Insurance Corporation.

Lawrence B. Gibbs,
Commissioner of Internal Revenue.

Approved January 26, 1989.

Dennis E. Ross,
Acting Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on March 1, 1989, 8:45 a.m., and published in the issue of the Federal Register for March 2, 1989, 54 F.R. 8728)

Section 818.—Other Definitions And Special Rules

Whether the Service will rule as to whether the purchase of stock of a life insurance subsidiary and its subsequent liquidation under section 334(b)(2) (pre-TEFRA) or section 338 (added by TEFRA) is, in fact, a purchase of the subsidiary's insurance contracts. See Rev. Proc. 89-36, page 919.

Part II.—Other Insurance Companies

Section 831.—Tax On Insurance Companies Other Than Life Insurance Companies

26 CFR 1.831-3: Tax on insurance companies (other than life or mutual), mutual marine insurance companies, mutual fire insurance companies issuing perpetual policies, and mutual fire or flood insurance companies operating on the basis of premium deposits; taxable years beginning after December 31, 1962.

Rev. Rul. 88-72, which holds that a parent corporation and its subsidiaries cannot deduct under section 162 of the Code amounts paid to the parent's wholly owned insurance subsidiary as "insurance premiums" notwithstanding the insurance subsidiary's acceptance of insurance risks from unrelated parties, is clarified. See Rev. Rul. 89-61, page 75.

Part III.—Provisions of General Application

Section 846.—Discounted Unpaid Losses Defined

Insurance companies; loss reserves; discounting unpaid losses. The loss payment patterns and discount factors for calendar year 1989 for each property and casualty business to be used in discounting the deduction for loss reserves for purposes of section 846 of the Code.

Rev. Rul. 89-66

[Rev. Rul. 89-66 was modified and superseded by Rev. Rul. 89-66A, below, this Bulletin.]

Insurance companies; loss reserves; discounting unpaid losses. The loss payment patterns and discount factors for calendar year 1989 for each property and casualty business to be used in discounting the deduction for loss reserves for purposes of section 846 of the Code. Rev. Rul. 89-66 modified and superseded.

Rev. Rul. 89-66A

This revenue ruling modifies and supersedes Rev. Rul. 89-66, 1989-21 I.R.B. 13, which contained erroneous column headings.

For purposes of section 846 of the Internal Revenue Code, the following are the loss payment patterns and discount factors for calendar year 1989 for each property and casualty line of business to be used in discounting the deduction for loss reserves. Section 846 requires all property and casualty loss reserves (unpaid losses and unpaid loss adjustment expenses) for each line of business (as shown on the annual statement approved by the National Association of Insurance Commissioners (NAIC)) to be discounted for federal income tax purposes. The discount factors were determined by using an interest rate for 1989 of 8.16 percent, the interest rate determined under section 846(c).

COMPOSITE SCHEDULE P

Years before current year	Year loss incurred	Loss & loss expense payments to date (000s)	Total losses and loss expense incurred (000s)	Cumulative fraction of loss paid (percent)	Fraction of loss paid during year (percent)	Fraction of loss unpaid, year-end (percent)	Discounted fraction unpaid, year-end (percent)	Reserve discount factor (percent)
AY + 0	1985	27050900	78832067	34.3146	34.3146	65.6854	54.4457	82.8886
AY + 1	1984	42762165	70059326	61.0371	26.7225	38.9629	31.0971	79.8120
AY + 2	1983	46304723	62932278	73.5787	12.5416	26.4213	20.5914	77.9346
AY + 3	1982	46339283	56724398	81.6920	8.1133	18.3080	13.8338	75.5613
AY + 4	1981	44014354	50826873	86.5966	4.9046	13.4034	9.8618	73.5769
AY + 5	1980	41790830	46281924	90.2962	3.6996	9.7038	6.8189	70.2708
AY + 6	1979	38531049	41768331	92.2494	1.9532	7.7506	5.3440	68.9500
AY + 7	1978	33285121	35572301	93.5703	1.3209	6.4297	4.4063	68.5315
AY + 8	1977	29524057	31225532	94.5510	0.9807	5.4490	3.7460	68.7467
AY + 9	1976	26745914	28167858	94.9519	0.4009	5.0481	3.6348	72.0024
AY + 10	Pre 1976	184257188	188825255	NA	0.4009	4.6472	3.5144	75.6244
AY + 11	NA	NA	NA	NA	0.4009	4.2464	3.3843	79.6992
AY + 12	NA	NA	NA	NA	0.4009	3.8455	3.2436	84.3473
AY + 13	NA	NA	NA	NA	0.4009	3.4446	3.0913	89.7439
AY + 14	NA	NA	NA	NA	0.4009	3.0437	2.9267	96.1538
AY + 15	NA	NA	NA	NA	3.0437	0.0000	0.0000	96.1538

AUTOMOBILE LIABILITY

Years before current year	Year loss incurred	Loss & loss expense payments to date (000s)	Total losses and loss expense incurred (000s)	Cumulative fraction of loss paid (percent)	Fraction of loss paid during year (percent)	Fraction of loss unpaid, year-end (percent)	Discounted fraction unpaid, year-end (percent)	Reserve discount factor (percent)
AY + 0	1985	10734519	31281287	34.3161	34.3161	65.6839	57.7769	87.9621
AY + 1	1984	18397279	28217053	65.1992	30.8830	34.8008	30.3732	87.2770
AY + 2	1983	20047428	24986353	80.2335	15.0344	19.7665	17.2159	87.0962
AY + 3	1982	19808529	22243403	89.0535	8.8200	10.9465	9.4479	86.3097
AY + 4	1981	18974882	20225872	93.8149	4.7614	6.1851	5.2670	85.1560
AY + 5	1980	17105852	17717213	96.5493	2.7344	3.4507	2.8530	82.6785
AY + 6	1979	16266022	16633374	97.7915	1.2421	2.2085	1.7939	81.2278
AY + 7	1978	14534843	14766868	98.4287	0.6373	1.5713	1.2776	81.3082
AY + 8	1977	12853464	13027563	98.6636	0.2349	1.3364	1.1375	85.1211
AY + 9	1976	11389407	11506437	98.9829	0.3193	1.0171	0.8983	88.3206
AY + 10	Pre 1976	91306371	91545592	NA	0.3193	0.6978	0.6395	91.6505
AY + 11	NA	NA	NA	NA	0.3193	0.3785	0.3596	95.0199
AY + 12	NA	NA	NA	NA	0.3193	0.0592	0.0569	96.1538
AY + 13	NA	NA	NA	NA	0.0592	0.0000	0.0000	96.1538

OTHER LIABILITY

Years before current year	Year loss incurred	Loss & loss expense payments to date (000s)	Total losses and loss expense incurred (000s)	Cumulative fraction of loss paid (percent)	Fraction of loss paid during year (percent)	Fraction of loss unpaid, year-end (percent)	Discounted fraction unpaid, year-end (percent)	Reserve discount factor (percent)
AY + 0	1985	824218	8957695	9.2012	9.2012	90.7988	67.6821	74.5408
AY + 1	1984	1752555	6901148	25.3951	16.1939	74.6049	56.3634	75.5492
AY + 2	1983	2493908	6222045	40.0818	14.6867	59.9182	45.6885	76.2514
AY + 3	1982	3181315	5762517	55.2070	15.1252	44.7930	33.6864	75.2047
AY + 4	1981	3429366	5180556	66.1969	10.9898	33.8031	25.0058	73.9748
AY + 5	1980	3548964	4724863	75.1125	8.9157	24.8875	17.7740	71.4174
AY + 6	1979	3339115	4162493	80.2191	5.1066	19.7809	13.9135	70.3380
AY + 7	1978	3050437	3610079	84.4978	4.2787	15.5022	10.5990	68.3709
AY + 8	1977	2812829	3245716	86.6628	2.1650	13.3372	9.2122	69.0719
AY + 9	1976	2702169	3081827	87.6807	1.0179	12.3193	8.9053	72.2878
AY + 10	Pre 1976	23480898	25101360	NA	1.0179	11.3013	8.5733	75.8614
AY + 11	NA	NA	NA	NA	1.0179	10.2834	8.2143	79.8791
AY + 12	NA	NA	NA	NA	1.0179	9.2655	7.8259	84.4634
AY + 13	NA	NA	NA	NA	1.0179	8.2475	7.4059	89.7950
AY + 14	NA	NA	NA	NA	1.0179	7.2296	6.9515	96.1538
AY + 15	NA	NA	NA	NA	7.2296	0.0000	0.0000	96.1538

WORKERS' COMPENSATION

Years before current year	Year loss incurred	Loss & loss expense payments to date (000s)	Total losses and loss expense incurred (000s)	Cumulative fraction of loss paid (percent)	Fraction of loss paid during year (percent)	Fraction of loss unpaid, year-end (percent)	Discounted fraction unpaid, year-end (percent)	Reserve discount factor (percent)
AY + 0	1985	3932938	15174769	25.9176	25.9176	74.0824	58.6978	79.2331
AY + 1	1984	7635807	14004437	54.5242	28.6066	45.4758	33.7367	74.1860
AY + 2	1983	8124465	11973169	67.8556	13.3314	32.1444	22.6249	70.3853
AY + 3	1982	8126215	10749254	75.5979	7.7423	24.4021	16.4191	67.2857
AY + 4	1981	8203632	10245226	80.0727	4.4748	19.9273	13.1051	65.7647
AY + 5	1980	7893190	9444281	83.5764	3.5037	16.4236	10.5307	64.1192
AY + 6	1979	7559441	8845526	85.4606	1.8842	14.5394	9.4304	64.8610
AY + 7	1978	6621807	7594942	87.1871	1.7264	12.8129	8.4044	65.5932
AY + 8	1977	5981586	6744498	88.6884	1.5013	11.3116	7.5288	66.5585
AY + 9	1976	5510811	6170361	89.3110	0.6226	10.6890	7.4957	70.1251
AY + 10	Pre 1976	46351166	48577936	NA	0.6226	10.0664	7.4598	74.1060
AY + 11	NA	NA	NA	NA	0.6226	9.4438	7.4210	78.5809
AY + 12	NA	NA	NA	NA	0.6226	8.8211	7.3790	83.6515
AY + 13	NA	NA	NA	NA	0.6226	8.1985	7.3336	89.4505
AY + 14	NA	NA	NA	NA	0.6226	7.5759	7.2845	96.1538
AY + 15	NA	NA	NA	NA	7.5759	0.0000	0.0000	96.1538

MEDICAL MALPRACTICE

Years before current year	Year loss incurred	Loss & loss expense payments to date (000s)	Total losses and loss expense incurred (000s)	Cumulative fraction of loss paid (percent)	Fraction of loss paid during year (percent)	Fraction of loss unpaid, year-end (percent)	Discounted fraction unpaid, year-end (percent)	Reserve discount factor (percent)
AY + 0	1985	85689	2835465	3.0220	3.0220	96.9780	64.0702	66.0668
AY + 1	1984	312207	2404595	12.9838	9.9617	87.0162	58.9382	67.7324
AY + 2	1983	534322	2280478	23.4303	10.4465	76.5697	52.8831	69.0653
AY + 3	1982	745691	2095689	35.5821	12.1519	64.4179	44.5605	69.1741
AY + 4	1981	836834	1839826	45.4844	9.9023	54.5156	37.8982	69.5182
AY + 5	1980	846392	1574497	53.7563	8.2719	46.2437	32.3879	70.0375
AY + 6	1979	800223	1316417	60.7880	7.0316	39.2120	27.7179	70.6872
AY + 7	1978	745973	1109154	67.2560	6.4681	32.7440	23.2529	71.0142
AY + 8	1977	639578	883594	72.3837	5.1277	27.6163	19.8175	71.7603
AY + 9	1976	627818	835753	75.1200	2.7363	24.8800	18.5889	74.7142
AY + 10	Pre 1976	1959501	2323449	NA	2.7363	22.1436	17.2599	77.9453
AY + 11	NA	NA	NA	NA	2.7363	19.4073	15.8225	81.5288
AY + 12	NA	NA	NA	NA	2.7363	16.6709	14.2678	85.5851
AY + 13	NA	NA	NA	NA	2.7363	13.9346	12.5863	90.3242
AY + 14	NA	NA	NA	NA	2.7363	11.1982	10.7675	96.1538
AY + 15	NA	NA	NA	NA	11.1982	0.0000	0.0000	96.1538

FARMOWNERS MULTIPLE PERIL, HOMEOWNERS MULTIPLE PERIL, COMMERCIAL MULTIPLE PERIL, OCEAN MARINE, AIRCRAFT (ALL PERILS) AND BOILER AND MACHINERY

Years before current year	Year loss incurred	Loss & loss expense payments to date (000s)	Total losses and loss expense incurred (000s)	Cumulative fraction of loss paid (percent)	Fraction of loss paid during year (percent)	Fraction of loss unpaid, year-end (percent)	Discounted fraction unpaid, year-end (percent)	Reserve discount factor (percent)
AY + 0	1985	11473534	20582849	55.7432	55.7432	44.2568	38.7743	87.6120
AY + 1	1984	14664316	18532075	79.1294	23.3862	20.8706	17.6166	84.4086
AY + 2	1983	15104598	17470233	86.4591	7.3297	13.5409	11.4313	84.4200
AY + 3	1982	14477532	15873533	91.2055	4.7464	8.7945	7.4278	84.4590
AY + 4	1981	12569638	13335391	94.2577	3.0523	5.7423	4.8595	84.6274
AY + 5	1980	12396429	12821063	96.6880	2.4303	3.3120	2.7286	82.3850
AY + 6	1979	10566246	10810520	97.7404	1.0524	2.2596	1.8567	82.1715
AY + 7	1978	8332059	8491257	98.1252	0.3847	1.8748	1.6081	85.7731
AY + 8	1977	7236609	7324158	98.8047	0.6795	1.1953	1.0327	86.3897
AY + 9	1976	6515706	6573477	99.1212	0.3165	0.8788	0.7878	89.6358
AY + 10	Pre 1976	21159251	21276916	NA	0.3165	0.5624	0.5229	92.9823
AY + 11	NA	NA	NA	NA	0.3165	0.2459	0.2364	96.1538
AY + 12	NA	NA	NA	NA	0.2459	0.0000	0.0000	96.1538

FIRE

Years before current year	Year loss incurred	Net losses paid in year (000s)	Unpaid losses beginning of year (000s)	Fraction of unpaid loss paid in year (percent)	Fraction of total loss paid in year (percent)	Fraction of loss unpaid, year-end (percent)	Discounted fraction unpaid, year-end (percent)	Reserve discount factor (percent)
AY + 0	1985	1182445	2142829	55.1815	55.1815	44.8185	41.8000	93.2650
AY + 1	1984	687222	944426	72.7661	32.6127	12.2058	11.2937	92.5267
AY + 2	Pre 1984	196764	462600	NA	6.1029	6.1029	5.8682	96.1538
AY + 3	NA	NA	NA	NA	6.1029	0.0000	0.0000	96.1538

ALLIED LINES

Years before current year	Year loss incurred	Net losses paid in year (000s)	Unpaid losses beginning of year (000s)	Fraction of unpaid loss paid in year (percent)	Fraction of total loss paid in year (percent)	Fraction of loss unpaid, year-end (percent)	Discounted fraction unpaid, year-end (percent)	Reserve discount factor (percent)
AY + 0	1985	657907	1076282	61.1278	61.1278	38.8722	36.4104	93.6667
AY + 1	1984	297197	388220	76.5538	29.7582	9.1141	8.4330	92.5267
AY + 2	Pre 1984	77676	174175	NA	4.5570	4.5570	4.3818	96.1538
AY + 3	NA	NA	NA	NA	4.5570	0.0000	0.0000	96.1538

INLAND MARINE

Years before current year	Year loss incurred	Net losses paid in year (000s)	Unpaid losses beginning of year (000s)	Fraction of unpaid loss paid in year (percent)	Fraction of total loss paid in year (percent)	Fraction of loss unpaid, year-end (percent)	Discounted fraction unpaid, year-end (percent)	Reserve discount factor (percent)
AY + 0	1985	1101567	1913177	57.5779	57.5779	42.4221	39.7499	93.7008
AY + 1	1984	562321	731477	76.8747	32.6119	9.8102	9.0771	92.5267
AY + 2	Pre 1984	140515	321225	NA	4.9051	4.9051	4.7165	96.1538
AY + 3	NA	NA	NA	NA	4.9051	0.0000	0.0000	96.1538

MISCELLANEOUS CASUALTY

Years before current year	Year loss incurred	Net losses paid in year (000s)	Unpaid losses beginning of year (000s)	Fraction of unpaid loss paid in year (percent)	Fraction of total loss paid in year (percent)	Fraction of loss unpaid, year-end (percent)	Discounted fraction unpaid, year-end (percent)	Reserve discount factor (percent)
AY + 0	1985	185443	216664	85.5901	85.5901	14.4099	13.6211	94.5264
AY + 1	1984	12581	14861	84.6578	12.1991	2.2108	2.0456	92.5267
AY + 2	Pre 1984	1729	4100	NA	1.1054	1.1054	1.0629	96.1538
AY + 3	NA	NA	NA	NA	1.1054	0.0000	0.0000	96.1538

EARTHQUAKE

Years before current year	Year loss incurred	Net losses paid in year (000s)	Unpaid losses beginning of year (000s)	Fraction of unpaid loss paid in year (percent)	Fraction of total loss paid in year (percent)	Fraction of loss unpaid, year-end (percent)	Discounted fraction unpaid, year-end (percent)	Reserve discount factor (percent)
AY + 0	1985	3852	13974	27.5655	27.5655	72.4345	66.1871	91.3751
AY + 1	1984	1654	3010	54.9502	39.8029	32.6316	30.1930	92.5267
AY + 2	Pre 1984	722	1757	NA	16.3158	16.3158	15.6883	96.1538
AY + 3	NA	NA	NA	NA	16.3158	0.0000	0.0000	96.1538

AUTO PHYSICAL DAMAGE

Years before current year	Year loss incurred	Net losses paid in year (000s)	Unpaid losses beginning of year (000s)	Fraction of unpaid loss paid in year (percent)	Fraction of total loss paid in year (percent)	Fraction of loss unpaid, year-end (percent)	Discounted fraction unpaid, year-end (percent)	Reserve discount factor (percent)
AY + 0	1985	13876758	16695051	83.1190	83.1190	16.8810	16.1151	95.4631
AY + 1	1984	1743502	1864945	93.4881	15.7817	1.0993	1.0171	92.5267
AY + 2	Pre 1984	-128871	-44115	NA	0.5496	0.5496	0.5285	96.1538
AY + 3	NA	NA	NA	NA	0.5496	0.0000	0.0000	96.1538

FIDELITY

Years before current year	Year loss incurred	Net losses paid in year (000s)	Unpaid losses beginning of year (000s)	Fraction of unpaid loss paid in year (percent)	Fraction of total loss paid in year (percent)	Fraction of loss unpaid, year-end (percent)	Discounted fraction unpaid, year-end (percent)	Reserve discount factor (percent)
AY + 0	1985	63993	281102	22.7650	22.7650	77.2350	70.2552	90.9630
AY + 1	1984	108652	212771	51.0652	39.4402	37.7947	34.9702	92.5267
AY + 2	Pre 1984	76630	196869	NA	18.8974	18.8974	18.1706	96.1538
AY + 3	NA	NA	NA	NA	18.8974	0.0000	0.0000	96.1538

SURETY

Years before current year	Year loss incurred	Net losses paid in year (000s)	Unpaid losses beginning of year (000s)	Fraction of unpaid loss paid in year (percent)	Fraction of total loss paid in year (percent)	Fraction of loss unpaid, year-end (percent)	Discounted fraction unpaid, year-end (percent)	Reserve discount factor (percent)
AY + 0	1985	322557	869869	37.0811	37.0811	62.9189	57.3625	91.1689
AY + 1	1984	221719	418289	53.0062	33.3509	29.5680	27.3583	92.5267
AY + 2	Pre 1984	29380	252418	NA	14.7840	14.7840	14.2154	96.1538
AY + 3	NA	NA	NA	NA	14.7840	0.0000	0.0000	96.1538

GLASS

Years before current year	Year loss incurred	Net losses paid in year (000s)	Unpaid losses beginning of year (000s)	Fraction of unpaid loss paid in year (percent)	Fraction of total loss paid in year (percent)	Fraction of loss unpaid, year-end (percent)	Discounted fraction unpaid, year-end (percent)	Reserve discount factor (percent)
AY + 0	1985	5330	8021	66.4506	66.4506	33.5494	31.7972	94.7773
AY + 1	1984	1482	1703	87.0229	29.1957	4.3537	4.0284	92.5267
AY + 2	Pre 1984	145	518	NA	2.1769	2.1769	2.0931	96.1538
AY + 3	NA	NA	NA	NA	2.1769	0.0000	0.0000	96.1538

BURGLARY AND THEFT

Years before current year	Year loss incurred	Net losses paid in year (000s)	Unpaid losses beginning of year (000s)	Fraction of unpaid loss paid in year (percent)	Fraction of total loss paid in year (percent)	Fraction of loss unpaid, year-end (percent)	Discounted fraction unpaid, year-end (percent)	Reserve discount factor (percent)
AY + 0	1985	16947	35142	48.2243	48.2243	51.7757	48.6450	93.9533
AY + 1	1984	10304	13001	79.2554	41.0350	10.7406	9.9380	92.5267
AY + 2	Pre 1984	3182	8093	NA	5.3703	5.3703	5.1638	96.1538
AY + 3	NA	NA	NA	NA	5.3703	0.0000	0.0000	96.1538

CREDIT

Years before current year	Year loss incurred	Net losses paid in year (000s)	Unpaid losses beginning of year (000s)	Fraction of unpaid loss paid in year (percent)	Fraction of total loss paid in year (percent)	Fraction of loss unpaid, year-end (percent)	Discounted fraction unpaid, year-end (percent)	Reserve discount factor (percent)
AY + 0	1985	54286	218630	24.8301	24.8301	75.1699	67.6021	89.9324
AY + 1	1984	52253	126369	41.3495	31.0824	44.0875	40.7927	92.5267
AY + 2	Pre 1984	9995	43661	NA	22.0438	22.0438	21.1959	96.1538
AY + 3	NA	NA	NA	NA	22.0438	0.0000	0.0000	96.1538

CREDIT ACCIDENT AND HEALTH (Group and Individual)

Years before current year	Year loss incurred	Net losses paid in year (000s)	Unpaid losses beginning of year (000s)	Fraction of unpaid loss paid in year (percent)	Fraction of total loss paid in year (percent)	Fraction of loss unpaid, year-end (percent)	Discounted fraction unpaid, year-end (percent)	Reserve discount factor (percent)
AY + 0	1985	50544	93229	54.2149	54.2149	45.7851	42.2105	92.1927
AY + 1	1984	26637	42512	62.6576	28.6879	17.0973	15.8195	92.5267
AY + 2	Pre 1984	8295	18171	NA	8.5486	8.5486	8.2198	96.1538
AY + 3	NA	NA	NA	NA	8.5486	0.0000	0.0000	96.1538

Subchapter M.—Regulated Investment Companies and Real Estate Investment Trusts
Part I.—Regulated Investment Companies

Section 851.—Definition of Regulated Investment Company

26 CFR 1.851-1: Definition of regulated investment company.

Whether, for purposes of section 562(c) of the Code, the term "shareholder" refers to the legal owner of the shares of a regulated investment company rather than the beneficial owner of the shares. See Rev. Rul. 89-79, page 172.

Section 852.—Taxation of Regulated Investment Companies and Their Shareholders

26 CFR 1.852-1: Taxation of regulated investment companies.

Nonproportionate designation of dividends paid by regulated investment company with multiple classes of stock. If a regulated investment company has two or more classes of stock and it designates the dividends that it pays on one class as consisting of more than that class' proportionate share of a particular type of income, the designations are not effective for federal tax purposes to the extent that they exceed the class' proportionate share of that type of income. Rev. Ruls. 70-597 and 74-177 modified.

Rev. Rul. 89-81

ISSUE

If a regulated investment company (RIC) has two or more classes of stock and it designates the dividends that it pays on one class as consisting of more than that class' proportionate share of a particular type of income, are the designations of the excess over the class' proportionate share effective for federal tax purposes?

FACTS

Fund is a closed-end diversified management investment company registered under the Investment Company Act of 1940, as amended (15 U.S.C. sections 80a-1 to 80b-2). Fund qualifies as a regulated investment company under section 851 of the Internal Revenue Code.

Fund has issued two classes of stock, one common class and one preferred class.

Holders of the preferred shares are entitled to receive cumulative dividends at a fixed rate. In addition, under the terms of the preferred shares, Fund is required to designate, for purposes of section 854(b)(1) of the Code, the dividends paid on the preferred shares as dividends qualifying for the dividends received deduction under section 243 to the extent that those dividends do not exceed the aggregate dividends received by Fund determined in accordance with section 854.

Holders of the common shares are entitled to receive all income not required to satisfy the claims of the preferred shares. Dividends paid on the common shares are designated by Fund as dividends qualifying for the dividends received deduction only to the extent that the aggregate dividends received by Fund exceed the dividends paid on the preferred shares.

For 1989, without regard to the dividends paid deduction, Fund had investment company taxable income of $100x and net capital gain of $100x. Fund received $50x of aggregate dividends in 1989.

In 1989, Fund paid a total of $30x of dividends to the holders of its preferred stock and a total of $170x of dividends to the holders of its common stock. Fund designated all $30x of dividends paid to the holders of its preferred stock as dividends qualifying for the dividends received deduction. Of dividends paid to the holders of its common stock, Fund designated $20x as dividends qualifying for the dividends received deduction and $100x as capital gain dividends.

LAW

Under section 851(a) of the Code, the term "regulated investment company" includes a domestic corporation that is a management company registered under the Investment Company Act of 1940, as amended.

Under section 851(b) of the Code, the corporation must elect to be treated as a RIC, must derive at least 90 percent of its gross income from dividends, interest, and other specified sources, and must satisfy certain other requirements.

If a corporation meets these requirements, it is treated in certain respects as a conduit entity for tax purposes. Dividends paid by the RIC are generally taxable as ordinary income to the shareholders, and the RIC is allowed a deduction for such dividends in computing its investment company taxable income under sections 852(b)(2)(D) and 561. Dividends designated by the RIC as capital gain dividends are treated as long-term capital gains in the hands of the shareholders, and, in computing its net capital gain, the RIC is allowed a dividends paid deduction for these amounts so that the RIC is taxed only on the excess. Section 852(b)(3) of the Code. Similarly, depending on the types of gross income received by the RIC, appropriate portions of any dividends paid may be designated by the RIC—and consequently taxed to the shareholders—as exempt-interest dividends (section 852(b)(5)) or as dividends qualifying for the dividends received deduction (section 854). *See also* section 853, which permits the RIC to elect to be treated as a conduit for purposes of the foreign tax credit.

ANALYSIS

A corporation registered under the Investment Company Act of 1940 as a closed-end management investment company may have more than one class of stock. The question presented is whether a designation to one class of shareholders of more than that class' proportionate share of a particular type of income is effective for federal tax purposes. The tax treatment of RICs that make such designations has been addressed by the Service in two published revenue rulings.

In Rev. Rul. 70-597, 1970-2 C.B. 146, an investment company issued income shares and capital shares. Holders of the income shares received all net income from the initial investment portfolio of the company, and holders of the capital shares received the benefit of all capital gains. The ruling held that the company could elect to be treated as a RIC and that the dividends paid to the two classes of shareholders qualified for the dividends paid deduction under section 852 of the Code. In addition, the ruling held that undistributed net capital gain designated in respect of the capital shares was treated in accordance with the provisions of section 852(b)(3)(D).

In Rev. Rul. 74-177, 1974-1 C.B. 166, an otherwise qualifying RIC issued common and preferred shares. Holders of the preferred shares enjoyed a preference as to assets and received fixed quarterly cumulative dividends payable out of net investment income. Holders of the common shares generally were entitled to receive distributions of any remaining net investment income. Holders of the common shares also generally received annual distributions of all net short-term capital gain. Long-term capital gains accrued to the benefit of the holders of the common shares. The ruling held that the issuance of the two classes of stock with the rights described above did not prevent the corporation from qualifying as a RIC and that the RIC was entitled to include the amounts paid and designated in accordance with those rights in computing the relevant dividends paid deduction.

The Internal Revenue Service has reconsidered these rulings and has determined that, to the extent that they approve non-proportionate designations of particular types of income, they do not represent proper interpretations of law. The designation of the dividends paid to the holders of one class of stock as consisting of more than that class' proportionate share of a particular type of income is inconsistent with the purposes underlying sections 851 through 855.

RICs are provided special tax treatment to enable small investors to pool their resources and obtain diversification of investment and experienced management without paying the penalty of a second layer of tax. Thus, the RIC vehicle affords small investors the benefits already available to large investors through direct investment in assets.

Although there is no express rule that designations of all RIC distributions must be proportionate, Congress appears to have assumed that designations of distributions are proportionate. One example of this is found in the legislative history of section 854, the section which provides that the dividends designated as qualifying for the shareholders' dividends received deduction may not exceed the aggregate dividends received by the RIC. The Conference Report for this section indicates that Congress intended that each share of stock "have the same designation ... made with respect to it" and that "the RIC cannot designate the same quarterly dividend as being from dividend income for some shareholders and from tax-exempt interest for others." H.R. Conf. Rep. No. 861, 98th Cong., 2d Sess. 815 (1984), 1984-3 (Vol. 2) C.B. 69.

Of similar import is the history of section 852(b)(5), the provision that allows certain RICs to pay exempt-interest dividends to the extent of their tax-exempt interest income. In introducing the amendment that became section 852(b)(5), its sponsor noted that it was "wholly consistent with the concept of a mutual fund, under which the shareholders of the fund are considered, for tax purposes, as the actual owners of the fund's holdings, and the direct recipients of their share of the fund's earnings." 122 Cong. Rec. 26, 111 (1976) (statement of Senator Percy).

A proportionate rule is expressly stated in section 853, which allows an election that enables a RIC's shareholders to qualify for foreign tax credits. Pursuant to this election, each shareholder of the RIC is treated as having paid a proportionate share of the taxes paid by the RIC to a foreign country and as having received a proportionate share of the gross income derived by the RIC from sources within a foreign country. The legislative history of this provision speaks both of the RIC being a conduit and of RIC shareholders being placed in the same position as persons directly owning stock in foreign corporations. H.R. Rep. No. 1337, 83d Cong., 2d Sess. 241 (1954). Although the proportionate rule is explicitly stated with respect to foreign tax credits, there is no indication that proportionate designations were other than the normal rule applicable to RICs.

The only legislative history that is arguably inconsistent concerns section 852(b)(5)(C), which provides that 50 percent of the interest received by a RIC on loans to employee stock ownership plans (ESOPs) may be passed through to shareholders as tax-exempt interest. Citing Rev. Rul. 74-177, the Conference Committee Report states that the conferees "understand that it may be appropriate for a mutual fund to have two classes of stock, one of which would pay exempt-interest dividends and the other of which would pay taxable dividends." 2 H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. II-559 (1986), 1986-3 (Vol. 4) C.B. 559. In isolation, this statement appears to be in conflict with the legislative history of earlier provisions. In context, however, it is only a comment that the Service, in its published rulings, had permitted non-proportionate designations of distributions.

With the exception of this single reference to Rev. Rul. 74-177, there is no evidence in the legislative history that RICs were intended to be other than straight pass-through entities or that designations of distributions to shareholders could be made on other than a proportionate basis.

In the present situation, in 1989 Fund designated to the holders of its preferred stock more than their proportionate share of the dividends qualifying for the dividends received deduction. Fund's preferred stockholders received 15% of the total dividends paid by Fund in 1989. Thus, their proportionate share of the dividends qualifying for the dividends received deduction is $7.5x, 15% of the $50x aggregate dividends received by Fund. Similarly, Fund designated to the holders of its common stock more than their proportionate share of the capital gain dividends. Fund's common shareholders received 85% of the total dividends paid by Fund in 1989. Thus, their proportionate share of the capital gain dividends is $85x, 85% of the $100x net capital gain received by Fund. The designation by Fund of more than these amounts is not effective for federal tax purposes. As a result, Fund's preferred stockholders may treat only $7.5x of the dividends they received as dividends qualifying for the dividends received deduction, and Fund's common stockholders may treat only $85x of the dividends they received as capital gain dividends. In addition, Fund may include only $85x of the dividends it designated as capital gain dividends in computing its dividends paid deduction for purposes of section 852(b)(3)(A).

Analogous principles apply to make ineffective non-proportionate designations of other types of income.

HOLDING

If a regulated investment company has two or more classes of stock and it designates the dividends that it pays on one class as consisting of more than that class' proportionate share of a particular type of income, the designations are not effective for federal tax purposes to the extent that they exceed the class' proportionate share of that type of income.

EFFECT ON OTHER RULINGS

To the extent that they hold that non-proportionate designations are effective for federal tax purposes, Rev. Rul. 70-597, 1970-2 C.B. 146, and Rev. Rul. 74-177, 1974-1 C.B. 166, are modified.

PROSPECTIVE APPLICATION

Under the authority contained in section 7805(b) of the Code, if a RIC makes a non-proportionate designation pursuant to a rule described in a registration statement that was filed with the Securities and Exchange Commission before June 13, 1989, this revenue ruling will not be applied to render the designation ineffective for federal tax purposes.

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26 CFR 1.852-1: Taxation of regulated investment companies.

Whether, for purposes of the dividends paid deduction under section 562 of the Code, the term "shareholder" refers to the legal owner of the shares of a regulated investment company rather than the beneficial owner of the shares. See Rev. Rul. 89-79, page 172.

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26 CFR 1.852-3: Investment company table income.

Whether, for purposes of the dividends paid deduction under section 562 of the Code, the term "shareholder" refers to the legal owner of the shares of a regulated investment company rather than the beneficial owner of the shares. See Rev. Rul. 89-79, page 172.

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 1.861-8T: Computation of taxable income from sources within the United States and from other sources and activities (Temporary)

T.D. 8236

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1

Allocation and Apportionment of Deduction for State Income Taxes

AGENCY: Internal Revenue Service, Treasury.

ACTION: Temporary Regulations.

SUMMARY: This document provides temporary Income Tax Regulations relating to the allocation and apportionment of deductions for state income taxes in computing taxable income from sources inside and outside the United States. The text of the temporary regulations set forth in this document also serves as the text of the proposed regulations * * * [page 1019, this Bulletin].

EFFECTIVE DATES: The rules of §1.861-8T(e)(6)(i) and the language preceding the examples in §1.861-8T)(g) are effective for taxable years beginning after December 31, 1976. The remaining regulations are effective for taxable years beginning on or after January 1, 1988.

SUPPLEMENTARY INFORMATION:

BACKGROUND

This document contains temporary Income Tax Regulations (26 CFR Part 1) under sections 861(b), 862(b), and 863(a) of the Internal Revenue Code of 1986. The temporary regulations are issued under the authority contained in section 7805 (26 U.S.C. 7805) of the Internal Revenue Code of 1986.

Sections 861(b) and 862(b) of the Code provide that, in determining taxable income attributable to items of United States source income enumerated in section 861(a) and foreign source income enumerated in section 862(a), deductions must be properly allocated and apportioned to such income. In addition, section 863(a) provides that deductions must be properly allocated and apportioned to items of income not described in section 861(a) or 862(a) in order to compute taxable income under section 863. The allocation and apportionment of deductions is fundamental to the computation of taxable income of foreign corporations under section 882 and the foreign tax credit limitation under section 904(a) of the Code. Questions have recently arisen about the allocation and apportionment of the deduction for state taxes in situations not explicitly addressed by the current regulations. The temporary regulations promulgated herein provide guidance with respect to these questions.

NEED FOR TEMPORARY REGULATIONS

Because of the significant number of taxpayers needing immediate guidance for purposes of filing income tax returns, the Internal Revenue Service has found it to be impractical to issue these temporary regulations after the notice and public comment procedure under section 553(b) of title 5 of the United States Code or subject to the effective date limitation of subsection (d) of that section.

DISCUSSION

§1.861-8

This document revises §1.861-8 by reserving paragraph (e) of §1.861-8, the language of §1.861-8(g) that precedes the examples, and Examples (25) and (26) of paragraph (g) of §1.861-8.

§1.861-8T(e)(6)

Paragraph (e)(6)(i) of §1.861-8T as promulgated herein restates the previously promulgated general principle that state, local, and foreign income, war profits and excess profits taxes are definitely related and allocable to the gross income with respect to which such taxes are imposed. Paragraph (e)(6)(i) also clarifies that the deduction for a state franchise tax that is computed based on income is to be allocated in the same manner as an income tax. Paragraph (e)(6)(ii) also cites five examples illustrating the application of the general principle for allocation of that deduction, and provides that taxpayers may use another method of allocation or apportionment if shown to the satisfaction of the district director that such method produces a more accurate result. This allocation and apportionment is necessary because states may tax income that is foreign source under the Internal Revenue Code provided the income is attributable to activities performed in the state. *Mobil Oil Corp. v. Commissioner of Taxes*, 445 U.S. 425 (1980). Paragraph (e)(6)(iii) of §1.861-8T provides that the regulations in paragraph (e)(6)(i) are effective for all taxable years beginning after December 31, 1976, and that the regulations in paragraph (e)(6)(ii) and *Examples* (25) through (29) of §1.861-8T(g) are effective for taxable years beginning on or after January 1, 1988. This paragraph also provides taxpayers with the option to apply the regulations to deductions for state tax incurred in taxable years beginning before January 1, 1988.

§1.861-8T(g)

Paragraph (g) of §1.861-8T as promulgated herein first restates the previously promulgated language that precedes the examples in §1.861-8(g), and supplements that language to clarify that the examples do not establish as substantive rules the particular methods of allocation set forth therein. Because the application of the general rule is inherently factual in nature and an allocation must be reasonable under all the facts and circumstances, this paragraph provides that the methods of allocation illustrated in the examples may not be used if the result is not a reasonable allocation, under all of the facts and circumstances, of the deduction to the gross income to which it relates.

Paragraph (g) of §1.861-8T then provides five examples, Examples (25) through (29), that illustrate the general rule for allocation and apportionment of the deduction for state income tax.

EXAMPLES (25) AND (26)

Examples (25) and (26) of §1.861-8T (g) are modifications of previously promulgated examples. The modification to each example provides that for purposes of allocating the deduction for state taxes neither U.S. nor foreign source income is reduced by the amount of the state income tax deduction being allocated. Example (25) provides that the deduction for state income taxes is allocable to a class of income that includes foreign source income when the laws of the states imposing tax on the taxpayer do not specifically exempt foreign source income, and the total amount of income taxed by the states, as determined under state law, exceeds the amount of U.S. source income for Federal income tax purposes. Example (26) describes the allocation and apportionment of state income tax when one (but not all) of the states imposing an income tax on the taxpayer explicitly exempts foreign source income. If, under the facts of Examples (25) and (26), the total amount of state taxable incomes is less than or equal to the amount of U.S. source income for Federal income tax purposes, none of the state income tax is allocable to a class of income that includes foreign source income.

EXAMPLE (27)

Example (27) of §1.861-8T(g) indicates that when a taxpayer conducts income producing operations in a state that does not impose an income tax, an adjustment is necessary before the allocation and apportionment methods contained in Examples (25) and (26) may be applied. Examples (25) and (26) determine whether foreign source income is taxed by states by comparing total state taxable incomes with U.S. source taxable income for Federal income tax purposes. Without an adjustment, this comparison may be inaccurate when the taxpayer has significant activities in a state that does not impose a tax computed on income attributable to activities in that state.

Example (27) provides that the allocation and apportionment of state income taxes is to be made by first making a reasonable estimate of the taxable income attributable to activities in states that do not impose a tax computed on state taxable income and subtracting this estimated amount from U.S. source taxable income for Federal income tax purposes. The taxpayer must then apply the allocation and apportionment methods described in Example (26) by comparing total state taxable incomes in states that imposed an income tax with the reduced amount of U.S. source taxable income for Federal income tax purposes. Example (27) of the temporary regulations provides a method that will be deemed to produce a reasonable estimate of the taxable income attributable to activities in a state that does not define state taxable income.

EXAMPLE (28)

Example (28) of §1.861-8T(g) provides for the allocation and apportionment of the deduction for a state income tax imposed by a state that defines a corporation's business income to include dividends from noncontrolled companies ("portfolio dividends") and that determines the corporation's state taxable income by apportioning the corporation's business income based upon a ratio of its factors in the state to those outside the state. Under state law, the factors used to compute the ratio used to apportion income to the state do not include factors attributable to corporations paying portfolio dividends. In such a situation, a portion of the state tax is definitely related to the portfolio dividends and must be allocated to the classes of gross income consisting of foreign source and U.S. source portfolio dividends, respectively. Any remaining tax is to be allocated and apportioned separately under the principles illustrated in the other examples of §1.861-8T(g).

EXAMPLE (29)

Example (29) of §1.861-8T(g) illustrates the allocation and apportionment of the deduction for state income taxes when a state imposes an income tax on a worldwide unitary basis. Under this example, an appropriate portion of unitary tax is first allocated to the taxpayer's portfolio dividends in the manner described in Example (28). An appropriate portion of unitary tax is then allocated to state taxable income attributable to the inclusion, under state tax rules, of controlled foreign corporations (CFCs) and "80/20" companies as defined in section 861(c)(1) in the unitary group. The state tax imposed on such income is apportioned on the basis of the income earned by the CFCs and the 80/20 companies. The state tax remaining after reduction for tax attributable to portfolio dividends and tax attributable to the inclusion of other related companies in the unitary group is added to the state tax imposed by the other states and apportioned under the principles illustrated in Examples (25) through (27).

SPECIAL ANALYSES

It has been determined that this temporary rule is not a major legislative regulation subject to Executive Order 12291. Accordingly, a Regulatory Impact Analysis is not required. A general notice of proposed rulemaking is not required by 5 U.S.C. §553 for temporary regulations. Accordingly, these temporary regulations do not constitute regulations subject to the Regulatory Flexibility Act (5 U.S.C. Chapter 6).

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Adoption of amendments to the regulations

Accordingly, 26 CFR Part 1 is amended as follows:

INCOME TAX REGULATIONS
(26 CFR Part I)

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

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

Par. 2. Section 1.861-8(e)(6) and the introductory text of paragraph (g) and *Examples* (25) and (26) are revised to read as follows:

§1.861-8. Computation of taxable income from sources within the United States and from other sources and activities.

* * * * * *

(e) *Allocation and apportionment of certain deductions.*

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(6) *Income taxes.* (Reserved) For guidance see §1.861-8T (e)(6).

* * * * * *

(g) *General examples.* (Reserved) For guidance see §1.861-8T(g).

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Example (25)—Income Taxes. (Reserved) For guidance see §1.861-8T(g) *Examples* (25) through (29).

Example (26)—Income Tax. (Reserved) For guidance see §1.861-8T(g) *Examples* (25) through (29).

Par. 3. Section 1.861-8T is amended by adding paragraph (e)(6), the introductory text of paragraph (g), and *Examples* (25) - (29), to read as follows:

§1.861-8T Computation of taxable income from sources within the United States and from other sources and activities (Temporary).

* * * * * *

(6) *Income taxes—(i) In general.* The deduction for state, local, and foreign income, war profits and excess profits taxes allowed by section 164 shall be considered definitely related and allocable to the gross income with respect to which such taxes are imposed. For example, if a domestic corporation is subject to state income tax and such state income tax is imposed in part on an amount of foreign source income, that

part of the taxpayer's state income tax attributable to foreign source income is definitely related and allocable to foreign source income. A state franchise tax that is computed on the basis of income attributable to business activities conducted within the state must be allocated and apportioned in the same manner as an income tax.

(ii) *Methods of allocation and apportionment. Examples* (25) through (29) of paragraph (g) of this section illustrate the application of this paragraph (e)(6). Taxpayers may utilize methods of allocation or apportionment other than those illustrated in these examples if it is established to the satisfaction of the District Director upon examination that a different method yields a more accurate allocation and apportionment of state taxes, based on the factual relationship of the state tax to the income on which the tax is imposed.

(iii) *Effective dates.* The rules of §1.861-8T(e)(6)(i) are effective for taxable years beginning after December 31, 1976. The rules of §1.861-8T(e)(6)(ii) and *Examples* (25) through (29) of §1.861-8T(g) are effective for taxable years beginning on or after January 1, 1988. At the option of the taxpayer, however, the rules of §1.861-8T (e)(6)(ii) and *Examples* (25) through (29) of §1.861-8T(g) may be applied with respect to deductions for state taxes incurred in taxable years beginning before January 1, 1988.

* * * * * *

(g) *General examples.* The following examples illustrate the principles of this section. In each example, unless otherwise specified, the operative section which is applied and gives rise to the statutory grouping of gross income is the overall limitation to the foreign tax credit under section 904(a). In addition, in each example, where a method of allocation or apportionment is illustrated as an acceptable method, it is assumed that such method is used by the taxpayer on a consistent basis from year to year (except in the case of the optional method for apportioning interest under paragraph (e)(2)(vi) of this section or the optional method for apportioning research and development expense under paragraph (e)(3)(iii) of this section). Further, it is assumed that each party named in each example operates on a calendar year accounting basis and, where the party is a U.S. taxpayer, files returns on a calendar year basis. The examples contained in this section illustrate the general rule that a deduction must be allocated to the class of gross income with respect to which the deduction is factually related. The application of this general rule is inherently factual in nature. These illustrations of this inherently factual rule are presented as examples because the particular methods of allocation utilized merely illustrate in particular factual situations the regulatory rule requiring an allocation that is reasonable under all the facts and circumstances. These examples do not establish as substantive rules the particular methods of allocation therein set forth. Thus, these particular methods of allocation may not be used if the result is not a reasonable allocation, under all of the facts and circumstances of the particular case, of the deduction to the class of gross income to which it relates.

* * * * * *

Example (25)—Income Taxes—(i) *Facts.* X, a domestic corporation, is a manufacturer and distributor of electronic equipment with operations in states A, B, and C. X also has a branch in country Y which manufactures and distributes the same type of electronic equipment. In 1988, X has taxable income from these activities, as determined under the Code (without taking into account the deduction for state taxes), of $1,000,000, of which $200,000 is foreign source general limitation income subject to a separate limitation under section 904(d)(1)(I) ("general limitation income") and $800,000 is domestic source income. States A, B, and C each determine X's income subject to tax within their state by making adjustments to X's taxable income as determined under the Code, and then apportioning the adjusted taxable income on the basis of the relative amounts of payroll, property, and sales with respect to each state as compared to worldwide payroll, property, and sales of the taxpayer. The adjustments made by states A, B, and C all involve adding and subtracting enumerated items from taxable income as determined under the Code. However, in making these adjustments to taxable income, none of the states specifically exempts foreign source income as determined under the Code. On this basis, it is determined that X has taxable income of $550,000, $200,000, and $200,000 in states A, B, and C, respectively. The corporate tax rates in states A, B, and C are 10 percent, 5 percent, and 2 percent, respectively, and X has total state income tax liabilities of $69,000 ($55,000 + $10,000 + $4,000), which it deducts as an expense for Federal income tax purposes.

(ii) *Allocation.* X's deduction of $69,000 for state income taxes is definitely related and thus allocable to the gross income with respect to which the taxes are imposed. Presumptively, states A, B, and C only tax income from domestic sources. However, since the statutes of states A, B, and C do not specifically exempt foreign source income (as determined under the Code) from taxation and since, in the aggregate, states A, B, and C tax $950,000 of X's income while only $800,000 is domestic source income under the Code, it is presumed that state income taxes are imposed on $150,000 of foreign source income. The deduction for state income taxes is therefore related and allocable to both X's foreign source and domestic source income.

(iii) *Apportionment.* For purposes of computing the foreign tax credit limitation, X's income is comprised of one statutory grouping, foreign source general limitation gross income, and one residual grouping, gross income from sources within the United States. The state income tax deduction of $69,000 must be apportioned between these two groupings. Corporation X calculates the apportionment on the basis of relative amounts of foreign source general limitation taxable income and U.S. source taxable income subject to state taxation. In this case, state income taxes are imposed on $800,000 of domestic source income and $150,000 of foreign source general limitation income.

State income tax deduction apportioned to foreign source general limitation income (statutory grouping): $69,000 × ($150,000/$950,000)	$10,895
State income tax deduction apportioned to income from sources within the United States (residual grouping): $69,000 × ($800,000/$950,000)	$58,105
Total apportioned state income tax deduction	$69,000

Example (26)—Income Taxes—(i) *Facts.* Assume the same facts as in *Example* (25) except that state A's statute exempts from taxation all foreign source income, as determined under the Code, so that foreign source income is not included in adjusted taxable income subject to apportionment in state A (and factors relating to X's country Y branch are not taken into account in computing the state A apportionment fraction).

(ii) *Allocation.* X's deduction of $69,000 for state income taxes is definitely related and thus allocable to the gross income with respect to which the taxes are imposed. Since state A exempts all foreign source income by statute, state A is presumed to impose tax on $550,000 of X's $800,000 of domestic source income. X's state A tax of $55,000 is allocable, therefore, solely to domestic source income. Since the statutes of states B and C do not specifically exclude all foreign source income as determined under the Code, and since states B and C impose tax on $400,000 ($200,000 + $200,000) of X's income of which only $250,000 ($800,000 − $550,000) is presumed to be domestic source, the deduction for the $14,000 of income taxes imposed by states B and C is related and allocable to both X's foreign source and domestic source income.

(iii) *Apportionment.* For purposes of computing the foreign tax credit limitation, X's income is comprised of one statutory grouping, foreign source general limitation gross income, and one residual grouping, gross income from sources within the United States. The deduction of $14,000 for income taxes of states B and C must be apportioned between these two groupings. Corporation X calculates the apportionment on the basis of relative amounts of foreign source general limitation income and U.S. source income subject to state taxation.

States B and C income tax deduction apportioned to foreign source general limitation income (statutory grouping): $14,000 × ($150,000/$400,000)	$ 5,250
States B and C income tax deduction apportioned to income from sources within the United States (residual grouping): $14,000 × ($250,000/$400,000)	$ 8,750
Total apportioned state income tax deduction	$14,000

Of X's total income taxes of $69,000, the amount allocated and apportioned to foreign source general limitation income equals $5,250. The total amount of state income taxes allocated and apportioned to U.S. source income equals $63,750 ($55,000 + $8,750).

Example (27)—Income Tax—(i) *Facts.* Assume the same facts as in *Example* (25) except that state A, in which X has significant income producing activities, does not impose a corporate income tax or other state tax imposed on income derived from business activities conducted in state A. X therefore has a total state income tax liability in 1988 of $14,000 ($10,000 paid to state B plus $4,000 paid to state C), all of which is subject to allocation and apportionment under paragraph (b) of this section.

(ii) *Allocation.* (A) X's deduction of $14,000 for state income taxes is definitely related and allocable to the gross income with respect to which the taxes are imposed. An adjustment is necessary, however, before the aggregate state taxable incomes can be compared with U.S. source income on the Federal income tax return in the manner described in *Examples* (25) and (26). Unlike the facts in *Examples* (25) and (26), state A imposes no income tax and does not define taxable income attributable to activities in state A. The total amount of X's income subject to state taxation is, therefore, $400,000 ($200,000 in state B and $200,000 in state C). This total presumptively does not include any income attributable to activities performed in state A and therefore can not properly be compared to total U.S. source income reported by X for Federal income tax purposes, which does include income attributable to state A activities. Under these facts, the application of the method used in *Examples* (25) and (26), which compares total state taxable incomes with total U.S. source income for Federal income tax purposes, would presume that states B and C are taxing U.S. source income attributable to state A before taxing any foreign source income, a result which may or may not be warranted depending on the particular facts.

(B) Before applying the method used in *Examples* (25) and (26) to the facts of this example, it is necessary to estimate the amount of income that state A could reasonably attribute to X's activities in state A. The rules of the Uniform Division of Income for Tax Purposes Act ("UDITPA") attribute income to a state on the basis of the average of three ratios that are based upon the taxpayer's facts — property within the state over total property, payroll within the state over total payroll, and sales with n the state over total sales — and may be used, with adjustments, for this purpose. In order to estimate U.S. source income derived from state A activities, the taxpayer's UDITPA factors must be adjusted to eliminate taxable income and any factors attributable to a foreign branch. In this example all taxable income as well as UDITPA apportionment factors (property, payroll, and sales) attributable to X's country Y branch must be eliminated.

(C) Since it is presumed that state A would not attempt to tax the income derived by X's country Y branch, a reasonable estimate of the income that would be taxed by state A if state A had an income tax equals Federally defined taxable income (before deduction for state income taxes) less income derived by X's country Y branch, multiplied by the average of the taxpayer's state A property, payroll, and sales ratios, determined using the principles of UDITPA (adjusted to eliminate the country Y branch factors). The amount so determined is presumed to be imposed exclusively on U.S. source income and the allocation and apportionment method described in *Example* (26) must be applied. If, for example, state A taxable income is determined to equal $550,000, then $550,000 of U.S. source income for Federal income tax purposes is presumed to constitute state A taxable income. The remaining $250,000 of U.S. source income for Federal income tax purposes is presumed to be subject to tax in states B and C. Since states B and C impose tax on $400,000, of which $150,000 is presumed to be foreign source income and $250,000 is presumed to be domestic source income, the deduction for the $14,000 of income taxes of states B and C is related and allocable to both X's foreign source and domestic source income and is subject to apportionment

(iii) *Apportionment.* The deduction of $14,000 for income taxes of states B and C is apportioned in the same manner as in *Example* (26). As a result, $5,250 of the $14,000 of state B and state C income taxes is apportioned to foreign source general limitation income ($14,000 × $150,000/$400,000), and $8,750 ($14,000 × $250,000/$400,000) of the $14,000 of state B and state C income taxes is apportioned to U.S. source income.

Example (28)—Income Tax—(i) *Facts.* (A) Assume the same facts as in *Example* (25) (X has $1,000,000 of taxable income for Federal income tax purposes, $800,000 of which is U.S. source income and $200,000 of which is foreign source general limitation income), except that $100,000 of X's $200,000 of foreign source general limitation income consists of dividends from controlled foreign corporations ("CFCs") in which X owns stock representing 10 to 50 percent of the vote and value in such corporations. The income derived by the CFCs paying the dividends consists entirely of foreign source general limitation income.

(B) State A taxable income is computed by first making adjustments to X's Federal taxable income. These adjustments result in X having a total of $1,100,000 of apportionable taxable income for state A tax purposes. None of the $100,000 of adjustments made by state A relate to the dividends paid by the CFCs. As in *Example* (25), the amount of apportionable taxable income attributable to business activities conducted in state A is determined by multiplying apportionable taxable income by a fraction (the "state apportionment fraction") that compares the relative amounts of X's payroll, property, and sales within state A with X's worldwide payroll, property and sales. An analysis of state A law indicates that state A includes "portfolio dividends" in its definition of the taxable income of X which is apportionable to X's state A activities. However, the factors of the corporations paying those dividends are not included in the state A apportionment fraction for purposes of apportioning income to the state. Portfolio dividends are defined under state A law as any dividends paid from less than 50 percent owned subsidiaries. The dividends received by X from the 10 to 50 percent owned controlled foreign corporations, therefore, are considered to be portfolio dividends for state A tax purposes. The comparison of X's state A factors with X's worldwide factors results in a state apportionment fraction of 50 percent. Applying this fraction to apportionable taxable income of $1,100,000, as determined under state law, results in attributing 50 percent of apportionable taxable income to state A, and produces total state A taxable income of $550,000. State A imposes an income tax at a rate of 10 percent on the amount of income that is attributed to state A, which results in $55,000 of tax imposed by state A.

(ii) *Allocation.* (A) States A, B, and C impose income taxes of $69,000 which must be allocated to the classes of income upon which the taxes are imposed. A portion of X's Federal income tax deduction of $55,000 for state A income tax is definitely related and thus allocable to the class of gross income consisting of foreign source portfolio dividends. A definite relationship exists between a deduction for state income tax and portfolio dividend income when a state includes portfolio dividends in state taxable income apportionable to the state on the basis of an apportionment fraction that excludes the factors of the corporations paying the dividends. By applying a state apportionment fraction that excludes factors of the corporations paying portfolio dividends to apportionable taxable income that includes the $100,000 of foreign source portfolio dividends, $50,000 (50 percent of the $100,000) of the portfolio dividends is attributed to X's activities in state A and subjected to state A income tax. Applying the state A income tax rate of 10 percent to the $50,000 of foreign source portfolio dividends subjected to state A income tax, $5,000 of X's $55,000 total state A income tax liability is definitely related and allocable to a class of income consisting of the foreign source portfolio dividends. (If a state imposes a graduated tax rate, the average effective state tax rate for the taxpayer for the taxable year may be utilized to determine the amount of tax attributable to the portfolio dividends.) Since under the look-through rules of section 904 (d)(3) the foreign source portfolio dividends are included within the general limitation described in section 904 (d)(1)(I), the $5,000 of state A tax on foreign source portfolio dividends is allocated entirely to foreign source general limitation income and, therefore, is not apportioned. [If the total amount of state A tax imposed on foreign source portfolio dividends were to exceed the actual amount of X's state A income tax liability (for example, due to net operating losses), the actual amount of state A tax would be entirely allocated to the foreign source portfolio dividends.] After allocation of a portion of the state A tax to portfolio dividends, $50,000 ($55,000 − $5,000) of state A tax remains to be allocated.

(B) A total of $64,000 (the aggregate of the $50,000 remaining state A tax, and the $10,000 and $4,000 of taxes imposed by states B and C, respectively) is to be allocated as provided in *Example* (25), by comparing U.S. source taxable income, as determined under the Code, with the aggregate of the state taxable incomes determined by states A, B, and C, after reducing state apportionable taxable incomes by the amount of any portfolio dividends to which tax has been specifically allocated. X's state A taxable income, after reduction by the $50,000 of portfolio dividends taxed by the state, equals $500,000. X also has taxable income of $200,000 and $200,000 in states B and C, respectively. In the aggregate, therefore, states A, B, and C tax $900,000 of X's income, after excluding state taxable income attributable to portfolio dividends. Since X has only $800,000 of U.S. source taxable income for Federal income tax purposes, it is presumed that state income taxes are imposed on $100,000 of foreign source income. The remaining deduction of $64,000 for state income taxes is therefore related and allocable to both X's foreign source and domestic source income and is subject to apportionment.

(iii) *Apportionment.* For purposes of computing the foreign tax credit limitation, there is one statutory grouping, foreign source general limitation income, and one residual grouping, gross income from sources within the United States. The remaining state income tax deduction of $64,000 must be apportioned between these two groupings on the basis of relative amounts of foreign source general limitation taxable income and U.S. source taxable income subject to state taxation. In this case, the $64,000 of state income taxes is considered to be imposed on $800,000 of domestic source income and $100,000 of foreign source general limitation income and is apportioned as follows:

State income tax deduction apportioned to foreign source general limitation income (statutory grouping):

$64,000 × ($100,000/$900,000).... $ 7,111

State income tax deduction apportioned to income from sources within the United States (residual grouping):

$64,000 × ($800,000/$900,000) ... $56,889

Total apportioned state income tax deduction........................ $64,000

Of the total state income taxes of $69,000, the amount allocated and apportioned to foreign source general limitation income equals $12,111 ($5,000 + $7,111). The total amount of state income taxes allocated and apportioned to U.S. source income equals $56,889.

Example (29)—Income Taxes—(i) *Facts.* (A) P, a domestic corporation, is a manufacturer and distributor of electronic equipment with operations in states F, G, and H. P also has a branch in country Y which manufactures and distributes the same type of electronic equipment. In addition, P has three wholly owned subsidiaries, US1, US2, and FS, the latter a controlled foreign corporation ("CFC") as defined in section 957 (a) of the Code. P also holds interests ranging from 10 to 50 percent ownership in various controlled foreign corporations.

(B) In 1988, P derives $1,000,000 of Federal taxable income (without taking into account the deduction for state income taxes), which consists of $250,000 of foreign source general limitation income and $750,000 of U.S. (domestic) source income. The foreign source general limitation income consists of a $25,000 subpart F inclusion with respect to FS, $150,000 of dividends from other CFCs in which P owns stock representing 10 to 50 percent of the vote and value, and $75,000 of manufacturing and sales income derived by P's U.S. operations and country Y branch. The $750,000 of U.S. source income consists of manufacturing and sales income derived by P's U.S. operations.

(C) For Federal income tax purposes, US1 derives $75,000 of taxable income, before deduction for state income taxes, which consists entirely of U.S. source income. US2, a so-called "80/20" corporation described in section 861(c)(1), derives $250,000 of Federal taxable income before deduction for state or foreign income taxes, all of which is derived from foreign operations and consists entirely of foreign source general limitation income. FS is not engaged in a U.S. trade or business and derives $550,000 of foreign source general limitation income before deduction for foreign income taxes.

(D) State F imposes a corporate income tax of 10 percent on P's state F taxable income, which is determined on the basis of a worldwide unitary apportionment. State F determines P's taxable income for state F tax purposes by first making adjustments to the taxable income, as determined for Federal income tax purposes, of the members of the unitary group to determine the unitary business income of the group. State F then attributes a portion of that unitary business income to activities of P that are conducted in state F by multiplying the unitary business income (adjusted Federal taxable income) of the unitary group by a fraction (the "state apportionment fraction") that compares the relative amount of the unitary group's payroll, property, and sales (the "factors") in state F with the payroll, property, and sales of the unitary group. P is the only member of its unitary group that has state F factors and that is thereby subject to state F income tax and filing requirements. State F defines the unitary group to include any corporation more than 50 percent of which is directly or indirectly owned by a state F taxpayer and is engaged in the same unitary business. P's unitary group, therefore, includes P, US1, US2, and FS, but does not include the 10 to 50 percent owned CFCs. The unitary business income of the unitary group excludes intercompany dividends between members of the unitary group and subpart F inclusions with respect to a member of the unitary group. Dividends paid from nonmembers of the unitary group (the 10 to 50 percent owned CFCs) are referred to as portfolio dividends for state F tax purposes and are included in unitary income. None of the factors (in state F or worldwide) of the corporations paying portfolio dividends are included in the state F apportionment fraction for purposes of apportioning unitary business income to P's state F activities.

(E) After adjustments to Federal taxable income, the unitary business income of P's unitary group equals $2,000,000, consisting of $1,050,000 of P's income ($100,000 of foreign source manufacturing and sales income, $150,000 of foreign source portfolio dividends, and $800,000 of U.S. source manufacturing and sales income, but excluding the $25,000 subpart F inclusion attributable to FS since FS is a member of the unitary group), $100,000 of US1's income (from sales made in the United States), $275,000 of US2's income (from an active business outside the United States), and $575,000 of FS's income. The differences between Federal taxable income and state F apportionable taxable income for P, US1, US2, and FS represent adjustments to Federal taxable income pursuant to the tax laws of state F.

(F) The Federal and state taxable income for each member of the unitary group is summarized in the following table. (The items of income listed in the "Federal" column of the table refer to taxable income before deduction for state income tax.)

		Federal	State F
P			
	U.S. source income	$ 750,000	$ 800,000
	Foreign source general limitation income:		
	Portfolio dividends	150,000	150,000
	Subpart F income	25,000	0
	Manufacturing and sales income	75,000	100,000
	Total taxable income	$1,000,000	$1,050,000
US1			
	U.S. source income	$ 75,000	100,000
US2			
	Foreign source general limitation income	$ 250,000	275,000
FS			
	Foreign source general limitation income	$ 550,000	575,000
	Unitary business income		$2,000,000

(G) P's state F taxable income equals $500,000, which is determined by multiplying the group's unitary business income ($2,000,000) by the group's state F apportionment fraction, which equals 25 percent in these facts. P's state F taxable income is multiplied by the state F tax rate of 10 percent, resulting in a state F tax liability of $50,000. State G and state H, unlike state F, do not tax portfolio dividends. Although state G and state H apportion taxable income to those states on the basis of an apportionment fraction that compares state factors to total factors, state G and state H, unlike state F, do not tax on a unitary basis and only consider P's taxable income and factors in computing P's taxable income. P's taxable income under state G law equals $300,000, which is subject to a 5 percent tax rate resulting in a state G tax liability of $15,000. P's taxable income under state H law is $300,000, which is subject to a tax rate of 2 percent resulting in a state H tax liability of $6,000. P has a total Federal income tax deduction for state income taxes of $71,000 ($50,000 + 15,000 + 6,000).

(ii) *Allocation.* (A) P's deduction of $71,000 for state income taxes is definitely related and allocable to the gross income with respect to which the taxes are imposed. Adjustments may be necessary, however, before aggregate state taxable incomes can be compared with U.S. source income on the Federal income tax return in the manner described in *Examples* (25) and (26). In allocating P's deduction for state income taxes, it is necessary first to determine the portion, if any, of the deduction that is definitely related and allocable to a particular class of gross income. A definite relationship exists between a deduction for state income tax and dividend income when a state includes portfolio dividends in state taxable income apportionable to the state on the basis of an apportionment fraction (whether or not calculated on a unitary basis) that excludes the factors of the corporations paying portfolio dividends.

(B) In this case, $150,000 of foreign source portfolio dividends are subject to a state F apportionment fraction of 25 percent, which results in a total of $37,500 of state F taxable income attributable to such dividends. As illustrated in *Example* (28), $3,750 ($150,000 × 25 percent state F apportionment percentage × 10 percent state F tax rate) of P's state F income tax is definitely related and allocable to a class of gross income consisting entirely of the foreign source portfolio dividends. Since under the look-through rules of section 904(d)(3) the foreign source portfolio dividends are included within the general limitation described in section 904(d)(1)(I), the $3,750 of state F tax on foreign source portfolio dividends is allocated entirely to foreign source general limitation income and, therefore, is not apportioned.

(C) After reducing state F taxable income of the unitary group by the taxable income attributable to portfolio dividends, state F taxes P on $462,500 ($500,000 − $37,500), the income of a unitary group that includes P and other affiliated companies. Accordingly, in order to allocate and apportion the remaining $46,250 of state F tax ($50,000 of state F tax minus the $3,750 of state F tax allocated to foreign source portfolio dividends), it is necessary first to determine if state F is taxing only P's separate company income or is imposing its tax partly on income of other members of the unitary group. If state F is taxing income of other members of the unitary group, a portion of the state F tax must be allocated and apportioned on the basis of the income of the other members of the group subject to state F taxation. In order to determine if state F is taxing only P's separate company income, it is necessary to compute P's separate company taxable income using only P's income (excluding portfolio dividends) and state F apportionment factors. If P's separate company taxable income equals or exceeds the $462,500 of remaining state F taxable income, it is presumed that state F is only taxing P's separate company income and the entire amount of the remaining state F tax should be allocated and apportioned in the manner described in *Example* (25).

(D) If P's separate company taxable income is less than the $462,500 of remaining state F taxable income (after reduction for the $37,500 of state F taxable income attributable to portfolio dividends), it is presumed that state F is taxing the income of other affiliates included in the unitary group. In such a case, it is necessary to determine if the state is imposing tax in part on the foreign source income of foreign affiliates and 80/20 companies included in the unitary group or is limiting its taxation to U.S. source income of domestic members of the unitary group.

(E) Assume for purposes of this example that P's separate company taxable income equals $396,000, computed by multiplying P's state F taxable income of $900,000 (P's state F taxable income (before state F apportionment) of $1,050,000 less the $150,000 of foreign source portfolio dividends) by P's separate company state F apportionment fraction of 44 percent. Because P's separate company taxable income of $396,000 is less than the $462,500 of remaining state F taxable income, state F is presumed to be taxing the income of P's affiliates that are included in the unitary group. To determine if state F tax is being imposed on members of the unitary group (other than P) that produce foreign source income, it is necessary to compute a hypothetical state F taxable income for all companies in the unitary group with significant U.S. operations. (For this purpose, the hypothetical group of companies with significant domestic operations is referred to as the "water's edge group.") State F is presumed to be taxing income of foreign corporations and 80/20 companies to the extent that the remaining state F taxable income ($462,500) exceeds the hypothetical state F taxable income for the water's edge group.

(F) The members of the water's edge group are P and US1. The unitary business income of this water's edge group equals $1,000,000, the sum of $900,000 (P's state F taxable income (before state F apportionment) of $1,050,000 less the $150,000 of foreign source portfolio dividends) and $100,000 (US1's separate company state F taxable income). For purposes of this example, the state F apportionment fraction determined on a unitary basis for this water's edge group is assumed to equal 40 percent, the average of P and US1's state F payroll, property, and sales factor ratios (the water's edge group's state F factors over its worldwide factors). Applying this apportionment fraction to the $1,000,000 of unitary business income of the water's edge group yields state F water's edge taxable income of $400,000. The excess of the remaining $462,500 of state F taxable income over the $400,000 of state F water's edge taxable income equals $62,500, and is attributable to the inclusion of US2 and FS in the unitary group. The state F tax attributable to US2 and FS equals $6,250 and is allocated entirely to a class of gross income consisting of foreign source general limitation income, because the income of FS and US2 consists entirely of such income. The $6,250 of state F tax attributable to US2 and FS is subtracted from the remaining $46,250 of net state F tax, and P has $40,000 of state F tax remaining to be allocated and apportioned.

(G) To the extent that the remaining state F taxable income ($400,000) exceeds P's separate company state F taxable income ($396,000), it is presumed that state F is taxing U.S. source income of members of the water's edge group other than P In these facts, the $4,000 excess over P's separate company state F taxable income is attributable to the inclusion of US1 in the unitary group. The $400 of state F tax attributable to the inclusion of US1 in the unitary group (10 percent of $4,000) is allocated entirely to U.S. source income. P's remaining $39,600 of state F tax ($40,000 of state F tax attributable to the water's edge group minus $400 of state F tax attributable to US1 and allocated to U.S. source income) is the state F tax attributable to P's separate company state F taxable income and is to be allocated and apportioned together with P's state G tax of $15,000 and state H tax of $6,000 as illustrated in *Example* (25).

(H) In allocating the $60,600 of state tax liabilities ($39,600 state F tax attributable to P's separate company state F income + $15,000 state G tax + $6,000 state H tax) under *Example* (25), P's state taxable income in state G and state H ($300,000 + $300,000) must be added to P's separate company state F taxable income ($396,000). The resulting $996,000 of combined state taxable incomes is compared with $750,000 of U.S. source income on P's Federal income tax return. It is presumed that the $60,600 of state income taxes are imposed in part on $246,000 of foreign source income, which is the excess of P's combined state taxable incomes over P's Federal U.S. source taxable income. Accordingly, P's remaining deduction of $60,600 ($39,600 + $15,000 + $6,000) for state income taxes is related and allocable to both P's foreign source and domestic source income and is subject to apportionment.

(iii) *Apportionment.* The $60,600 of state taxes (the remaining $39,600 of state F tax + $15,000 of state G tax + $6,000 of state H tax) must be apportioned between foreign source general limitation income and U.S. source income for Federal income tax purposes. This apportionment is based upon the relative amounts of foreign source general limitation taxable income and U.S. source taxable income comprising the $996,000 of income subject to tax by the states after reducing the total amount of income subject to tax by the portfolio dividends and income attributable to the inclusion of other members of the unitary group. The deduction for the $60,600 of state income taxes is apportioned as follows:

State income tax deduction apportioned to foreign source general limitation income (statutory grouping): $60,600 × ($246,000/$996,000)	$14,967
State income tax deduction apportioned to income from sources within the United States (residual grouping): $60,600 × ($750,000/$996,000) ..	$45,633
Total apportioned state income tax deduction	$60,600

Of the total state income taxes of $71,000, the amount allocated and apportioned to foreign source general limitation income is $24,967 — the sum of $14,967 of state F, state G, and state H taxes apportioned to foreign source general limitation income, $3,750 of state F tax allocated to foreign source portfolio dividend income, and the $6,250 of state F tax allocated to foreign source general limitation income as the result of state F's worldwide unitary method of taxation (*i.e.*, the inclusion of US2 and FS in the unitary group). The total amount of state income taxes allocated and apportioned to U.S. source income equals $46,033 — the sum of the $400 of state F tax attributable to the inclusion of US1 in the state F unitary group and $45,633 of combined state F, G, and H tax apportioned under the method provided in *Example* (25).

Lawrence B. Gibbs,
Commissioner of Internal Revenue.

Approved: October 7, 1988.

O. Donaldson Chapoton,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on December 7, 1988, 3:39 p.m., and published in the issue of the Federal Register for December 12, 1988, 53 F.R. 49873)

Section 863.—Items Not Specified in Section 861 or 862

Income source; scholarship or grant. The source of a payment made to a nonresident alien as a scholarship or grant is determined by the residence of the payor. Rev. Ruls. 66-291 and 66-292 revoked.

Rev. Rul. 89-67

ISSUE

What is the source of an amount paid as a fellowship or a scholarship?

LAW AND ANALYSIS

Section 863(a) of the Internal Revenue Code of 1986 provides authority for the Commissioner to allocate or apportion items of gross income not specified in sections 861 and 862 to sources within and without the United States. No statutory rule is provided under section 861 or 862 for income received to support or subsidize a recipient's research or study activities.

Rev. Rul. 66-292, 1966-2 C.B. 280, held that the source of an amount received as a scholarship or fellowship is determined by where the research or study activities take place. A companion ruling, Rev. Rul. 66-291, 1966-2 C.B. 279, held that the source of an award for a puzzle contest is determined by where the activities required to solve the puzzle are performed. The rules contained in these revenue rulings are analogous to the rule contained in sections 861(a)(3) and 862(a)(3) of the Code that sources compensation from personal services where the services are performed. There is no indication in either cited revenue ruling, however, that the recipients performed any services for the payor, and Rev. Rul. 66-292 explicitly states to the contrary. (*See also* Rev. Rul. 80-98, 1980-1 C.B. 368, and Rev. Rul. 61-65, 1961-1 C.B. 17, where receipt of fellowship awards similar to the awards under consideration in Rev. Rul. 66-292 are treated as not involving compensation for personal services). The amount received to support or subsidize research and study and the amount received in respect of puzzle solving activities described in the two revenue rulings is not compensation for personal services because no services are performed. It is more appropriate to source these payments at the residence of the payor, where the principal economic nexus with the payments exists, than at the place where the study and research and puzzle solving activities are performed, where the economic nexus is less significant. Thus, for example, scholarship or fellowship payments for research or study, and amounts paid for puzzle-solving activities, made by the United States or a political subdivision thereof, a noncorporate U.S. resident, or a domestic corporation will be from U.S. sources. Similar payments by a foreign government or a foreign corporation will be foreign source payments. Payments made by an entity designated as a public international organization under the International Organizations Immunities Act (*See* section 7701(a)(18)) will be foreign source payments

The fact that payments are made by an intermediary agency acting on behalf of the payor does not alter this result, provided that a genuine agency relationship exists. (*Compare* Rev. Rul. 54-483, 1954-2 C.B. 168, where amounts paid by the United States Government, acting as an agent of a contractor rendering services abroad for the Government, to U.S. citizen employees of the contractor directly pursuant to contract are not amounts paid by the United States).

HOLDING

The source of a payment made as a scholarship, fellowship, or an award for puzzle solving contest activities is the residence of the payor.

EFFECT ON OTHER REVENUE RULINGS

Rev. Rul. 66-291 and Rev. Rul. 66-292 are revoked.

EFFECTIVE DATE

The effective date of this revenue ruling is May 15, 1989. Taxpayers may apply the ruling retroactively to amounts received on or after January 1, 1986.

Part II.—Nonresident Aliens and Foreign Corporations
Subpart A.—Nonresident Alien Individuals

Section 872.—Gross Income

(Also Section 883; 1.883-1.)

International operation of ships and aircraft; income exempt from tax. Listed are those countries that provide equivalent exemptions for income derived from the international operation of ships or aircraft.

Rev. Rul. 89-42

The purpose of this revenue ruling is to assist foreign persons who derive income from the international operation of ships or aircraft in determining whether such income is exempt from United States taxation under section 872(b) or 883(a) of the Internal Revenue Code of 1986.

Gross income derived by an individual resident of a foreign country from the international operation of ships or aircraft is not included in the gross income of the nonresident alien individual and is exempt from United States tax under section 872(b)(1) and (2) of the Code, if such foreign country grants an equivalent exemption to individual residents of the United States. Section 872(b)(5) extends the exemption to income derived from the rental (on a full or bareboat basis) of ships or aircraft. Section 872(b)(6) permits the reciprocal exemption rules to be applied separately with respect to different types of income from the international operation of ships and aircraft.

Similarly, section 883(a)(1) and (2) of the Code provides that gross income derived by a corporation organized in a foreign country from the international operation of ships or aircraft is exempt from United States taxation if such foreign country grants an equivalent exemption to corporations organized in the United States. Section 883(a)(4) extends the exemption to income derived by a foreign corporation from the rental (on a full or bareboat basis) of ships or aircraft and provides that the reciprocal exemption rules may be applied separately with respect to different types of income from the international operation of ships and aircraft.

A foreign country may grant an exemption from tax by exempting persons from that 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 provides a list of countries which are known to grant an equivalent exemption for various types of international shipping or aircraft income. This Table is intended only as a summary. The full text of the relevant document 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. An income tax convention between the United States and the foreign country may provide benefits under articles covering business profits, shipping and aircraft, rentals and royalties, capital gains or other income. However, to determine whether a convention provides an equivalent exemption for purposes of section 883(c), only the exemptions in articles providing for a full exemption (rather than, for example, articles that base exemption on the absence of a permanent establishment), are to be considered. This is because a full exemption is not granted under the business profits article and under many royalties, rentals, and capital gains articles. The look-through requirements of section 883(c) of the Code do not apply to a foreign corporation deriving income from the international operation of a ship or aircraft, if such income is exempt from U.S. tax under an income tax convention. However, the following income tax conventions contain a look-through provision: Australia, Article 16; Barbados, Article 22; Cyprus, Article 26; France, Article 7; Italy, Article 2(a) of the Protocol with respect to gains from the alienation of ships and aircraft; Jamaica, Article 17; Malta, Article 8(5); and New Zealand, Article 16. These provisions may differ from the requirements of section 883(c).

Part I of the Table summarizes exemptions available under income tax conventions with the United States. Part I also summarizes 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 II of the Table summarizes exemptions available in countries that have exchanged diplomatic notes with the United States covering shipping and aircraft income.

Finally, the Service may determine, upon examination of the law of a foreign jurisdiction, that a country offers an equivalent exemption by statute or decree, or by not imposing a tax on such income. This determination will be made on a country by country basis. Part III provides a list of the countries for which such a determination has been made and summarizes the types of income that qualify for the exemption.

A taxpayer may request a ruling that a particular country qualifies as an equivalent exemption jurisdiction. For instructions see Rev. Proc. 87-4, 1987-1 C.B. 529, as modified and amplified by Rev. Proc. 88-8, 1988-1 C.B. 628. Any request for a ruling should include a certified English translation of any applicable foreign statute, decree, etc., supplemented by an official statement from the foreign government. The statement should indicate whether income from the international operation of ships and aircraft includes rental (on a full or bareboat basis) of ships or aircraft, rental of containers and related equipment, and gains from the sale or exchange of a vessel or aircraft used in international transportation, and whether such income is exempt only when incidental to the operation of a ship or aircraft.

This Table will be updated periodically.

Countries Granting Equivalent Exemptions For Income From The Operation of Ships and Aircraft in International Traffic

	Basis for Exemption			*TYPES OF SHIPPING AND AIRCRAFT INCOME EXEMPTED*[2]				
Countries and Territories	Residence Based No Flag	Residence & Flag Reciprocal	Residence & Flag Unilateral	Operating Income	Full Rental (Time or voyage charter)	Bare-Boat Rental	Container[5] Rental	Capital[5] Gains
PART I TREATIES[1]								
Aruba[11]		X		X[3]				
Australia	X			X	X[4]	X[5]	X[5]	X[5/6]
Austria	X			X[3]				
Barbados	X			X	X	X	X	X
Belgium		X[7]		X	X[5]	X[5]	X[5]	X[5]
Canada	X			X	X	X	X	X
Cyprus	X			X	X	X	X	X
Denmark		X		X[3]				
Egypt	X			X	X[5]	X[5]	X[5]	
Finland		X		X	X[5]	X[5]	X[5]	X
France	X			X	X	X	X[5]	X[5]
Germany	X			X[3]			X[5]	X
Greece		X		X[3]				
Hungary	X			X	X[5]	X[5]	X	X[5]
Iceland			X[8]	X	X[5]	X[5]	X[5]	X
Ireland		X		X[3]				
Italy	X			X	X	X[5]	X	X[5]
Jamaica	X			X	X	X	X	X[5]
Japan[9]		X[10]		X	X[5]	X[5]	X[5]	X[5]
Korea	X			X[3]			X[5]	
Luxembourg		X		X[3]				
Malta	X			X	X	X	X	X[5]
Morocco		X[7]		X[3]				X[5]
Netherlands		X		X[3]			X[5]	
Netherlands Antilles[11]		X		X[3]				
New Zealand	X			X	X	X[5]	X[5]	X[6]
Norway[9]	X			X	X[5]	X[5]	X[5]	X
Pakistan[12]		X		X[3]				
Peoples Republic of China	X			X	X	X	X	X
Philippines	X							X[5]

Countries and Territories	*Basis for Exemption* Residence Based No Flag	Residence & Flag Reciprocal	Residence & Flag Unilateral	*TYPES OF SHIPPING AND AIRCRAFT INCOME EXEMPTED*[2] Operating Income	Full Rental (Time or voyage charter)	Bare-Boat Rental	Container[5] Rental	Capital[5] Gains
PART I TREATIES[1]								
Poland			X[8]	X	X[5]	X[5]	X[5]	X
Romania		X		X	X[5]	X[5]	X[5]	X
Sweden		X		X[3]				
Switzerland		X		X[3]				
Trinidad & Tobago			X[8]	X	X[5]	X[5]		X
USSR		X		X	X	X	X	X
U.K.	X			X	X	X[5]	X	X[5]
PART II EXCHANGE OF NOTES[16]								
Argentina	X			X	X	X	X[5]	X[5]
Bahamas	X			X	X	X	X[5]	
Belgium	X			X	X		X[5]	
Bolivia	X			X	X	X	X[5]	
Colombia	X			X	X	X	X[5]	
Cyprus	X			X	X	X	X[5]	
Czechoslovakia	X[12]			X[3]				
Denmark	X			X	X	X	X[5]	
El Salvador[12]	X			X	X	X	X[5]	X[5]
Finland	X			X	X	X	X[5]	
Greece	X			X	X	X	X[5]	
Jordan	X			X	X	X	X[5]	
Liberia	X			X	X	X	X[5]	X[5]
Panama	X			X	X	X	X[5]	
Singapore	X			X	X	X	X[5]	X[5]
Sweden	X			X	X	X[5]	X[5]	
Taiwan	X			X	X	X	X[5]	
Venezuela	X			X	X	X[5]	X[5]	X[5]
PART III DOMESTIC LAW								
Bermuda	X			X	X	X	X[5]	X[5]
Brazil[15]	X			X	X	X[5]	X[5]	
Bulgaria	X			X	X	X	X[5]	X[5]
Cayman Islands	X			X	X	X	X[5]	X[5]
Chile[14]	X			X	X	X[5]	X[5]	X[5]
Netherlands	X			X	X	X[5]	X[5]	
Netherlands Antilles	X			X	X	X	X[5]	X[5]
Portugal[12/15]	X			X	X	X		
Spain[17]	X			X	X		X[5]	
Turkey[13]				X			X[5]	
Vanuatu	X			X	X	X	X[5]	X[5]

[1]A reciprocal exemption based on treaty relief is limited to the circumstances in which the treaty itself would be available.

[2]An X indicates full exemption unless otherwise footnoted, 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]If incidental to operating income. In the case of the Netherlands, see Rev. Rul. 76-568, 1976-2 C.B. 492. In the case of Germany, see Rev. Rul. 74-92, 1974-1 C.B. 373. Certain countries that have exchanged diplomatic notes with the United States, or countries whose domestic law permits the shipping and aircraft exemptions, may permit full exemption of income derived from the rental of containers and gain from the sale or exchange of a vessel or aircraft used in international traffic. However, sections 872(b) and 883 permit a reciprocal exemption only for income that is incidental to the international operation of a vessel or aircraft.

[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 enterprises only.

[9]See also the diplomatic notes accompanying this treaty.

[10]With regard to residents of Japan, the ships or aircraft need not be registered in Japan if the ships are leased by such a resident.

[11]This treaty terminated January 1, 1988.

[12]This exemption applies to aircraft only.

[13]See Rev. Rul. 87-18, 1987-1 C.B. 178.

[14]This exemption covers shipping only.

[15]Brazilian and Portugese law exempts only companies.

[16]Notes signed prior to the Technical and Miscellaneous Revenue Act of 1988 (Technical Corrections) will be interpreted in accordance with Technical Corrections.

[17]The Spanish statute exempts only corporations.

Subpart B.—Foreign Corporations

Section 883.—Exclusions From Gross Income

26 CFR 1.883-1: Exclusions from gross income of foreign corporations.

Whether income derived from the international operation of ships or aircraft is exempt from United States taxation under section 883. See Rev. Rul. 89-42, page 234.

Part III.—Income From Sources Without the United States
Subpart A.—Foreign Tax Credit

Section 901.—Taxes of Foreign Countries and of Possessions of United States

(Also Sections 902, 960, 1248.)

Denial of foreign tax credit; South Africa. The denial of foreign tax credit shall apply to taxes paid or accrued with respect to income earned in and taxes paid to South Africa derived in taxable years of the person deriving the income beginning after December 31, 1987.

Rev. Rul. 89-44

ISSUE

What is the effective date of section 901(j)(2)(C) of the Internal Revenue Code of 1986, relating to income earned in and taxes paid to South Africa?

FACTS

P, a calendar year domestic corporations receives dividends attributable to South African sources from *FX*, its wholly owned subsidiary, on April 1, 1988, and on April 1, 1989, subject to South African withholding taxes. *FX* has a June 30 taxable year. In its taxable years ending June 30, 1988, 1989, and 1990, *FX* pays taxes to South Africa on its income from South African sources. In its taxable years ending June 30, 1988, and June 30, 1989, *FX* has no income that would be characterized as subpart F income under section 952 of the Code but for the application of section 952(a)(5). On June 1, 1990, *P* sells all of the stock of *FX*.

LAW AND ANALYSIS

In General

Section 901(a) of the Code allows a credit against U.S. taxes for foreign taxes paid or accrued by a taxpayer and for taxes deemed to be paid by a corporation under sections 902 and 960. Section 901(j) disallows a credit under section 901(a) for taxes paid or accrued to certain countries. Section 952(a)(5) further requires that income derived from those countries be treated as Subpart F income and taxed currently.

Section 10231 of the Omnibus Budget Reconciliation Act of 1987 (the Act), Pub. L. No. 100-203, 101 Stat. 1330 (1987), applies section 901(j) of the Code to South Africa by adding section 901(j)(2)(C). Section 10231(c) of the Act provides that section 901(j)(2)(C) applies to taxable years beginning after December 31, 1987. Section 10231 of the Act further requires that, under section 952(a)(5), income derived in South Africa in taxable years beginning after December 31, 1987, is to be treated as subpart F income and taxed currently.

The legislative history of section 10231 of the Act states that the provision will apply to "income attributable to the period from January 1, 1988," until the date on which the Secretary of the Treasury certifies that certain actions have been taken to undermine apartheid in South Africa. H.R. Conf. Rep. No. 495, 100th Cong., 1st Sess., 976-977 (1987). Section 901(j)(1)(A) of the Code provides that a credit will be disallowed for taxes paid or accrued "with respect to income attributable to a period to which [section 901(j)] applies to such country."

As the foregoing language indicates, both the statutory provisions and the legislative history focus on when the income subject to tax by South Africa is derived, not on when the foreign tax credit may be claimed. Accordingly, for purposes of section 901 of the Code, section 901(j)(2)(C) shall apply to taxes paid or accrued with respect to income derived in the taxable years of the person deriving the income beginning after December 31, 1987. Thus, if *P* directly derives income from South Africa after January 1, 1988, the beginning of its 1988 taxable year, no foreign taxes paid to South Africa (including withholding taxes) attributable to such income will be creditable under section 901.

Withholding taxes

South African withholding taxes imposed on the actual dividends received by *P* on April 1, 1988, and April 1, 1989, will not be creditable. Such taxes are imposed upon the income of the recipient derived from South Africa in taxable years beginning after December 31, 1987, and, therefore, are taxes with respect to income attributable to the period to which section 901(j)(2)(C) of the Code applies.

Application to Sections 902 and 960

Under sections 902 and 960 of the Code, foreign taxes paid or accrued by a foreign corporation are deemed to be paid by a corporate shareholder only when the shareholder receives a dividend distribution (or an inclusion in gross income under section 951(a)) from the earnings and profits of the foreign corporation. Under pre-1987 law, the foreign taxes were creditable only when a distribution was made from the earnings and profits of the year in which the foreign taxes were paid or accrued. Under post-1986 law, the foreign taxes deemed to be paid bear the same proportion to the post- 1986 foreign taxes paid as the dividend distribution bears to all post-1986 undistributed earnings, defined in section 902(c)(1) as the earnings and profits of the foreign corporation. Accordingly, in post-1986 years, foreign taxes will be pooled, and become creditable on a proportionate basis when earnings are distributed.

The taxes deemed to be paid by *P* under section 902 of the Code attributable to the April 1, 1988, dividend payment to *P* were paid by *FX* to South Africa with respect to income earned in a taxable year of *FX* that did not begin after December 31, 1986. Accordingly, such taxes are not subject to section 901(j) and may be claimed as a credit under section 901. Such taxes and the earnings and profits with respect to which they are paid are subject to the post-1986 pooling requirements.

In the case of the subpart F inclusion of *P* with respect to the income of *FX* earned in its taxable year ending June 30, 1989, the taxes paid by *FX* were paid with respect to income earned after December 31, 1987, and in a taxable year of *FX* beginning after that date. Accordingly, such taxes are subject to section 901(j) of the Code, and are not allowed as a credit under section 901.

Application of Section 952(a)(5) to the Income of FX

The first taxable year of *FX* subject to section 901(j) of the Code and, therefore, subject to section 952(a)(5), is its taxable year ending June 30, 1989, its first taxable year beginning after December 31, 1987. Accordingly, *FX* has no subpart F income in its taxable year ending June 30, 1988. All of the income of *FX* derived from South African sources in its taxable year ending June 30, 1989, however, is subpart F income.

Application to Section 1248

Section 1248 of the Code requires that, under certain circumstances, the gain derived by a U.S. person from the sale of stock of a controlled foreign corporation be included in the gross income of that U.S. person as a dividend to the extent of earnings and profits as calculated under section 1248(c) and (d). If a dividend is deemed to be paid under section 1248, a foreign tax credit is ordinarily available to the U.S. person under sections 901 and 902 at the time of the deemed dividend distribution.

The limitation of section 901(j)(2)(C) of the Code applies to foreign tax credits allowed with respect to amounts included in gross income as dividends under section 1248 as though an actual dividend had been paid. Thus, to the extent that South African taxes were paid with respect to amounts treated as a dividend under section 1248 and attributable to earnings and profits derived from South Africa in taxable years beginning after December 31, 1987, no foreign tax credit will be allowed with respect to such taxes. A foreign tax credit, however, will be allowed to the extent that South African taxes were paid with respect to amounts treated as a dividend under section 1248 and attributable to earnings and profits derived from South Africa in taxable years beginning before January 1, 1988.

Deduction under Section 164

Section 901(j) of the Code has no effect upon the allowance of deductions under section 164 for taxes paid or accrued to South Africa. The legislative history of section 901(j) states that "foreign taxes that are not creditable under this provision are deductible." H.R. Conf. Rep. No. 1012, 99th Cong., 2d Sess., 374 (1986). Accordingly, the withholding taxes paid with respect to the dividends received by *P* on April 1, 1988, and on April 1, 1989, may be deducted to the extent allowed under section 164.

HOLDING

For purposes of sections 901, 902, 960, and 1248 of the Code, the limitation of section 901(j)(2)(C) applies to taxes paid or accrued to South Africa with respect to income attributable to taxable years beginning after December 31, 1987.

Section 902.—Deemed Paid Credit Where Domestic Corporation Owns 10 Percent or More of Voting Stock of Foreign Corporation

Whether the limitation of section 901(j)(2)(C) of the Code applies prospectively to earnings derived in South Africa in taxable years beginning after December 31, 1987. See Rev. Rul. 89-44, page 237.

Section 907.—Special Rules in Case of Foreign Oil and Gas Income

26 CFR 1.907(a)-0A: Introduction (for taxable years beginning before January 1, 1983).

T.D. 8240

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1

Limitation of Foreign Tax Credit for Foreign Oil and Gas Taxes

AGENCY: Internal Revenue Service, Treasury.

ACTION: Temporary regulations.

SUMMARY: This document contains temporary Income Tax Regulations relating to the amendments made to the Internal Revenue Code by the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA). The amendments require that foreign oil and gas extraction income and losses from all foreign countries be aggregated before computing the limit on creditability of foreign taxes. The amendments also repeal the separate application of the foreign tax credit limitation to taxes on foreign oil related income. The text of the temporary regulations set forth in this document also serves as the text of the proposed regulations cross-referenced in the notice of proposed rulemaking in * * * [INTL-152-86, page 1022, this Bulletin].

DATES: The amendments are effective for taxable years beginning after December 31, 1982, except as follows. The special rule provided at §1.907(c)-2T(d)-(7) with respect to allocation of earnings and profits or deficits that arise in taxable years beginning after December 31, 1986, is effective after that date. The special rules provided for determination of FORI and FOGEI tax with respect to dividends received and amounts includible in gross income under section 951(a) in taxable years beginning after December 31, 1986, at §1.907(c)-3T(b)(1) and (c), respectively, are effective after December 31, 1986.

SUPPLEMENTARY INFORMATION:

BACKGROUND

This document contains temporary Income Tax Regulations (26 CFR Part 1) under section 907 of the Internal Revenue Code. These amendments conform the regulations to changes made to section 907 by section 211 (96 Stat. 448) of TEFRA.

NEED FOR TEMPORARY REGULATIONS

The proper application of changes made to section 907 by TEFRA is dependent upon the Internal Revenue Service's detailed specifications of the manner in which those changes will be administered. These regulations are necessary to provide taxpayers with immediate guidance with regard to their taxable years that remain open under the statute of limitations. Therefore, good cause is found to dispense with the notice and public procedure requirements of 5 U.S.C. §553 (b) and the delayed effective date requirement of 5 U.S.C. §553(d).

EXPLANATION OF PROVISIONS

The amount allowed as a foreign tax credit under section 901 for foreign taxes paid with respect to foreign oil and gas extraction income (FOGEI) is limited by section 907(a). The amount of the foreign tax credit cannot exceed the amount of FOGEI multiplied by, in the case of a corporation, the highest corporate tax rate or, in the case of an individual, the individual's average tax rate.

Changes Made by TEFRA

Since enactment of section 907 by the Tax Reduction Act of 1975, in computing the FOGEI limitation of section 907(a), pre-TEFRA section 907(c)(4) provided that net operating losses relating to extraction of minerals from oil or gas wells arising in one foreign country did not offset FOGEI arising in other foreign countries. This per-country loss rule was repealed by TEFRA; thus, for taxable years beginning after December 31, 1982, FOGEI and foreign oil extraction losses from all foreign countries are aggregated before computing the limitation of section 907(a). Section 907(c)(4), amended by TEFRA, provides for the recapture of overall foreign oil extraction losses for years preceding the limitation year, but beginning after December 31, 1982, against limitation year FOGEI before application of section 907 (a). Foreign taxes in excess of the section 907(a) limitation, under section 907(f), as amended by TEFRA, may be carried back for two years and forward for five years. Under old section 907(f), the carryback-carryover tax amount could not exceed 2% of FOGEI for the limitation year. This 2% limitation was eliminated by TEFRA.

Prior to TEFRA, after section 907(a) limited creditable FOGEI taxes to a certain percentage of FOGEI, the creditability of those taxes, together with taxes on foreign oil related income (FORI), were subject to the further limitation of pre-TEFRA section 907(b). That section provided that the section 904 limitation on foreign tax credits would be applied separately with respect to FORI, which prior to TEFRA included FOGEI. This separate application of the section 904 limitation to FORI was repealed by section 211 of TEFRA for taxable years beginning after December 31, 1982.

New section 907(b) was added by TEFRA in order to neutralize the consequence of the shifting by some foreign countries of the tax burden from taxes on FOGEI, creditability of which would be limited by section 907(a), to taxes on FORI. New section 907(b) limits creditable FORI taxes, which do not include FOGEI taxes, to the amount that would have been imposed by the foreign country on income that is neither FORI nor FOGEI if, under foreign law, FORI taxes in excess of this limitation were treated as a deductible expense. For United States tax purposes, FORI taxes in excess of the section 907(b) limitation are deductible as business expenses.

New section 907(e), as added by TEFRA, provides transitional rules applicable to unused taxes carried from a year beginning before January 1, 1983, to a year beginning after December 31, 1982, (the effective date of the TEFRA changes) and to unused taxes carried back from a year beginning after December 31, 1982, to a year beginning before January 1, 1983.

Section 212 of TEFRA added certain foreign base company oil related income as an additional item to the category of foreign base company income under the subpart F provisions of sections 951 through 964. See section 954(a)(5) and (g)(1). These regulations define this FORI for purposes of section 954(a)(5) and (g)(1).

Section 907 Regulations

The regulations under section 907 consist of two sets: the set of regulations proposed by this notice dealing with taxable years beginning after December 31, 1982, and the set published as T.D. 7961 (49 FR 26208) [1984-2 C.B. 130] dealing with taxable years beginning before January 1, 1983 (1984 Treasury Decision). This latter set of regulations was supplemented by T.D. 8160 (52 FR 33930) [1987-2 C.B. 191] published in the FEDERAL REGISTER on September 9, 1987 (1987 Treasury Decision) which contained definitions of interest on working capital, exchange gain or loss, directly related services and lease or license of related property. Many of the provisions of the regulations contained in these temporary regulations are substantially similar to provisions of the regulations contained in the 1984 and 1987 Treasury Decisions because they deal with provisions in section 907 that were not affected by TEFRA. Thus, §§1.907(c)-1T, 1.907(c)-2T, and 1.907(c)-3T are very similar to §§1.907(c)-1A, 1.907(c)-2A and 1.907(c)-3A, respectively, and §1.907(d)-1T is virtually identical to §1.907(d)-1A. The treatment by the temporary regulations of two matters, the carryover of foreign oil extraction losses and the new limitation on FORI taxes in section 907(b), are explained below in more detail.

Carryover of Foreign Oil Extraction Losses

New section 907(c)(4) requires that a foreign oil extraction loss incurred in one year be carried over and offset against FOGEI of a later year. This rule operates only for purposes of determining FOGEI under section 907(a) and thus operates independently of the rule of section 904(f) dealing with overall foreign losses. Taxes imposed on FOGEI retain their character as FOGEI taxes even though FOGEI is reduced by a loss carryover. Therefore, they may be carried back and forward to other taxable years under section 907(f).

Limitation on FORI Taxes

Section 907(b), as amended, places a limitation on the amount of creditable FORI tax if the FORI tax is excessive. In §1.907(b)-1T(a), the temporary regulations provide that non-dual capacity taxpayers and dual capacity taxpayers that use the facts and circumstances method of §1.901-2A(c)(2) to determine their creditable taxes and specific economic benefits must apply the safe harbor formula of §1.901-2A(e)(1) to the FORI tax payments made to the foreign country to determine the amount of FORI tax that is creditable under section 907(b). Section 907(b) does not apply, however, if the safe harbor formula has already been applied to the tax paid by a dual capacity taxpayer under section 901. These temporary regulations provide examples showing the interaction of sections 901 and 907(b).

Treatment of Income from Sale of Stock

In light of the Supreme Court decision in *Arkansas Best v. Commissioner*, 108 S. Ct. 971 (1988), the temporary regulations provide that for both pre-TEFRA and post-TEFRA years, stock of any corporation will not be treated as an asset used by a person in section 907(c) activities. Therefore, income (or loss) from the sale of stock will never be FOGEI or FORI.

SPECIAL ANALYSES

It has been determined that these rules are not major rules as defined in Executive Order 12291. Therefore, a Regulatory Impact Analysis is not required. A general notice of proposed rulemaking is not required by 5 U.S.C. §553 for temporary regulations. Therefore, these rules do not constitute regulations subject to the Regulatory Flexibility Act (5 U.S.C. Chapter 6) and a Regulatory Flexibility Analysis is not required.

* * * * * *

Adoption of amendments to the regulations

Accordingly, 26 CFR Part 1 is amended as follows:

INCOME TAX REGULATIONS (26 CFR Part 1)

Paragraph 1. The authority for Part 1 is amended by adding a new citation to read as follows:

Authority: 26 U.S.C. 7805. * * * Section 1.907(b)-1T is also issued under 26 U.S.C. 907(b). * * *

Par. 2. Section 1.907-0 is redesignated as §1.907(a)-0A and the heading is revised to read "§1.907(a)-0A Introduction (for taxable years beginning before January 1, 1983).".

Par. 3. Sections 1.907(a)-1, 1.907(b)-1, 1.907(b)-2, 1.907(c)-1, 1.907(c)-2, 1.907(c)-3, 1.907(d)-1, 1.907(e)-1 and 1.907(f)-1 are redesignated by adding an "A" at the end of each regulation section number and by deleting the period at the end of each section heading and adding "(for taxable years beginning before January 1, 1983).".

Par. 4. The following center heading is inserted immediately preceding the caption to §1.907(a)-0A:

REGULATIONS APPLICABLE TO TAXABLE YEARS BEGINNING BEFORE JANUARY 1, 1983

Par. 5. Paragraphs(a) through (j) of §1.907(a)-0A are redesignated as paragraphs (b) through (k), respectively, and a new paragraph (a) is added.

§1.907(a)-0A Introduction (for taxable years beginning before January 1, 1983).

(a) *Effective dates*. [Reserved] For guidance, see §1.907(a)-OAT.

* * * * * *

Par. 6. A new §1.907(a)-OAT is added immediately after §1.907(a)-OA to read as follows:

§1.907(a)-0AT Introduction (for taxable years beginning before January 1, 1983) (Temporary regulations).

(a) *Effective dates*. The provisions of §§1.907(a)-0A through 1.907(f)-1A apply to taxable years beginning before January 1, 1983, and all references in these regulations to section 907 are to section 907 as it existed prior to the amendments made by section 211 of the Tax Equity and Fiscal Responsibility Act of 1982 (96 Stat. 448). For provisions that apply to taxable years beginning after December 31, 1982, see §§1.907(a)-0T through 1.907(f)-1T.

(b) through (k) [Reserved]

Par. 7. Section 1.907(c)-1A is amended as follows:

1. By removing the last sentence of paragraph (d) (1), and
2. By revising paragraph (d) (3).

§1.907(c)-1A Definitions relating to FORI and FOGEI (for taxable years beginning before January 1, 1983).

* * * * * *

(d) *Assets used in a trade or business*.

* * * * * *

(3) *Stock*. [Reserved] For guidance, see §1.907(c)-1AT(d)(3).

* * * * * *

Par. 8. A new §1.907(c)-1AT is added immediately after §1.907(c)-1A to read as follows:

§1.907 (c)-1AT Definitions relating to FORI and FOGEI (for taxable years beginning before January 1, 1983) (Temporary regulations).

(a) through (c) [Reserved]

(d)*Assets used in a trade or business*.

(1) and (2) [Reserved]

(3) *Stock*. Stock of any corporation (whether foreign or domestic) will not be treated as an asset used by a person in section 907(c) activities. This provision applies to taxable years beginning after December 31, 1974, and beginning before January 1, 1983.

(d) (4) through (h) [Reserved]

Par. 9. There is added immediately preceding the new center heading above §1.907(a)-0A the following new §1.907-0, a new center heading and new §§1.907(a)-0T through 1.907(f)-1T:

§1.907-0 Outline of regulation provisions for section 907.

This section lists the paragraphs contained in pp 1.907(a)-0T through 1.907(f)-1A.

REGULATIONS APPLICABLE TO TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1982

§1.907(a)-OT Introduction (for taxable years beginning after December 31, 1982) (Temporary regulations).

(a) Effective dates.
(b) Key terms.
(c) FOGEI tax limitation.
(d) Reduction of creditable FORI taxes.
(e) FOGEI and FORI.
(f) Posted prices.
(g) Transitional rules.
(h) Section 907(f) carrybacks and carryovers.
(i) Statutes covered.

§1.907(a)-1T Reduction in taxes paid on FOGEI (for taxable years beginning after December 31, 1982) (Temporary regulations).

(a) Amount of reduction.
(b) Foreign taxes paid or accrued.
 (1) Foreign taxes.
 (2) Foreign taxes paid or accrued.
(c) Limitation level.
 (1) In general.
 (2) Limitation percentage for corporations.
 (3) Limitation percentage for individuals.
 (4) Losses.
 (5) Priority.
(d) Illustrations.
(e) Effect on other provisions.
 (1) Deduction denied.

(2) Reduction inapplicable.
(3) Section 78 dividend.
(f) Section 904 limitation.

§1.907(b)-1T Reduction of creditable FORI taxes (for taxable years beginning after December 31, 1982) (Temporary regulations).

(a) In general.
(b) Amount of income, war profits, or excess profits tax.
(1) Dual capacity taxpayer.
(2) Non-dual capacity taxpayer.
(c) Amount that is not income, war profits, or excess profits tax.
(d) Examples.

§1.907(c)-1T Definitions relating to FOGEI and FORI (for taxable years beginning after December 31, 1982) (Temporary regulations).

(a) Scope.
(b) FOGEI.
(1) General rule.
(2) Amount.
(3) Other circumstances.
(4) Income directly related to extraction.
(5) Income not included.
(6) Fair market value.
(7) Economic interest.
(c) Carryover of foreign oil extraction losses.
(1) In general.
(2) Reduction.
(3) Foreign oil extraction loss defined.
(4) Affiliated groups.
(5) FOGEI taxes.
(6) Examples.
(d) FORI.
(1) In general.
(2) Transportation.
(3) Distribution or sale.
(4) Processing.
(5) Primary product from oil.
(6) Primary product from gas.
(7) Directly related income.
(e) Assets used in a trade or business.
(1) In general.
(2) Section 907(c) activities.
(3) Stock.
(4) Losses on sale of stock.
(5) Character of gain or loss.
(6) Allocation of amount realized.
(7) Interest.
(f) Terms and items common to FORI and FOGEI.
(1) Minerals.
(2) Taxable income.
(3) Interest on working capital.
(4) Exchange gain or loss.
(5) Allocation.
(6) Facts and circumstances.
(g) Directly related income.
(1) In general.
(2) Directly related services.
(3) Leases and licenses.
(4) Related person.
(5) Gross income.
(h) Coordination with other provisions.
(1) Certain adjustments.
(2) Section 901 (f).

§1.907(c)-2T Section 907(c)(3) items (for taxable years beginning after December 31, 1982) (Temporary regulations).

(a) Scope.
(b) Dividend.
(1) Section 1248.
(2) Section 78 dividend.
(c) Taxes deemed paid.
(1) Voting stock test.
(2) Dividends and interest.
(3) Amounts included under section 951(a).
(d) Amount attributable to certain items.
(1) Certain dividends.
(2) Interest received from certain foreign corporations.
(3) Dividends from domestic corporation.
(4) Amounts with respect to which taxes are deemed paid under section 960 (a).
(5) Section 78 dividend.
(6) Special rule.
(7) Deficits.
(8) Illustrations.
(e) Dividends, interest, and other amounts from sources within a possession.
(f) Income from partnerships, trusts, etc.

§1.907(c)-3T FOGEI and FORI taxes (for taxable years beginning after December 31, 1982) (Temporary regulations).

(a) Tax characterization, allocation and apportionment.
(1) Scope.
(2) Three classes of income.
(3) More than one class in a foreign tax base.
(4) Allocation of tax within a base.
(5) Modified gross income.
(6) Allocation of tax credits.
(7) Withholding taxes.
(b) Dividends.
(1) In general.
(2) Section 78 dividend.
(c) Includible amounts under section 951(a).
(d) Partnerships.
(e) Illustrations.

§1.907(d)-1T Disregard of posted prices for purposes of chapter 1 of the Code (for taxable years beginning after December 31, 1982) (Temporary regulations).

(a) In general.
(1) Scope.
(2) Initial computation requirement.
(3) Burden of proof.
(4) Related parties.
(b) Adjustments.
(c) Definitions.
(1) Foreign government.
(2) Minerals.
(3) Posted price.
(4) Other pricing arrangement.
(5) Fair market value.

§1.907(e)-1T Transitional rules (for amounts carried between a taxable year beginning before January 1, 1983, and a taxable year beginning after December 31, 1982) (Temporary regulations).

(a) General rule.
(b) Rules for carryover of FORI and pre-TEFRA non-FORI taxes.
(c) Examples.

§1.907(f)-1T Carryback and carryover of credits disallowed by section 907(a) (for amounts carried between taxable years that each begin after December 31, 1982) (Temporary regulations).

(a) In general.
(b) Unused FOGEI.
(1) In general.
(2) Year of origin.
(c) Tax deemed paid or accrued.
(d) Excess extraction limitation.
(e) Excess general section 904 limitation.
(f) Section 907(f) priority.
(g) Cross-reference.
(h) Example.

REGULATIONS APPLICABLE TO TAXABLE YEARS BEGINNING BEFORE JANUARY 1, 1983

§1.907(d)-1A Disregard of posted prices for purposes of chapter 1 of the Code (for taxable years beginning before January 1, 1983).

(a) In general.

(1) Scope.

(2) Initial computation requirement.

(3) Burden of proof.

(4) Related parties.

(b) Adjustments.

(c) Definitions.

(1) Foreign government.

(2) Minerals.

(3) Posted price.

(4) Other pricing arrangement.

(5) Fair market value.

§1.907(e)-1A Transitional rules for section 904 carrybacks and carryovers (for taxable years beginning before January 1, 1983).

(a) Carryovers from taxable years ending before January 1, 1975.

(1) In general.

(2) Sections 901(e) and 907(a).

(3) General rule for division of unused foreign tax.

(4) Computation.

(5) Illustrations.

(b) Transitional rules for carryovers from per-country limitation years ending before January 1, 1976.

(1) In general.

(2) Pro rata reduction of carryovers.

(3) Illustrations.

(c) Transitional rules for carryback from taxable years ending after December 31, 1974.

(1) In general.

(2) Applicable principles.

§1.907(f)-1A Carryback and carryover of credits disallowed by section 907(a) (for taxable years beginning before January 1, 1983).

(a) In general.

(b) Unused foreign extraction tax.

(1) In general.

(2) Limit.

(3) Year of origin.

(c) Tax deemed paid or accrued.

(d) Excess extraction limitation.

(e) Excess oil related limitation.

(f)Limitation percentage in certain excess limitation years.

(g) Section 907(f) priority.

(h) Per-country limitation.

(i) Cross-reference.

(j) Illustration.

REGULATIONS APPLICABLE TO TAXABLE YEARS BEGINNING AFTER DECEMBER 31,1982

§1.907(a)-0T Introduction (for taxable years beginning after December 31, 1982) (Temporary regulations).

(a) *Effective dates.* The provisions of §§1.907(a)-0T through §1.907(f)-1T apply to taxable years beginning after December 31, 1982. For provisions that apply to taxable years beginning before January 1, 1983, see pp 1.907(a)-0A through 1.907(f)-1A, 1.907(a)-0AT and 1.907(c)-1AT.

(b) *Key terms.* For purposes of the regulations under section 907 —

(1) "FOGEI" means foreign oil and gas extraction income.

(2) "FORI" means foreign oil related income.

(3) "FOGEI taxes" mean foreign oil and gas extraction taxes as defined in section 907(c)(5).

(4) "FORI taxes" mean foreign taxes on foreign oil related income. See §1.907(c)-3T.

(c) *FOGEI tax limitation.* Section 907(a) limits the foreign tax credit for taxes paid or accrued on FOGEI. See §1.907(a)-1T.

(d) *Reduction of creditable FORI taxes.* Section 907(b) recharacterizes FORI taxes as non-creditable deductible expenses to the extent that the foreign law imposing the FORI taxes is structured, or in fact operates, so that the amount of tax imposed with respect to FORI will be materially greater, over a reasonable period of time, than the amount generally imposed on income that is neither FOGEI nor FORI. See §1.907(b)-1T.

(e) *FOGEI and FORI.* FOGEI includes the taxable income from the extraction of minerals from oil or gas wells by a taxpayer (or another person) and from the sale or exchange of assets used in the extraction business. FORI is a broader category of income than FOGEI. FORI includes taxable income from the activities of processing oil and gas into their primary products, transporting or distributing oil and gas and their primary products, and from the disposition of assets used in these activities. For this purpose, a disposition includes only a sale or exchange. FOGEI and FORI may also include taxable income from the performance of related services or from the lease of related property and certain dividends, interest, or amounts described in section 951(a). See §§1.907(c)-1T through 1.907(c)-3T.

(f) *Posted prices.* Certain sales prices are disregarded when computing FOGEI for purposes of chapter 1 of the Code. See §1.907(d)-1T.

(g) *Transitional rules.* Section 907(e) provides rules for the carryover of unused FOGEI taxes from taxable years beginning before January 1, 1983, and carryback of FOGEI taxes arising in taxable years beginning after December 31, 1982. See §1.907(e)-1T.

(h) *Section 907(f) carrybacks and carryovers.* FOGEI taxes disallowed under section 907(a) may be carried back or forward to other taxable years. These FOGEI taxes may be absorbed in another taxable year to the extent of the lesser of the separate excess extraction limitation or the excess limitation in the general limitation category (section 904(d)(1)(I)) for the carryback or carryover year. See §1.907(f)-1T.

(i) *Statutes covered.* The regulations under section 907 are issued as a result of the enactment of section 601 by the Tax Reduction Act of 1975, of section 1035 by the Tax Reform Act of 1976, of section 301(b)(14) of the Revenue Act of 1978, and of section 211 of the Tax Equity and Fiscal Responsibility Act of 1982.

§1.907(a)-1T Reduction in taxes paid on FOGEI (for taxable years beginning after December 31, 1982) (Temporary regulations).

(a) *Amount of reduction.* FOGEI taxes are reduced by the amount by which they exceed a limitation level (as defined in paragraph (c) of this section).

(b) *Foreign taxes paid or accrued.* For purposes of the regulations under section 907 —

(1) *Foreign taxes.* The term "foreign taxes" means income, war profits, or excess profits taxes of foreign countries or possessions of the United States otherwise creditable under section 901 (including those creditable by reason of section 903).

(2) *Foreign taxes paid or accrued.* The terms "foreign taxes paid or accrued," "FOGEI taxes paid or accrued," and "FORI taxes paid or accrued" include foreign taxes deemed paid under sections 902 and 960. Unless otherwise expressly provided, these terms do not include foreign taxes deemed paid by reason of sections 904(c) and 907(f).

(c) *Limitation level*—(1) *In general.* The limitation level is FOGEI for the taxable year multiplied by the limitation percentage for that year.

(2) *Limitation percentage for corporations.* A corporation's limitation percent-

age is the highest rate of tax specified in section 11(b) for the particular year.

(3) *Limitation percentage for individuals*. Section 907(a)(2)(b) provides that the limitation percentage for individual taxpayers is the effective rate of tax for those taxpayers. The effective rate of tax is computed by dividing the entire tax, before the credit under section 901(a) is taken, by the taxpayer's entire taxable income.

(4) *Losses*. (i) For purposes of determining whether income is FOGEI, a taxpayer's FOGEI will be recharacterized as foreign source non-FOGEI to the extent that FOGEI losses for preceding taxable years beginning after December 31, 1982, exceed the amount of FOGEI already recharacterized. See §1.907-(c)-1T(c). However, taxes that were paid or accrued on the recharacterized FOGEI will remain FOGEI taxes.

(ii) Taxes paid or accrued by a person to a foreign country may be FOGEI taxes even though that person has under U.S. law a net operating loss from sources within that country.

(iii) For purposes of determining whether income is FOGEI, a taxpayer's income will be treated as income from sources outside the United States even though all or a portion of that income may be resourced as income from sources with the United States under section 904(f)(1) and (4).

(5) *Priority*. (i) Section 907(a) applies before section 908, relating to reduction of credit for participation in or cooperation with an international boycott.

(ii) Section 901(f) (relating to certain payments with respect to oil and gas not considered as taxes) applies before section 907.

(d) *Illustrations*. Paragraphs (a) through (c) of this section are illustrated by the following examples.

Example (1). M, a U.S. corporation, uses the accrual method of accounting and the calendar year as its taxable year. For 1984, M has $20,000 of FOGEI, derived from operations in foreign countries X and Y, and has accrued $11,500 of foreign taxes with respect to FOGEI. The highest tax rate specified in section 11(b) for M's 1984 taxable year is 46 percent. Pursuant to section 907(a), M's FOGEI taxes limitation level for 1984 is $9,200 (46% × $20,000). The foreign taxes in excess of this limitation level ($2,300) may be carried back or forward. See section 907(f) and §1.907(f)-1T and section 907(e) and §1.907(e)-1T.

Example (2). The facts are the same as in *Example* (1) except that M is a partnership owned equally by U.S. citizens A and B who each file as unmarried individuals and do not itemize deductions. Pursuant to section 905(a), A and B have elected to credit foreign taxes in the year accrued. The total foreign taxes accrued by A and B with respect to their distributive shares of M's FOGEI is $11,500 ($5,750 accrued by A and $5,750 accrued by B). A and B have no other FOGEI. A's only taxable income for 1984 is his 50% distributive share ($10,000) of M's FOGEI and A has a preliminary U.S. tax liability of $1,079. B has $112,130 of taxable income for 1984 (including his 50% distributive share ($10,000) of M's FOGEI) and has a preliminary U.S. tax liability of $44,000. Pursuant to section 907(a), A's FOGEI taxes limitation level for 1984 is $1,079 (($1,079/$10,000) × $10,000)) and B's FOGEI taxes limitation level for 1984 is $3,924 (($44,000/$112,130) × $10,000)).

(e) *Effect on other provisions*—(1) *Deduction denied*. If a credit is claimed under section 901, no deduction under section 164(a)(3) is allowed for the amount of the FOGEI taxes that exceed a taxpayer's limitation level for the taxable year. See section 275(a)(4)(A). Thus, FOGEI taxes disallowed under section 907(a) are not added to the cost or inventory amount of oil or gas.

(2) *Reduction inapplicable*. The reduction under section 907(a) does not apply to a taxpayer that deducts foreign taxes and does not claim the benefits of section 901 for a taxable year.

(3) *Section 78 dividend*. The reduction under section 907(a) has no effect on the amount of foreign taxes that are treated as dividends under section 78.

(f) *Section 904 limitation*. FOGEI taxes as reduced under section 907(a) are creditable only to the extent permitted by the general limitation of section 904(d)-(1)(I).

§1.907(b)-1T Reduction of creditable FORI taxes (for taxable years beginning after December 31, 1982) (Temporary regulations).

(a) *In general*. If the foreign law imposing a FORI tax (as defined in §1.907(c)-3T) is either structured in a manner, or operates in a manner, so that the amount of tax imposed on FORI is generally materially greater than the tax imposed by the foreign law on income that is neither FORI nor FOGEI ("described manner"), section 907(b) provides a special rule which limits the amount of FORI taxes paid or accrued by a person to a foreign country which will be considered income, war profits, or excess profits taxes. Section 907(b) will apply to a person regardless of whether that person is a dual capacity taxpayer as defined in §1.901-2(a)(2)(ii)(A). (In general, a dual capacity taxpayer is a person who pays an amount to a foreign country part of which is attributable to an income tax and the remainder of which is a payment for a specific economic benefit derived from that country.) Foreign law imposing a tax on FORI will be considered either to be structured in or to operate in the described manner if any of the tax imposed on FORI is considered not to be an income, war profits or excess profits tax under paragraph (b) of this section.

(b) *Amount of income, war profits, or excess profits tax*—(1) *Dual capacity taxpayer*. If for a taxable year a dual capacity taxpayer has applied the safe harbor formula of §1.901-2A(e) to determine the portion of a FORI tax paid or accrued during the year that is a payment of tax rather than a payment for a specific economic benefit, section 907(b) shall not apply. However, if the dual capacity taxpayer has used the facts and circumstances method of §1.901-2A(c)-(2) to establish the portion of the FORI tax that is a payment of tax rather than a payment for a specific economic benefit, the safe harbor formula of §1.901-2A(e) will be applied to the portion of the payment determined to be a tax under the facts and circumstances method to determine whether section 907(b) will further reduce that amount.

(2) *Non-dual capacity taxpayer*. With regard to non-dual capacity taxpayers, the portion of the FORI tax that is considered an income, war profits, or excess profits tax is determined by applying the safe harbor formula of §1.901-2A(e) with respect to the person's foreign oil related income (as determined under foreign law pursuant to the provisions of paragraph(e) (2) of that section).

(c) *Amount that is not income, war profits, or excess profits tax*. The difference between the amount of FORI tax and the amount determined pursuant to paragraph (b) of this section is considered a tax that is not an income, war profits, or excess profits tax. This amount will be treated as a business expense deduction.

(d) *Examples*. The provisions of this section may be illustrated by the following examples:

Example (1)—(i) *Facts*. X, a U.S. corporation that uses the accrual method of accounting and the calendar year as its taxable year, extracts oil in foreign country FC, transports it via pipeline to a refinery located in FC, and sells it to Y, an unrelated corporation that operates the refinery. X is a dual capacity taxpayer as defined in §1.9012(a)(2)-(ii)(A). The only income X has that is taxed by FC is its income from the sale of oil to Y. FC imposes a generally applicable tax at the rate of 45% on the net income derived by foreign corporations from a trade or business carried on in FC. That tax is an income tax within the meaning of section 901. Taxable FOGEI and taxable FORI are determined under foreign law which, for purposes of this example, is assumed to be the same as United States law. X is subject to this generally applicable tax except that it is subject to a 60%, rather than a 45%, rate. For 1985, assume the following additional facts:

X's total gross income from sales to Y	1,000
Gross income attributable to extraction (FOGEI)	700
Gross income attributable to transportation (FORI)	300
Deductions incurred deriving FOGEI	525
Deductions incurred deriving FORI	225
Taxable FOGEI under FC law	175
Taxable FORI under FC law	75
Accrued tax to FC (under FC law) (.60 × (1000 − 750))	150

(ii) *Computation of section 901 tax without regard to section 907(b).* Because X is a dual capacity taxpayer, it is subject to the rules of §1.901-2A. X has chosen to establish the amount of its payment to FC that is tax by using the facts and circumstances method of §1.901-2A(c)(2). Under this method, X claims that 110 of the 150 it paid to FC is tax. The remainder (40) is considered an amount paid in exchange for a specific economic benefit X is receiving from FC.

(iii) *Determination of FORI tax accrued in 1985.* For purposes of this example it is assumed that the 40 determined in subdivision (ii) to be paid in exchange for a specific economic benefit relates only to X's FOGEI activities. Therefore, of the total payment to FC of 150, the part that is FORI tax for United States purposes is determined by the following equation:

FORI tax for United States purposes = (Total tax) × (Taxable FORI under FC law/total taxable income under FC law)

Accordingly, for 1985, FORI tax for U.S. purposes is 45, computed as follows:

$45 = (150) \times (75/250)$.

(iv) *Application of section 907(b).* Pursuant to paragraph(b) of this section, the portion of FORI tax for U.S. purposes for 1985 (45) that will be considered an income tax for purposes of section 901 after application of section 907(b) is determined by applying the safe harbor formula of §1.901-2A(e), as follows:

$$(A - B - C) \times D/(1 - D)$$

A = Gross income attributable to FORI = 300
B = Deductions incurred deriving FORI = 225
C = FORI tax for U.S. purposes = 45
D = Generally applicable tax rate = 45%

$$24.55 = (300 - 225 - 45) \times .45/(1-.45)$$

The remainder (20.45) is not an income tax and is deductible, for U.S. tax purposes, as a business expense.

Example (2)—(i) *Facts.* Y, a U.S. corporation that uses the accrual method of accounting and the calendar year as its taxable year, operates the refinery mentioned in *Example* (1). Y is not receiving a specific economic benefit from FC. Since §1.901-2(a)(2)(ii)(E), relating to the indirect receipt of a specific economic benefit, does not apply to Y, Y is not a dual capacity taxpayer with respect to FC. The only income Y has that is taxed by FC is its income from the sale of refined oil. All of this income is FORI as defined in section 907(c)(2)(A). Y is subject to the generally applicable tax mentioned in *Example* (1) except that Y is subject to a 50%, rather than a 45%, rate. For 1985, Y has accrued tax to FC of 25 based on the following additional facts:

Y's gross receipts — sales of refined oil	1,200
Cost of purchases of oil	1,000
Expenses from refining operations	150
Taxable income	50
Accrued tax	25

(ii) *Computation of section 901 tax without regard to section 907(b).* Because Y is not a dual capacity taxpayer, it is not subject to the rules of §1.901-2A. Thus, none of the tax accrued to FC (25) is paid in exchange for a specific economic benefit. Therefore, the entire 25 is creditable under section 901 if section 907(b) does not apply.

(iii) *Determination of FORI tax accrued in 1985.* All of the tax accrued to FC was accrued with respect to processing income described in section 907(c)(2)(A), and, thus, all of it is FORI tax.

(iv) *Application of section 907(b).* Pursuant to paragraph(b) of this section, the portion of FORI tax accrued by Y for 1985 that will be considered an income tax for purposes of section 901 after application of section 907(b) is determined by applying the safe harbor formula in §1.901-2A(e), as follows:

$$(A - B - C) \times D/(1 - D)$$

A = Gross income attributable to FORI = 1,200
B = Deductions incurred deriving FORI = 1,150
C = FORI tax for U.S. purposes = 25
D = Generally applicable tax rate = 45%

$$20.45 = (1,200 - 1,150 - 25) \times .45/(1 - 45)$$

Accordingly, 20.45 is an income tax and the remainder (4.55) is not an income tax and is deductible, for U.S. tax purposes, as a business expense.

§1.907(c)-1T Definitions relating to FOGEI and FORI (for taxable years beginning after December 31, 1982) (Temporary regulations).

(a) *Scope.* This section explains the meaning to be given certain terms and items in section 907(c)(1), (2), and (4). See also §1.907(a)-OT(b) for further definitions.

(b) *FOGEI*—(1) *General rule.* Under section 907(c)(1), FOGEI means taxable income (or loss) derived from sources outside the United States and its possessions from the extraction (by the taxpayer or any other person) of minerals from oil or gas wells located outside the United States and its possessions or from the sale or exchange of assets used by the taxpayer in extraction of those minerals. Extraction of minerals from oil or gas wells will result in gross income from extraction in every case in which that person has an economic interest in the minerals in place. For other circumstances in which gross income from extraction may arise, see paragraph (b)(3) of this section. For determination of the amount of gross income from extraction, see paragraph (b)(2) of this section. For definition of the phrase "assets used by the taxpayer in the trade or business" and for rules relating to that type of FOGEI, see paragraph (e)(1) of this section. The term "minerals" is defined in paragraph (f)(1) of this section. For determination of taxable income, see paragraph (f)(2) of this section. FOGEI includes, in addition, items listed in section 907(c)(3) (relating to dividends, interest, partnership distributions, etc.) and explained in §1.907-(c)-2T. For the reduction of what would otherwise be FOGEI by losses incurred in a prior year, see section 907(c)(4) and paragraph (c) of this section.

(2) *Amount.* The gross income from extraction is determined by reference to the fair market value of the minerals in the immediate vicinity of the well. Fair market value is determined under paragraph (b)(6) of this section.

(3) *Other circumstances.* Gross income from extraction or the sale or exchange of assets described in section 907(c)(1)(B) includes income from any arrangement, or a combination of arrangements or transactions, to the extent the income is in substance attributable to the extraction of minerals or such a sale or exchange. For instance, a person may have gross income from such a sale or exchange if the person purchased minerals from a foreign government at a discount and the discount reflects an arm's-length amount in consideration for the government's nationalization of assets that person owned and used in the extraction of minerals.

(4) *Income directly related to extraction.* Gross income from extraction includes directly related income under paragraph (g) of this section.

(5) *Income not included.* FOGEI as otherwise determined under this paragraph (b), nevertheless, does not include income to the extent attributable to marketing, distributing, processing or transporting minerals or primary products. Income from the purchase and sale of minerals is not ordinarily FOGEI. If the foreign taxes paid or accrued in connection with income from a purchase and sale are not creditable by reason of section 901(f), that income is not FOGEI. A taxpayer to whom section 901(f) applies is not a producer.

(6) *Fair market value.* For purposes of this paragraph (b), the fair market value of oil or gas in the immediate vicinity of the well depends on all of the facts and circumstances as they exist relative to a party in any particular case. The facts and circumstances that may be taken into account include, but are not limited to , the following—

(i) The facts and circumstances pertaining to an independent market value (if any) in the immediate vicinity of the well,

(ii) The facts and circumstances pertaining to the relationships between the taxpayer and the foreign government. If an independent fair market value in the immediate vicinity of the well cannot be determined but fair market value at the port, or a similar point, in the foreign country can be determined (port price), an analysis of the arrangements between the taxpayer and the foreign government that retains a share of production could be evidence of the appropriate, arm's-length difference between the port price and the field price, and

(iii) The other facts and circumstances pertaining to any difference in the producing country between the field and port prices.

(7) *Economic interest.* For purposes of this paragraph (b), the term "economic interest" means an economic interest as defined in §1.611-1(b)(1), whether or not a deduction for depletion is allowable under section 611.

(c) *Carryover of foreign oil extraction losses*—(1) *In general.* Pursuant to section 907(c)(4), the determination of FOGEI for a particular taxable year takes into account a foreign oil extraction loss incurred in prior taxable years beginning after December 31, 1982. There is no time limitation on this carryover of foreign oil extraction losses. Section 907(c)(4) does not provide for any carryback of these losses. Section 907(c)(4) operates solely for purposes of determining FOGEI and thus operates independently of section 904(f).

(2) *Reduction.* That portion of the income of the taxpayer for the taxable year which but for this paragraph (c) would be treated as FOGEI is reduced (but not below zero) by the excess of—

(i) The aggregate amount of foreign oil extraction losses for preceding taxable years beginning after December 31, 1982, over

(ii) The aggregate amount of reductions under this paragraph (c) for preceding taxable years beginning after December 31, 1982.

(3) *Foreign oil extraction loss defined*—(i) *In general.* For purposes of this paragraph (c), the term "foreign oil extraction loss" means the amount by which the gross income for the taxable year that is taken into account in determining FOGEI for that year is exceeded by the sum of the deductions properly allocated and apportioned to that gross income (as determined under paragraph (f)(2) of this section). A person can have a foreign oil extraction loss for a taxable year even if the person has not chosen the benefits of section 901 for that year.

(ii) *Items not taken into account.* For purposes of subdivision (i) of this paragraph, the following items are not taken into account—

(A) The net operating loss deduction allowable for the taxable year under section 172(a),

(B) Any foreign expropriation loss (as defined in section 172(h)) for the taxable year, and

(C) Any loss for the taxable year which arises from fire, storm, shipwreck, or other casualty, or from theft.

A loss mentioned in subdivision (ii)(B) or (C) of this paragraph is taken into account, however, to the extent compensation (for instance by insurance) for the loss is included in gross income.

(4) *Affiliated groups.* The foreign oil extraction loss of an affiliated group of corporations (within the meaning of section 1504(a)) that files a consolidated return is determined on a group basis. If the group does not have a foreign oil extraction loss, the foreign oil extraction loss of a member of that group will not reduce on a separate basis that member's FOGEI for a later taxable year.

(5) *FOGEI taxes.* If FOGEI is reduced pursuant to this paragraph(c) (and thereby recharacterized as non-FOGEI income), any foreign taxes imposed on the FOGEI that is recharacterized as other income retain their character as FOGEI taxes. See section 907(c)(5).

(6) *Examples.* The provisions of this paragraph (c) may be illustrated by the following examples.

Example (1)—(i) *Facts.* X, a U.S. corporation using the accrual method of accounting and the calendar year as its taxable year, is engaged in extraction activities in three foreign countries. X has only the following combined foreign tax items for the three countries (prior to the application of this paragraph (c)) for 1983, 1984, and 1985:

	1983	1984	1985
FOGEI	$(700)	$100	$450
FOGEI taxes	10	60	200
Net operating loss deduction	(200)	0	0
Foreign oil extraction loss allowable after adjustment for paragraph (c)(3)(ii) amounts	(500)	0	0

(ii) *1983.* Because X's FOGEI for 1983 is a loss of $(700), X's section 907(a) limitation for 1983 is $0 (.46 × $0). Thus, none of the FOGEI taxes paid or accrued in 1983 ($10) can be credited in 1983. They can, however, be carried back pursuant to the provisions of section 907(e)(2) and §1.907-(e)-1T and carried forward pursuant to the provisions of section 907(f) and §1.907(f)-1T.

(iii) *1984.* X's FOGEI for 1984, prior to the application of this paragraph (c), is $100. X has a foreign oil extraction loss for 1983 of $(500). This loss must be applied against X's preliminary FOGEI of $100 for 1984. Thus, X's FOGEI for 1984 is $0 and X has $(400) ($500 – $100) of foreign oil extraction loss from 1983 to be carried to 1985. Because X's FOGEI for 1984 is $0, its section 907(a) limitation is $0 (.46 × $0). Therefore, none of the FOGEI taxes paid or accrued in 1984 ($60) can be credited in 1984. They can, however, be carried back to 1982 pursuant to the provisions of section 907(e)(2) and §1.907(e)-1T and carried forward pursuant to the provisions of section 907(f) and §1.907(f)-1T.

(iv) *1985.* X's FOGEI for 1985, prior to the application of this paragraph (c), is $450. X's remaining foreign oil extraction loss carryover from 1983 is $(400) and this must be applied against X's preliminary FOGEI of $450 for 1985. Thus, X's FOGEI for 1984 is $50 ($450 – $400). X's section 907(a) limitation is $23 (.46 × $50). Therefore, $23 of the FOGEI taxes paid or accrued in 1985 can be credited in 1985, subject to the general limitation of section 904(d)(1)(E). The excess of FOGEI taxes, $177 ($200 – $23), can be carried forward pursuant to the provisions of section 907(f) and §1.907(f)-1T.

Example (2)—(i) *Facts.* The facts are the same as in *Example* (1) except that X's paragraph (c)(3)(ii) items for 1983 allocable to FOGEI are $(800) instead of $(200). FOGEI remains a loss of $(700). Thus, X does not have a foreign oil extraction loss for 1983 because it has $100 of FOGEI when its paragraph (c)(3)(ii) items are not taken into account ($(700) + $800).

(ii) *1983.* The results are the same as in *Example* (1).

(iii) *1984.* Although X had a FOGEI loss of $(700) in 1983, there is not a loss that can be carried forward after adjustment for paragraph (c)(3)(ii) items. Thus, X's FOGEI for 1984 is not reduced by the 1983 loss. X's section 907(a) limitation for 1984 is $46 (.46 × $100). Therefore, $46 of the FOGEI taxes paid or accrued in 1984 can be credited in 1984, subject to the general limitation of section 904(d)(1)(E). The excess of $14 ($60 – $46) can be carried back to 1982 pursuant to the provisions of section 907(e)(2) and §1.907-(e)-1T and carried forward pursuant to the provisions of section 907(f) and §1.907(f)-1T.

(iv) *1985.* Since there is no foreign oil extraction loss for either 1983 or 1984 to be applied in 1985, X's FOGEI for 1985 is $450. Thus, its section 907(a) limitation for 1985 is $207 (.46 × $450) and all of its FOGEI taxes paid or accrued in 1985 ($200) can be credited in 1985, subject to the general limitation of section 904(d)(1)(E). FOGEI taxes in the amount of $10 from 1983 and $14 from 1984 may be carried forward to 1985 if they have not been used in carryback years. However, because the excess section 907(a) limitation for 1985 is only $7, that is the maximum potential FOGEI taxes that may be used in 1985.

Example (3)—(i) *Facts.* Y, a U.S. corporation using the accrual method of accounting and the calendar year as its taxable year, is engaged in extraction activities in three foreign countries. Y's only foreign taxable income is income subject to the general limitation of section 904(d)(1)(e) and Y has no paragraph (c)(3)(ii) items. Y has the following foreign tax items for 1983 and 1984:

	1983	1984
FOGEI	$ (400)	$ 300
Other foreign taxable income	250	200
U.S. taxable income	1,000	1,100
Worldwide taxable income	850	1,600
FOGEI taxes	10	180
Foreign oil extraction loss	(400)	0

(ii) *1983*—(A) *Section 907(a) limitation.* Because Y's FOGEI for 1983 is a loss of $(400), Y's section 907(a) limitation for 1983 is $0. Thus, none of the FOGEI taxes paid or accrued in 1983 ($10) can be credited in 1983. They can, however, be carried back pursuant to the provisions of section 907(e)(2) and §1.907(e)-1T and carried forward pursuant to the provisions of section 907(f) and §1.907(f)-1T.

(B) *Section 904 (d) fraction.* Y has a foreign loss of $(150) ($(400) + $250) for 1983. Thus, its fraction for purposes of determining its general limitation of section 904(d)(1)(e) is $0/$850.

(iii) *1984*—(A) *Section 907(a) limitation.* Y's foreign oil extraction loss for 1983 is $(400). Applying this loss to its preliminary FOGEI for 1984 ($300) eliminates all of Y's FOGEI for 1984. Because Y's FOGEI for 1984 is $0, its section 907(a) limitation is also $0. Thus, none of the FOGEI taxes paid or accrued in 1984 ($180) can be credited in 1984. They can, however, be carried back to 1982 pursuant to the provisions of section 907(e)(2) and §1.907(e)-1T and carried forward pursuant to the provisions of section 907(f) and §1.907(f)-1T. Y has a remaining foreign oil extraction loss of $(100) from 1983 to be carried to 1985.

(B) *Section 904(d) fraction.* Y's preliminary foreign taxable income for purposes of determining its general limitation of section 904(d)(1)(e) is $500 ($300 + $200). However, Y has an overall foreign loss from 1983 of $(150) ($(400) + $250) and thus, pursuant to section 904(f), Y must recharacterize $150 (lesser of $150 or 50% of $500) of its 1984 foreign taxable income as U.S. taxable income. Thus, Y's fraction for purposes of determining its general limitation of section 904(d)(1)(e) for 1984 is $350/$1,600.

(d) *FORI*—(1) *In general.* Section 907(c)(2) define FORI to include taxable income from the processing of oil and gas into their primary products, from the transportation or distribution and sale of oil and gas and their primary products, from the disposition of assets used in these activities and from the performance of any other related service. FORI may also include, under section 907(c)-(3), certain dividends, interest, or amounts described in section 951(a). This paragraph (d) defines certain terms and items applicable to FORI.

(2) *Transportation.* Gross income from transportation of minerals or primary products ("gross transportation income") is gross income arising from carrying minerals or primary products between two places (including time or voyage charter hires) by any means of transportation, such as a vessel, pipeline, truck, railroad, or aircraft. Except for directly related income under paragraphs (d)(7) and (g) of this section, gross transportation income does not include gross income received by a lessor from a bareboat charter hire of a means of transportation, certain other rental income, or income from the performance of certain services.

(3) *Distribution or sale.* The term "distribution or sale" means the sale or exchange of minerals or primary products to processors, users who purchase, store, or use in bulk quantities, other persons for further distribution, retailers, or consumers. Gross income from distribution or sale includes interest income attributable to the distribution of minerals or primary products on credit.

(4) *Processing.* The term "processing" means the destructive distillation, or a process similar in effect to destructive distillation, of crude oil and the processing of natural gas into their primary products including processes used to remove pollutants from crude oil or natural gas.

(5) *Primary product from oil.* The term "primary product" (in the case of oil) means all products derived from the processing of crude oil, including volatile products, light oils (such as motor fuel and kerosene), distillates (such as naphtha), lubricating oils, greases and waxes, and residues (such as fuel oil).

(6) *Primary product from gas.* The term "primary product" (in the case of gas) means all gas and associated hydrocarbon components from gas wells or oil wells, whether recovered at the lease or upon further processing, including natural gas, condensates, liquefied petroleum gases (such as ethane, propane, and butane), and liquid products (such as natural gasoline).

(7) *Directly related income.* FORI also includes directly related income under paragraph (g) of this section.

(e) *Assets used in a trade or business*—(1) *In general.* The term "assets used by the taxpayer in the trade or business" in section 907(c)(1)(b) and (2)(d) means property primarily used in one or more of the trades or businesses that are section 907(c) activities. For purposes of this paragraph (e), assets used in a trade or business are assets described in section 1231(b) (applied without regard to any holding period or the character of the asset as being subject to the allowance for depreciation under section 167).

(2) *Section 907(c) activities.* Section 907(c) activities are those described in section 907(c)(1)(a) (for FOGEI) or (c)-(2)(a) through (c) (for FORI). If an asset is used primarily in one or more section 907(c) activities, then the entire gain (or loss) will be considered attributable to those activities. For example, if a person uses a service station primarily to distribute primary products from oil, then all of the gain (or loss) on the sale of the station is FORI even though the person uses the station to distribute products that are not primary products (such as tires or batteries). If an asset is not primarily used in one or more section 907(c) activities, then the entire gain or loss will not be FOGEI or FORI.

(3) *Stock.* Stock of any corporation (whether foreign or domestic) will not be treated as an asset used by a person in section 907(c) activities.

(4) *Losses on sale of stock.* If, under §1.861-8(e)(7), a loss on the sale, exchange, or disposition of stock is considered a deduction which is definitely related and allocable to FOGEI or FORI, then notwithstanding §1.861-8(e)(7) and paragraph (f)(2) of this section, this loss shall be allocated and apportioned to the same class of income that would have been produced if there were capital gain from the sale, exchange or disposition.

(5) *Character of gain or loss.* Except in the case of stock, gain or loss from the sale, exchange or disposition of assets used in the trade or business may be FORI or FOGEI to the extent taken into account in computing taxable income for the taxable year, whether or not the gain or loss is ordinary income or ordinary loss.

(6) *Allocation of amount realized.* The amount realized from the sale, exchange or disposition of several assets in one transaction is allocated among them in proportion to their respective fair market values. This allocation is made under the principles set forth in §1.1245-1(a)(5) (relating to allocation between section 1245 property and non-section 1245 property).

(7) *Interest.* Gross income from the sale, exchange or disposition of an asset used in a section 907(c) activity includes interest income from such a sale, exchange or disposition.

(f) *Terms and items common to FORI and FOGEI*—(1) *Minerals.* The term "minerals" means hydrocarbon minerals extracted from oil and gas wells, including crude oil or natural gas (as defined in section 613A(e)). The term includes incidental impurities from these wells, such as sulphur, nitrogen, or helium. The term does not include hydrocarbon minerals derived from shale oil or tar sands.

(2) *Taxable income.* Deductions to be taken into account in computing taxable income or net operating loss attributable to FOGEI or FORI are determined under the principles of §1.861-8. For an exception with regard to losses, see paragraph (e)(4) of this section.

(3) *Interest on working capital.* FORI and FOGEI may include interest on bank deposits or on any other temporary investment which is not in excess of funds reasonably necessary to meet the working capital requirements and the specifically anticipated business needs of the person that is engaged in the conduct of the activities described in section 907(c)(1) or (2).

(4) *Exchange gain or loss.* Exchange gain (and loss) may be FORI and FOGEI.

(5) *Allocation.* Interest income and exchange gain (or loss) described, respectively, in paragraph (f)(3) and (4) of this section are allocated among FORI, FOGEI, and any other class of income relevant for purposes of the foreign tax credit limitations under any reasonable method which is consistently applied from year-to-year.

(6) *Facts and circumstances.* Income not described elsewhere in this section may be FOGEI or FORI if, under the facts and circumstances in the particular case, the income is in substance directly attributable to the activities described in section 907(c)(1) or (2). For example, assume that a producer in the North Sea suffers a casualty caused by an explosion, fire, and resulting destruction of a drilling platform. Insurance proceeds received for the platform's destruction in excess of the producer's basis is extraction income if the excess constitutes income from sources outside the United States. In addition, income from an insurance policy for business interruption may be extraction income to the extent the payments under the policy are geared directly to the loss of income from production and are treated as income from sources outside the United States. Also, if an oil company's oil concession or assets used in extraction activities described in section 907(c)(1)(A) and located outside the United States are nationalized or expropriated by a foreign government, or instrumentality thereof, income derived from that nationalization or expropriation (including interest on the income paid pursuant to the nationalization or expropriation) is FOGEI. Likewise, if a company's assets used in the activities described in section 907(c)(2)(A) through (C) and located outside the United States are nationalized or expropriated by a foreign government, or instrumentality thereof, income (including interest on the income paid pursuant to the nationalization or expropriation) derived from the nationalization or expropriation will be FORI. Nationalization or expropriation is deemed to be a sale or exchange for purposes of section 907(c)(1)(B) and a disposition for purposes of section 907(c)(2)(D). In further example, assume that an oil company has an exclusive right to buy all the oil in country X from Y, an instrumentality of the foreign sovereign which owns all of the oil in X. The oil company does not have an economic interest in any oil in country X. Y has a temporary cash-flow problem and demands that the oil company make advance deposits for the purchase of oil not yet delivered. In return, Y grants the oil company a discount on the price of the oil when delivered. Income represented by the discount on the later disposition of the oil is FORI described in section 907(c)(2)(C). The result would be the same if Y credited the oil company with interest on the advance deposits, which had to be used to purchase oil (the interest income would be FORI).

(g) *Directly related income*— (1) *In general.* Section 907(c)(2)(E) and this paragraph (g) include in FORI, and this paragraph (g) includes in FOGEI, income from the performance of directly related services (as defined in paragraph (g)(2) of this section). This paragraph (g) also includes in FORI and FOGEI income from the lease or license of related property (as defined in paragraph (g)(3) of this section). Section 907(c)(2)(E) with regard to FORI and this paragraph (g) with regard to both FORI and FOGEI do not apply to a person if—

(i) Neither that person nor a related person (as defined in paragraph (g)(4) of this section) has FOGEI described in paragraph (b) of this section (other than paragraph (b)(4) thereof relating to directly related income) or FORI described in paragraph (d) of this section (other than paragraph (d)(7) thereof relating to directly related income), or

(ii) Less than 50 percent of that person's gross income from sources outside the United States which is related exclusively to the performance of services and from the lease or license of property described in paragraph (g)(2) and (3) of this section, respectively, is attributable to services performed for (or on behalf of), leases to, or licenses with, related persons, but

(iii) Subdivision (ii) of this paragraph (g)(1) will not apply to a person if 50 percent or more of that person's total gross income from sources outside the United States is FOGEI and FORI (as both are described in subdivision (i) of this paragraph (g)(1)).

A person described in subdivision (i) or (ii) of this paragraph will, however, have directly related services income which is FOGEI if the income is so classified by reason of the income based on output test set forth in paragraph (g)(2)(i)(B) of this section.

(2) *Directly related services*—(i) *FOGEI.* (A) Income from directly related services will be FOGEI, as that term is defined in paragraph (b)(1) and (3) of this section, if those services are directly related to the active conduct of extraction (including exploration) of minerals from oil and gas wells. Paragraph (b)(1) of this section provides that, in order to have extraction income, a person must have an economic interest in the minerals in place. However, paragraph (b)(3) of this section recognizes that income arising from "other circumstances" is extraction income if that income is in substance attributable to the extraction of minerals.

(B) An example of "other circumstances" under paragraph (b)(3) of this section is the "income based on output test." This income based on output test provides that, if the amount of compensation paid or credited to a person for services is dependent on the amount of minerals discovered or extracted, the income of the person from the performance of the services will be directly related services income which is FOGEI. This test will apply whether or not the person performing the services has, or had, an economic interest in the minerals discovered or extracted.

(ii) *FORI.* With regard to the determination of directly related services income which is FORI, directly related services are those services directly related to the active conduct of the operations described in section 907(c)(2)(A) through (C). Those services include, for example, services performed in relation to the distribution of minerals or primary products or in connection with the operation of a refinery, or the types of services described in §1.954-6(d) (other than paragraph (d)(4) thereof) which relate to foreign base company shipping income.

(iii) *Recipient of the services.* Directly related services described in paragraph (g)(2)(i) and (ii) of this section may be performed for any person without regard to whether that person is a related person.

(iv) *Excluded services*—(A) *FOGEI.* Directly related services which produce FOGEI do not include insurance, accounting or managerial services.

(B) *FORI.* Directly related services income which produce FORI do not, generally, include insurance, accounting or managerial services. These services will, however, produce FORI if they are performed by the person performing the operations described in section 907(c)(2)(A) through (C). For these purposes, insurance income which is FORI means taxable income as defined in section 832(a).

(3) *Leases and licenses.* A lease or license of related property is the lease or license of assets used (or held for use) by the lessor, licensor, or another person (including the lessee or a sublessee) in the active conduct of the activities described in section 907(c)(1)(A) or (c)-(2)(A) through (C). The leases or licenses described in this paragraph (g)-(3) include, for example, a lease of a means of transportation under a bareboat charter hire, of drilling equipment used in extraction operations, or the license of a patent, know-how, or similar intangible property used in extracting, transporting, distributing or processing minerals or primary products. This paragraph (g)(3) applies without regard to whether the parties are related persons.

(4) *Related person.* A person will be treated as a related person for purposes of this paragraph (g) if (i) that person would be so treated within the meaning of section 954(d)(3) (as applied by substituting the word "corporation" for the word "controlled foreign corporation") or (ii) that person is a partnership or partner described in section 707(b)(1).

(5) *Gross income.* A foreign corporation shall be treated as a domestic corporation for the purpose of applying the gross-income rules in paragraph (g)(1)(ii) and (iii) of this section.

(h) *Coordination with other provisions*—(1) *Certain adjustments.* The character of income as FOGEI or FORI is determined before making any adjustment under section 482 or section 907(d). For example, assume that X and Y are related parties, Y's only income is from the sale of oil that Y purchased from X, and FOGEI from X is diverted to Y through an arrangement described in paragraph (b)(3) of this section. Accordingly, Y has FOGEI. If under section 482 the Commissioner reallocates the FOGEI from Y to X, then Y's remaining income represents only a profit from distributing the oil, and thus is FORI. If the foreign taxes paid by Y on this income are otherwise creditable under section 901, the foreign taxes that are not refunded to Y retain their characterization as FOGEI taxes.

(2) *Section 901(f).* Section 901(f) (relating to certain payments with respect to oil and gas not considered as taxes) applies before section 907. Taxes disallowed by section 901(f) are added to the cost or inventory amount of oil or gas.

§1.907(c)-2T Section 907(c)(3) items (for taxable years beginning after December 31, 1982) (Temporary regulations).

(a) *Scope.* This section provides rules relating to certain items listed in section 907(c)(3). The rules of this section are expressed in terms of FORI but apply for determining FOGEI by substituting "FOGEI" for "FORI" whenever appropriate. FOGEI does not include interest described in section 907(c)(3)(A) or dividends described in section 907(c)(3)(B).

(b) *Dividend*—(1) *Section 1248 dividend.* A section 1248 dividend is a dividend described in section 907(c)(3)(A). Except as otherwise provided in this paragraph (b)(1) or in §1.907(c)-1T(e)-(3), gain (or loss) from the disposition of stock in any corporation is not FOGEI or FORI.

(2) *Section 78 dividend.* A section 78 dividend is FORI to the extent it arises from a dividend described in section 907(c)(3)(A), or an amount described in section 907(c)(3)(C).

(c) *Taxes deemed paid*—(1) *Voting stock test.* Items described in section 907(c)(3)(A) or (C) are FORI only if a deemed-paid-tax test is met under the criteria of section 902 or 960. The purpose of this test is to require minimum direct or indirect ownership by a domestic corporation in the voting stock of a foreign corporation as a prerequisite for the item to qualify as FORI in the hands of the domestic corporation. The test is whether a domestic corporation would be deemed to pay any taxes of a foreign corporation when a dividend or an amount described in section 907(c)(3)(A) or (C), respectively, is included in the domestic corporation's gross income. In the case of interest described in section 907(c)(3)(A), the test is whether any taxes would be deemed paid if there were a hypothetical dividend.

(2) *Dividends and interest.* For purposes of section 907(c)(3)(A), a domestic corporation is deemed under section 902 to pay taxes in respect of dividends and interest received from a foreign corporation if the following condition is met: the domestic corporation would be deemed under section 902 to pay taxes in respect of dividends received from the foreign corporation whether or not the foreign corporation—

(i) Actually pays or is deemed to pay taxes, or

(ii) In the case of interest, actually pays dividends.

This paragraph (c)(2) also applies to dividends received by a foreign corporation from a second-tier or third-tier foreign corporation (as defined in §1.902-1(a)-(3)(i) and (4), respectively). In the case of interest received by a foreign corporation from another foreign corporation, this paragraph (c)(2) applies if the taxes of both foreign corporations would be deemed paid under section 902(a) or (b) for purposes of applying section 902(a) to the same taxpayer which is a domestic corporation. In the case of interest received by any corporation (whether foreign or domestic), all members of an affiliated group filing a consolidated return will be treated as the same taxpayer under section 907(c)(3)(A) if the foreign taxes of the payor and (if the recipient is a foreign corporation) the foreign taxes of the recipient would be deemed paid under section 902 by at least one member. The term "member" is defined in §1.1502-1(b). Thus, for example, assume that P owns all of the stock of D1 and D2 and P, D1, and D2 are members of an affiliated group filing a consolidated return. Assume further that D1 owns all of the stock of F1 and D2 owns all of the stock of F2, where F1 and F2 are foreign corporations. Interest paid by F1 to P, D2, or F2 may be FORI.

(3) *Amounts included under section 951(a).* For purposes of section 907(c)-(3)(C), a domestic corporation is deemed under section 960 to pay taxes in respect of a foreign corporation, whether or not the foreign corporation actually pays taxes on the amounts included in gross income under section 951 (a).

(d) *Amount attributable to certain items*—(1) *Certain dividends*—(i) *General rule.* The portion of a dividend described in section 907(c)(3)(a) that is FORI equals—

Amount of dividend × a/b

a = FORI accumulated profits in excess of FORI taxes paid or accrued, and

b = Total accumulated profits in excess of total foreign taxes paid or accrued.

This paragraph (d)(1)(i) applies even though the FORI accumulated profits arose in a taxable year of a foreign corporation beginning before January 1, 1983. Determination of the FORI amount of dividends under this paragraph (d)(1)(i) must be made separately for FORI accumulated profits and total accumulated profits that arose in taxable years beginning before January 1, 1987, and for FORI accumulated profits and total accumulated profits that arose in taxable years beginning after December

31, 1986. Dividends are deemed to be paid first out of FORI and total accumulated profits that arose in taxable years beginning after December 31, 1986. With regard to FORI accumulated profits and total accumulated profits that arose in taxable years beginning after December 31, 1986, the portion of a dividend that is FORI equals—

Amount of dividend × a/b

a = Post-1986 undistributed FORI earnings determined under the principles of section 902(c)(1), and

b = Post-1986 undistributed earnings determined under the principles of section 902(c)(1).

(ii) *Cross-references*. See §1.902-1(g) for the determination of a foreign corporation's earnings and profits and of those out of which a dividend is paid. See §1.1248-2 or 1.1248-3 for the determination of the earnings and profits attributable to the sale or exchange of stock in certain foreign corporations.

(2) *Interest received from certain foreign corporations*. Interest described in section 907(c)(3)(A) is FORI to the extent the corresponding interest expense of the paying corporation is properly allocable and apportionable to the gross income of the paying corporation that would be FORI were that corporation a domestic corporation. This allocation and apportionment is made in a manner consistent with the rules of section 954(b)(5) and §1.861-8(e)(2).

(3) *Dividends from domestic corporation*. A dividend from a corporation described in section 907(c)(3)(B) that is FORI is determined under the principles of paragraph (d)(1)(i) of this section with respect to its current earnings and profits under section 316(a)(2) or its accumulated earnings and profits under section 316(a)(1), as the case may be.

(4) *Amounts with respect to which taxes are deemed paid under section 960(a)*—(i) *Portion attributable to FORI*. The portion of an amount described in section 907(c)(3)(C) that is FORI equals:

$$\text{Amount described in section 907(c)(3)(C)} \times \frac{\text{FORI earnings and profits}}{\text{Total earnings and profits}}$$

For taxable years ending after January 23, 1989, the facts and circumstances will be used to determine what part of the amount of the section 907(c)(3)(C) amount is directly attributable to FOGEI, FORI and other income.

(ii) *Earnings and profits*. Total earnings and profits are those of the foreign corporation for a taxable year under section 964 and the regulations under that section.

(5) *Section 78 dividend*. The portion of a section 78 dividend that will be considered FORI will equal the amount of taxes deemed paid under either section 902(a) or section 960(a)(1) with respect to the dividend to the extent the taxes deemed paid are FORI taxes under §1.907(c)-3T(b) or (c). See §1.907(c)-3T(a)(1).

(6) *Special rule*. (i) No item in the formula described in paragraph (d)(1)(i) of this section includes amounts excluded from the gross income of a United States shareholder under section 959(a)(1).

(ii) With respect to a foreign corporation, earnings and profits in the formula described in paragraph (d)(4)(i) of this section do not include amounts excluded under section 959(b) from its gross income.

(7) *Deficits*. In a taxable year, a deficit in earnings and profits in a separate category under section 904(d) (including a deficit in another separate category that is allocated under sections 902 and 960 pursuant to Notice 88-71, 1988-2 C.B. 374, to the first separate category) that is not attributable to FOGEI or FORI is to be allocated ratably between, and reduce, FOGEI earnings and profits and FORI earnings and profits within the first separate category. However, any deficit in earnings and profits within a separate category for the taxable year attributable either to FOGEI or FORI is to be allocated first to FORI or FOGEI (as the case may be) earnings and profits within a separate category before the deficit is allocated in that taxable year to earnings and profits that are not attributable to FORI and FOGEI, within the same separate category. Any deficit in FORI or FOGEI earnings and profits remaining after allocation within the first separate category will be allocated on a pro rata basis to other separate categories and will be allocated within those separate categories, first, to earnings and profits attributable to FORI or FOGEI depending on to which type of earnings and profits the deficit is attributable, second, to earnings and profits attributable to FORI or FOGEI, and, third, to other earnings and profits. For taxable years beginning before January 1, 1987, any deficit in FORI or FOGEI earnings and profits remaining after allocation within the first separate category will be allocated against earnings and profits attributable to United States source income and then to other separate categories pursuant to the preceding sentence. FORI earnings and profits are the earnings and profits attributable to FORI as defined in section 907(c)(2) and (3). FOGEI earnings and profits are the earnings and profits attributable to FOGEI as defined in section 907(c)(1)(3).

(8) *Illustrations*. The application of this paragraph (d) is illustrated by the following examples.

Example (1). X, a domestic corporation, owns all of the stock of Y, a foreign corporation organized in country S. Y owns all of the stock of Z, a foreign corporation also organized in country S. Each corporation uses the calendar year as its taxable year. In 1983, Z has $150 of FOGEI earnings and profits and $250 of earnings and profits other than FOGEI or FORI. Assume that Z paid no taxes to S and X must include $100 in its gross income under section 951(a) with respect to Z. Under paragraph (d)(4)(i) of this section, $37.50 of the amount described in section 951(a) is FOGEI ($100 × $150/$400). The remaining $62.50 of the section 951(a) amount represents other income.

Example (2). Assume the same facts as in *Example* (1) except that the taxable year in question is 1988. In addition, under the facts and circumstances, it is determined that of the $100 section 951(a) amount included in X's gross income, $30 is directly attributable to Z's FOGEI activity, $60 is directly attributable to Z's FORI activity and $10 is directly attributable to Z's other activity. Accordingly, under paragraph (d)(4)(i), $30 will be FOGEI and $60 will be FORI to X.

Example (3). (i) Assume the same facts as in *Example* (1). Assume further that, in 1983, Z distributes its entire earnings and profits ($400) to Y, which consists of a dividend of $300 and a section 959(a)(1) distribution of $100. Y has no other earnings and profits during 1983. Assume that the dividend and distribution are not foreign personal holding company income under section 954(c). Y pays no taxes to S. In 1983, Y distributes its entire earnings and profits to X.

(ii) Under paragraphs (c)(2) and (d)(1)(i) of this section, Y has FOGEI of $112.50, *i.e.*, the amount of the dividend received by Y ($300) multiplied by the fraction described in paragraph (d)(1)(i). The numerator of the fraction is Z's FOGEI accumulated profits in excess of the FOGEI taxes paid ($112.50) and the denominator is Z's total accumulated profits in excess of total foreign taxes paid ($400) minus the amount excluded from Y's gross income under section 959(a)(1) ($100). The rule of paragraph (d)(6)(ii) of this section does not apply since X does not include any amount in its gross income under section 951(a) with respect to Y. If Y paid taxes to S, this paragraph (d) would apply to characterize those taxes as FOGEI taxes or other taxes. See §1.907(c)-3T(a)(8) and *Example* 2 (iii) under §1.907(c)-3T(e).

(iii) The distribution from Y to X is a dividend to the extent of $300, *i.e.*, the amount of the distribution ($400) minus the amount excluded from X's gross income under section 959(a)(1) ($100). Under paragraph (d)(1)(i) and (6)(i) of this section, $112.50 of the dividend is FOGEI, *i.e.*, the amount of the dividend ($300) multiplied by a fraction. The numerator of the fraction is $112.50, *i.e.*, the FOGEI accumulated profits of Y in excess of FOGEI taxes paid ($150) minus the FOGEI accumulated profits of Y in excess of FOGEI taxes paid excluded from X's gross income under section 959(a)(1) ($37.50). The denominator of the fraction is $300, *i.e.*, the total accumulated profits of Y in excess of taxes paid ($400) minus the amount excluded from X's gross income under section 959(a)(1) ($100).

Example (4). Assume the same facts as in *Example* (1) with the following modifications: In 1983, Z's only earnings and profits are FORI earnings and profits which are included in X's gross income under section 951(a). Z distributes its entire earnings and profits to Y. In 1983, Y has total earnings and profits of $100 without regard to the dividend from Z, $60 of which are FORI earnings and profits. Y also has $40 which is included in X's gross income under section 951(a). Under paragraph (d)(6)(ii) of this section, the dividend from Z is disregarded for purposes of applying paragraph (d)(4)(i) of this section to the $40 included in X's gross income under section 951(a) with respect to Y. Accordingly, $24 of the amount described in section 951(a) is FORI ($40 × $60/$100). Had these circumstances existed in 1988, and if the $40 included in X's gross income under section 951(a) was directly attributable to FORI activity, all of that income would be FORI to X.

(e) *Dividends, interest, and other amounts from sources within a possession.* FORI includes the items listed in section 907(c)(3)(A) and (C) to the extent attributable to FORI of a corporation that is created or organized in or under the laws of a possession of the United States.

(f) *Income from partnerships, trusts, etc.* FORI and FOGEI include a person's distributive share (determined under the principles of section 704) of the income of any partnership and amounts included in income under subchapter J of chapter 1 of the Code (relating to the taxation of trusts, estates, and beneficiaries) to the extent the income and amounts are attributable to FORI and FOGEI.

§1.907(c)-3T FOGEI and FORI taxes (for taxable years beginning after December 31, 1982) (Temporary regulations).

(a) *Tax characterization, allocation and apportionment*—(1) *Scope.* Paragraph (a)(2) through (6) of this section provides rules for the characterization, allocation, and apportionment of the income taxes (other than withholding taxes) paid or accrued to a foreign country among FOGEI, FORI, and other income relevant for purposes of sections 907 and 904. Some of the rules in this section are expressed in terms of FOGEI taxes but they apply to FORI taxes by substituting "FORI taxes" for "FOGEI taxes" whenever appropriate. For the treatment of withholding taxes, see paragraph (a)(8) of this section. FOGEI taxes are determined without any reduction under section 907(a). In addition, determination of FOGEI taxes will not be affected by recharacterization of FOGEI by section 907(c)(4). See §1.907(c)-1T(c)(5). Foreign taxes will not be characterized as creditable FORI taxes if section 907(b) and §1.907(b)-1T apply.

(2) *Three classes of income.* There are three classes of income: FOGEI, FORI, and other income.

(3) *More than one class in a foreign tax base.* If more than one class of income is taxed under one tax base under the law of a foreign country, the amount of pre-credit foreign tax for each base must be determined. This amount is the foreign taxes paid or accrued to that country for the base as increased by the tax credits (if any) which reduced those taxes and were allowed in the country for that tax. More than one class of income is taxed under the same base, if, under a foreign country's law, deductions from one class of income may reduce the income of any other class and the classes are subject to foreign tax at the same rates.

(4) *Allocation of tax within a base.* If more than one class of income is taxed under the same base under a foreign country's law, the pre-credit foreign tax for the base is apportioned to each class of income in proportion to the income of each class. Tax credits are then allocated (under paragraph (a)(6) of this section) to the apportioned pre-credit tax. Income of a class is the excess of modified gross income for a class over the deductions allowed under foreign law for, and which are attributable to, that class.

(5) *Modified gross income.* Modified gross income is not necessarily the same as gross income as defined for purposes of chapter 1 of the Internal Revenue Code. Modified gross income is determined with reference to the foreign tax base for gross income (or its equivalent). However, the characterization of the base as a particular class of income is governed by general principles of U.S. tax law. Thus, for example—

(i) Gross income from extraction is the fair market value of oil or gas in the immediate vicinity of the well (as determined under §1.907(c)-1T(b)(6) (without any deductions)).

(ii) Whether cost of goods sold (or any other deduction) is a deduction from modified gross income and the amount of such a deduction is determined under foreign law.

(iii) Modified gross income includes items that are part of the foreign tax base even though they are not gross income under U.S. law so long as the foreign taxes paid on the base constitute creditable taxes under section 901 (including taxes described in section 903). For example, if a foreign country imposes a tax (creditable under section 901) on a tax base that includes in small part a percentage of the value of a company's oil reserves in place, modified gross income from extraction includes such a percentage of value solely for purposes of making the tax allocation in paragraph (a)(4) of this section.

(iv) Modified gross income from extraction is increased for purposes of this paragraph (a)(5) by the entire excess of the posted price over fair market value if the foreign country uses a posted price system or other pricing arrangement described in section 907(d) in imposing its income tax.

(v) Modified gross income from FORI is that income attributable to the activities in section 907(c)(2)(A) through (C) and (E).

(vi) Modified gross income for any class may not include gross income that is not subject to taxation by the foreign country.

(6) *Allocation of tax credits.* The foreign taxes paid or accrued on a particular class of income equals the pre-credit tax on the class reduced (but not below zero) by the credits allowed under foreign law against the foreign tax on the particular class. Any tax credit attributable to a class that is not allocated to that class is allocated to the other class in the base or, if there are three classes in the base, is apportioned ratably among the taxes paid or accrued on the other two classes (as reduced in accordance with the preceding sentence).

(7) *Withholding taxes.* Paragraph (a)(2) through (6) of this section does not apply to withholding taxes imposed by a foreign country. FOGEI taxes may include withholding taxes imposed with respect to a distribution from a corporation. The portion of the total withholding taxes on a distribution that constitutes FOGEI taxes is determined by the portion of the distribution that is FOGEI. In addition, FOGEI taxes may include taxes imposed on a distribution described in section 959(a)(1) or on amounts described in section 959(b). The portion of the total withholding taxes imposed on a distribution described in section 959(a)(1) or on amounts described in section 959(b) is determined by reference to the portion of the amount included in gross income under section 951(a) that was FOGEI.

(b) *Dividends*—(1) *In general.* FOGEI taxes deemed paid with respect to a dividend equal the total taxes deemed paid with respect to the dividend multiplied by the fraction:

FOGEI taxes paid or accrued by the payor/
Total foreign taxes paid or accrued by the payor.

With regard to dividends received in taxable years beginning after December 31, 1986, FOGEI taxes deemed paid with respect to a dividend equal the total taxes deemed paid with respect to the portion of the dividend within a separate category multiplied by the fraction:

$$\frac{\text{Post-1986 FOGEI taxes as determined under the principles of section 902(c)(2) that are allocable to that separate category}}{\text{Post-1986 foreign income taxes as determined under the principles of section 902(c)(2) that are allocable to that separate category.}}$$

This paragraph (b) applies to a dividend described in section 907(c)(3)(A) (including a section 1248 dividend) with reference to the particular taxable year or years of those accumulated profits out of which a dividend is paid. Determination of FOGEI taxes under this paragraph (b) must be made separately (i) for FOGEI taxes paid on FOGEI accumulated profits and total taxes paid on accumulated profits that arose in taxable years beginning before January 1, 1987, and (ii) for FOGEI taxes paid on FOGEI accumulated profits and total taxes paid on accumulated profits that arose in taxable years beginning after December 31, 1986. For purposes of these determinations, dividends are deemed to be paid first out of FOGEI and total accumulated profits that arose in taxable years beginning after December 31, 1986. See §1.907(c)-2T(d)(1)(i). See section 960(a)(3) and §1.960-2 relating to distributions that are treated as dividends for purposes of section 902.

(2) *Section 78 dividend.* There are no FOGEI taxes with respect to section 78 dividends.

(c) *Includible amounts under section 951(a).* FOGEI taxes deemed paid with respect to an amount includible in gross income under section 951(a) equal the total taxes deemed paid with respect to that amount multiplied by the fraction:

$$\frac{\text{FOGEI taxes paid or accrued by the foreign corporation}}{\text{Total foreign taxes paid or accrued by the foreign corporation.}}$$

With regard to an amount includible in gross income under section 951(a) in taxable years beginning after December 31, 1986, FOGEI taxes deemed paid with respect to that amount equal the total taxes deemed paid with respect to that amount within a separate category multiplied by the fraction:

$$\frac{\text{Post-1986 FOGEI taxes as determined under the principles of section 902(c)(2) that are allocable to that separate category}}{\text{Post-1986 foreign income taxes as determined under the principles of section 902(c)(2) that are allocable to that separate category.}}$$

Taxes in this fraction include only those foreign taxes that may be deemed paid under section 960(a) by reason of such inclusion. See §§1.960-1(c)(3) and 1.960-2(c).

(d) *Partnerships.* A partner's distributive share of the partnership's FOGEI taxes is determined under the principles of section 704.

(e) *Illustrations.* The application of this section may be illustrated by the following examples.

Example (1). X, a domestic corporation, owns all of the stock of Y, a foreign corporation organized in country S. Y owns all of the stock of Z, a foreign corporation organized in country T. Each corporation used the calendar year as its taxable year. In 1983, X includes in its gross income an amount described in section 951(a) with respect to Z. Assume that the taxes deemed paid under section 902(a) by X by reason of such an inclusion is $70. Assume further that Z paid total taxes of $120, $80 of which is FOGEI tax. Under paragraph (c) of this section, the FOGEI tax deemed paid is $46.67 (*i.e.*, $70 × $80/$120). This $46.67 is also FOGEI under §1.907(c)-2T(d)(5) because it must be included in X's gross income under section 78.

Example (2). (i) Assume the same facts as in *Example* (1). Assume further that in 1983, Z distributes its entire earnings and profits to Y. Y has no earnings and profits during 1983 other than this dividend. Y paid a tax of $50 to S. Assume that Y is deemed under section 902(b)(1) to pay $50 of the tax paid by Z which was not deemed paid by X under section 960(a)(1) in 1983. In 1983, Y distributes its entire earnings and profits to X. Assume that X is deemed under section 902(a) to pay $100 of the taxes actually paid, and deemed paid, by Y.

(ii) Paragraph (b)(1) of this section applies to characterize the $50 tax of Z that Y is deemed to pay under section 902(b)(1). Y is deemed to pay $33.33 of FOGEI tax, *i.e.*, the amount of the tax deemed paid by Y ($50) multiplied by a fraction. The numerator of the fraction is the amount of Z's FOGEI tax ($80) and the denominator is the total taxes paid by Z ($120).

(iii) Under paragraph (a)(8) of this section, a portion of the $50 tax actually paid by Y on the earnings and profits received from Z is FOGEI tax. The amount of tax actually paid by Y that is FOGEI tax depends on the amount of the distribution from Z that is FOGEI (see §1.907(c)-2T(d)(1)(i) and *Example* (2)(ii) under §1.907(c)-2T(d)(8)). This result does not depend upon whether a portion of the distribution from Z is described in section 959(b) and it follows even though a portion of Y's earnings and profits will be excluded from X's gross income under section 959(a)(1) when distributed by Y. Assume that $12.50 of the $50 tax actually paid by Y is FOGEI tax.

(iv) Under paragraph (b)(1) of this section, X is deemed to pay $45.83 of FOGEI tax by reason of the distribution from Y. This amount is determined by multiplying the total taxes deemed paid by X by reason of such distribution ($100) by a fraction. The numerator of the fraction is the FOGEI tax paid, and deemed paid, by Y ($45.83, *i.e.*, $33.33 under subdivision (ii) of this example plus $12.50 under subdivision (iii) of this example). The denominator of the fraction is the total taxes paid, and deemed paid, by Y ($100). This $45.83 is FOGEI under §1.907(c)-2T(d)(5) because it is included in X's gross income as a section 78 dividend.

Example (3). (i) X, a domestic corporation, has a concession with foreign country Y that gives it the exclusive right to extract and export the crude oil and natural gas owned by Y. The concession agreement and location of the oil and gas wells mandate that X construct a system of pipelines to transport the minerals that are extracted to a port where they are loaded onto tankers for export. X owns the transportation facilities. Y has an income tax system under which income from mineral operations is subject to a 50 percent tax rate. The taxation by Y of the mineral operations is a separate tax base under paragraph (a)(3) of this section. Under this system, Y imposes the tax at the port prior to export and it establishes a posted price of $12 per barrel. Y also collects royalties of $1.44 per barrel (*i.e.*, 12 percent of this posted price) which is deductible in computing the petroleum tax. Y also allows X deductible lifting costs of $.20 per barrel and deductible transporting costs of $.80 per barrel. Y does not allow any credits against the mineral tax. Assume that X does not have any income in Y other than the mineral income. (In 1983, X extracts, transports, and exports 10,000,000 barrels of crude oil, but for convenience, all computations are in terms of one barrel). X pays foreign taxes of $4.78 per barrel, computed as follows:

Sales		$12.00
Royalties	$1.44	
Lifting	.20	
Transporting	.80	
	2.44	(2.44)
Income base		9.56
Tax rate (percent)		.50
Tax		4.78

Assume that these taxes are creditable taxes under section 901, that the fair market value of the oil at the port is $10 per barrel, and that under §1.907(c)-1T(b)(6) fair market value in the immediate vicinity of the oil wells is $9 per barrel. Thus, at the port, the excess of posted price ($12) over fair market value ($10) is $2.

(ii) The $4.78 foreign tax paid to Y is allocated to FOGEI and FORI in accordance with the rules in paragraph (a)(2) through (5) of this section.

(iii) Under paragraph (a)(3) of this section, FOGEI and FORI are subject to foreign taxation under one tax base. This foreign tax is allocated between FOGEI tax and FORI tax in accordance with paragraph (a)(4) and (5) of this section.

(iv) The modified gross income for FOGEI is $11, *i.e.*, fair market value in the immediate vicinity of the well ($9) plus the excess at the port of posted price over fair market value ($2). The modified gross income for FORI is $1, *i.e.*, value added to the oil beyond the wellhead which is part of Y's tax base ($10-$9).

(v) The royalty deductions are all directly attributable to FOGEI.

(vi) Under paragraph (a)(4) of this section, the income of each class is determined as follows:

	FOGEI	FORI
Modified gross income..	$11.00	$ 1.00
Deductions:		
Royalties	1.44	0
Lifting	.20	0
Transporting	0	.80
Total	1.64	.80
Net Income	9.36	.20

(vii) Under paragraph (a)(4) of this section, the total tax paid to Y is allocated to FOGEI and FORI in proportion to the income in each class. The calculation is as follows:

FOGEI tax = $4.78 × $9.36/$9.56 = $4.68
FORI tax = $4.78 × $0.20/$9.56 = $0.10

Thus, for the 10,000,000 barrels, the FOGEI tax is $46,800,000 and the FORI tax is $1,000,000.

(viii) The allocation under paragraph (a)(4) of this section, rather than the direct application of stated foreign tax rates to foreign-law taxable income in each class of income (which would produce the same results in the facts of this example), is necessary when a foreign country taxes more than one class of income under a progressive rate structure. See *Example* (4) in this paragraph (e).

Example (4). Assume the same facts as in *Example* (3) except that Y's tax is imposed at 40 percent for the first $20,000,000 of income and at 60 percent for all other income. The foreign taxes are allocated under paragraph (a)(4) of this section between FOGEI and FORI in the same manner as in subdivisions (vi) and (vii) of *Example* (3), as follows:

(1) Taxable income		$95,600,000.
(2) Tax:		
(a) 40% of $20,000,000	$8,000,000	
(b) 60% of $75,600,000	45,360,000	
(c) Total tax		53,360,000
(3) FOGEI tax (line 2(c) × $9.36/$9.56)		52,243,680
(4) FORI tax (line 2(c) × $0.20/$9.56)		1,116,320

Example (5). Assume the same facts as in *Example* (3). Assume further that X refines the crude oil into primary products prior to export and Y imposes its tax on the basis of crude oil equivalences of $12 per barrel, rather than the value of the primary products, to establish port prices. Assume that this arrangement is a pricing arrangement described in section 907(d). Thus, Y does not tax the refinery income. The results are the same as in *Example* (3) even if $12 per barrel is equal to, more than, or less than, the value of the primary products at the port. See paragraph (a)(5)(vi) of this section.

§1.907(d)-1T Disregard of posted prices for purposes of chapter 1 of the Code (for taxable years beginning after December 31, 1982) (Temporary regulations).

(a) *In general*—(1) *Scope.* Section 907(d) applies if a person has FOGEI from the—

(i) Acquisition (other than from a foreign government) or

(ii) Disposition of minerals at a posted price that differs from the fair market value at the time of the transaction. Also, if a seller (other than a foreign government) derives FOGEI upon a disposition described in the preceding sentence, section 907(d) applies to the acquisition by the purchaser whether or not the purchaser has FOGEI. Thus, section 907(d) may apply in determining a person's FORI.

(2) *Initial computation requirement.* If section 907(d) applies to any person, income on the transaction as initially reflected on the person's return shall be computed as if the transaction were effected at fair market value. This requirement applies the first time a person has taxable income derived from either the transaction or an item (such as a dividend described in section 907(c)(3)(A)) determined with reference to that income.

(3) *Burden of proof.* The taxpayer must be able to demonstrate the transaction as it actually occurred and the basis for reporting the transaction under the principles of paragraph (a)(2) of this section.

(4) *Related parties.* Section 907(d) (as a rule of characterization) applies whether or not the parties to the transaction are related. Thus, the excess of the posted price over the fair market value may never be taken into account in determining a person's FOGEI under section 907(a) but may be taken into account in determining a person's FORI.

(b) *Adjustments.* If a taxpayer does not comply with the initial requirement of paragraph (a)(2) of this section, adjustments under section 907(d) may be made only by the Commissioner in the same manner that section 482 is administered. Correlative and similar adjustments consistent with the substantive and procedural principles of section 482 and §1.482-1(d) apply. However, section 907(d) is not a limitation on section 482. If a taxpayer disposing of minerals at a posted price does comply with the initial computation requirement of this section, adjustments and correlative and similar adjustments consistent with the substantive and procedural aspects of section 482 and §1.482-1(d) shall apply, whether made on the return by the taxpayer or on a later audit. This paragraph (b) does not apply to an actual sale or exchange of minerals made between persons with respect to whom adjustments under section 482 would never apply (but see paragraph (a)(4) of this section).

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

(1) *Foreign government.* The term "foreign government" means only the integral parts or controlled entities of a foreign sovereign and political subdivisions of a foreign country.

(2) *Minerals.* The term "minerals" has the same meaning as in §1.907(c)-1T(f)(1).

(3) *Posted price.* The term "posted price" means the price set by, or at the direction of, a foreign government (i) to calculate income for purposes of its tax or (ii) at which minerals must be sold.

(4) *Other pricing arrangement.* The term "other pricing arrangement" in section 907(d) means a pricing arrangement having the effect of a posted price.

(5) *Fair market value.* The term "fair market value", whether or not at the port prior to export, is determined in the same way that the wellhead price is determined under §1.907(c)-1T(b)(6).

§1.907 (e)-1T Transitional rules (for amounts carried between a taxable year beginning before January 1, 1983, and a taxable year beginning after December 31, 1982) (Temporary regulations).

(a) *General Rule.* Section 907(e)(1) provides rules for carryovers of FOGEI and FORI taxes from taxable years beginning before January 1, 1983 (the general effective date of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA)), to taxable years beginning after December 31, 1982. Section 907(e)(2) provides for carrybacks of those taxes from taxable years beginning after December 31, 1982, to taxable years beginning before January 1, 1983. Both the carryover and carryback amounts shall not exceed the lesser of the amount deemed paid or accrued which would have been deemed paid or accrued under the carryback and carryover rules of section 907(f) and §1.907(f)-1T (covering carryback and carryover of taxes that both begin after December 31, 1982) or the amount which would have been deemed paid or accrued if —

(1) Pre-TEFRA section 907(b) (which provided for a separate section 904 limitation for FORI taxes),

(2) Pre-TEFRA section 907(f) (which limited the carryback and carryover of FOGEI taxes to 2% of FOGEI for the year of origin), and

(3) Pre-TEFRA section 904(f)(4) (which dealt with the determination of foreign oil related loss if section 907 applied)

had remained in effect for taxable years beginning after December 31, 1982.

(b) *Rules for carryover of FORI and pre-TEFRA non-FORI taxes*—(1) Under this section, in general —

(i) The amount of unused pre-TEFRA FORI taxes that may be carried forward to any carryover year may not exceed the excess section 907(b) limitation, as in effect prior to the general effective date of TEFRA, for that carryover year;

(ii) The amount of unused pre-TEFRA, non-FORI taxes that may be carried forward to any carryover year may not exceed the excess section 904(d) general limitation, as in effect before the general effective date of TEFRA for that carryover year; and

(iii) The total of the amounts carried forward under subdivisions (i) and (ii) of this paragraph (b)(1) to any carryover year may not exceed the excess section 904(d) general limitation, as in effect after the general effective date of TEFRA, for that carryover year.

(2) The amount of unused pre-TEFRA FORI taxes that may be carried forward to any succeeding carryover year is the total of those taxes, less the amount of those taxes deemed accrued in the carryover year after reduction in accordance with paragraph (b)(1)(i) of this section (if applicable).

(3) The amount of unused pre-TEFRA, non-FORI taxes that may be carried forward to any succeeding carryover year is the total of those taxes, less the amount of those taxes deemed accrued in the carryover year after reduction in accordance with paragraph (b)(1)(ii) of this section (if applicable).

(c) *Examples*. The provisions of section 907(e)(1) may be illustrated by the following examples. For purposes of these examples, assume the following:

(1) The corporation's preliminary U.S. tax liability is computed at an effective rate of 46%;

(2) A term modified by "old" refers to the meaning the term had prior to the general effective date of TEFRA;

(3) The only foreign source income which the corporation had prior to 1983 is old FORI (which included FOGEI and other FORI) and old section 904(d)(1)(C) income (*i.e.*, income other than interest, DISC dividends and FORI); and

(4) The only foreign source income the corporation had during 1983 and 1984 was section 904(d)(1)(C) income (*i.e.*, income other than interest and DISC dividends) as applicable during those years.

Example (1)—(i) *Facts*. X, a calendar year U.S. corporation organized on January 1, 1982, uses the accrual method of accounting. For 1982, X had the following relevant tax items:

	1982
FOGEI	$500
FOGEI taxes	265
Section 907(a) limitation (46% × $500)	230
Unused FOGEI tax	35
Old section 907(f)(1) limitation (2% × $500)	10
Unused old section 907(b) limitation FORI taxes (not including unused FOGEI taxes)	63
Unused old section 904(d)(1)-(C) taxes	20

X's tax items for 1983 and 1984 under the Code provisions applicable to those years were as follows:

Table I

		1983	1984
(a)	FOGEI	$1,000	$1,200
(b)	FORI	400	350
(c)	Other foreign taxable income	122	250
(d)	Total taxable income (domestic and foreign)	2,000	2,500
(e)	FOGEI taxes	750	500
(f)	FORI taxes	140	62
(g)	Other foreign taxes	50	31
(h)	Section 907(a) limitation (46% × (a))	460	552
(i)	Total creditable foreign taxes (after section 907(a) limitation excluding carryovers)	650 ((f) + (g) + (h))	593 ((e) + (f) + (g))
(j)	Preliminary U.S. tax (46% × (d))	920	1,150
(k)	Section 904(d) overall limitation ((j) SAX $\frac{(a)+(b)+(c)}{(d)}$)	700	828
(1)	Excess FOGEI taxes (or excess limitation) ((e) − (h)	290	(52)
(m)	Excess section 904(d) taxes (or excess limitation) ((i) − (k))	(50)	(235)

X's foreign tax items for 1983 and 1984, had old sections 907(b) and (f) and 904(f)(4) applied, would have been as follows:

Table II

		1983	1984
(a)	FOGEI	$1,000	$1,200
(b)	Old FORI (less FOGEI)	400	350
(c)	Other foreign taxable income	122	250
(d)	Total taxable income (domestic and foreign)	2,000	2,500
(e)	FOGEI taxes	750	500
(f)	Old FORI taxes (less (e))	140	62
(g)	Other foreign taxes	50	31
(h)	Section 907(a) limitation (46% × (a))	460	552
(i)	Old FORI taxes (after section 907(a) limitation excluding carryovers)	600 ((f) + (h))	562 ((e) + (f))
(j)	Old section 904(d)(1)(C) taxes ((g))	50	31
(k)	Preliminary U.S. tax (46% × (d))	920	1,150
(l)	Old FORI section 907(b) limitation ((k) × $\frac{(a) + (b)}{(d)}$)	644	713
(m)	Old section 904(d)(1)(C) limitation ((k) × $\frac{(c)}{(d)}$)	56	115
(n)	Excess FOGEI taxes (or excess limitation) ((e) − (h))	290	(52)
(o)	Excess old FORI taxes (or excess limitation) ((i) − (1))	(44)	(151)
(p)	Excess old section 904(d)(1)(C) taxes (or excess limitation) ((j) − (m))	(6)	(84)

(ii) *Carryover from 1982 to 1983*—(A) *Unused FOGEI taxes*. X has $35 of unused FOGEI taxes available for carryover from 1982. Pursuant to section 907(f)(3)(A), X must determine its section 907(f) FOGEI tax carryover (taking into account the section 907(e) transition rules) from 1982 to 1983 before it determines its section 904(c) general foreign tax carryover. In determining the carryover from 1982 to 1983, section 907(e)(l) requires that the old section 907(f)(l) limitation be applied. Under old section 907(f)(1), FOGEI taxes in excess of the section 907(a) limitation could only be carried over to succeeding years in an amount equal to 2% of the FOGEI ($10 in this example) in the year of origin. See §1.907(f)-1A(b)(2). The $10 is not deemed accrued, however, in 1983 because FOGEI taxes paid or accrued in 1983 ($750) exceed the section 907(a) limitation ($460) for 1983 (Table I, 1983, line (l)).

(B) *Unused FORI taxes*. X has $63 of unused old section 907(b) limitation FORI taxes available for carryover from 1982. Pursuant to section 907(e)(1), the amount of unused FORI taxes that may be carried over from 1982 to 1983 may not exceed the excess old section 907(b) limitation for 1983. Since the excess 1983 old section 907(b) limitation is $44 (Table II, 1983, line (o)), only that amount of the $63 of total unused 1982 FORI taxes (not including unused FOGEI taxes) may becarried over and deemed accrued in 1983. Therefore, X has unused 1982 old section 907(b) limitation FORI taxes (not including unused FOGEI taxes) in the amount of $19 ($63 less $44) available for carryover to 1984.

(C) *Unused other foreign taxes*. X has $20 of unused old section 904(d)(1)(C) taxes available for carryover from 1982. However, only $6 may be deemed accrued in 1983 since for 1983 the excess old section 904(d)(1)(C) limitation was only $6 (Table II, 1983, line (p)). Therefore, X has unused 1982 old section 904(d)(1)(C) taxes in the amount of $14 ($20 less $6) available for carryover to 1984.

(iii) *Carryover from 1982 to 1984*—(A) *Unused FOGEI taxes*. The unused FOGEI tax carryover from 1982 of $10 will be deemed accrued in 1984 since the limitations of both old and new section 907(f)(2) do not limit the deemed accrual. The $10 amount is not as great as the lesser of the excess extraction limitation under new section 907(f)(2)(A), $52 (Table I, 1984, line (l)) and the excess overall limitation under new section 907(f)(2)(B), $235 (Table I, 1984, line (m)). Likewise, the $10 amount is not as great as the lesser of the excess extraction limitation under old section 907(f)(2)(A), $52 (Table II, 1984, line (n)) and the excess oil related limitation under old section 907(f)(2)(B), $151 (Table II, 1984, line (o)).

(B) *Unused FORI taxes*. The $29 of 1982 unused old section 907(b) limitation FORI taxes (including $10 of unused FOGEI taxes) are deemed accrued in 1984 since they do not exceed the excess old section 907(b) limitation for 1984, $151 (Table II, 1984, line (o)).

(C) *Unused other foreign taxes*. X's $14 of unused 1982 old section 904(d)(1)(C) taxes are deemed accrued in 1984 since they do not exceed the old section 904(d)(1)(C) limitation, $84 (Table II, 1984, line (p)).

Example (2)—(i) *Facts*. Assume the same facts as in *Example* (1) except that X's other foreign taxable income for 1983, line (c) in both tables in *Example* (1), is $46. It is assumed that total taxable income remains the same as in *Example* (1).

(ii) *Carryover from 1982 to 1983*—(A) *Unused FOGEI taxes*. Same result as in *Example* (1). None of the $10 of unused FOGEI taxes carried over from 1982 may be deemed accrued in 1983.

(B) *Unused FORI and other foreign taxes*. The old excess section 907(b) limitation for 1983 remains at $44 (Table II, 1983, line (o)). There is, however, no old excess section 904(d)(1)(C) limitation for 1983 (Table II, 1983, line (p)). The tentative carryovers are therefore $44 of FORI taxes and $0 of section 904(d)(1)(C) taxes. In addition, the excess section 904(d) overall limitation (Table I, 1983, line (m)) is now only $15. Accordingly, under paragraph (b)(1)-(D) of this section, the maximum amount of FORI taxes and old section 904(d)(1)(C) taxes that may be carried forward to 1983 is $15.

Therefore, $15 of the $63 of total unused 1982 FORI taxes (not including unused FOGEI taxes) may be carried over from 1982 and deemed accrued in 1983. X has unused 1982 old section 907(b) limitation FORI taxes (not including unused FOGEI taxes) in the amount of $48 available for carryover to 1984. X need not reduce the unused 1982 FORI taxes by the amount ($44) which would have been deemed accrued had the old excess section 907(b) limitation applied.

Example (3)—(i) *Facts*. Y, a U.S. corporation organized on January 1, 1982, uses the accrual method of accounting and the calendar year as its taxable year. For 1982, Y had the following tax items:

Table I

(a)	FOGEI	$ 900
(b)	Old FORI (less FOGEI)	250
(c)	Other foreign taxable income	200
(d)	World wide taxable income	2,050
(e)	FOGEI taxes	300
(f)	Old FORI taxes (less (e))	130
(g)	Other foreign taxes	170
(h)	Section 907(a) limitation (46% × (a))	414
(i)	Old FORI taxes (after section 907(a) limitation) (lesser of (e) or (h) plus (f))	430
(j)	Old section 904(d)(1)(C) taxes ((g))	170
(k)	Preliminary U.S. tax (46% × (d))	943
(l)	Old FORI section 907(b) limitation $\left((k) \times \frac{(a) + (b)}{(d)}\right.$	529
(m)	Old section 904(d)(1)(C) limitation $\left((k) \times \frac{(c)}{(d)}\right)$	
(n)	Excess FOGEI taxes (or excess limitation) ((e) − (h))	(114)
(o)	Excess old FORI taxes (or excess limitation) ((i) − (1))	(99)
(p)	Excess old section 904(d)(1)(C) taxes (or excess limitation) ((j) − (m))	78

Y's tax items for 1983 and 1984 under the Code provisions applies to those years were as follows:

Table II

		1983	*1984*
(a)	FOGEI	$1,000	$1,200
(b)	FORI	300	450
(c)	Other foreign taxable income (loss)	200	150
(d)	Total taxable income (domestic and foreign)	2,200	2,500
(e)	FOGEI taxes	400	750
(f)	FORI taxes	180	290
(g)	Other foreign taxes	60	90
(h)	Section 907(a) limitation (46% × (a))	460	552
(i)	Total creditable foreign taxes (after section 907(a) limitation excluding carryovers)	640 ((e) + (f) + (g))	932 ((f) + (g) + (h))
(j)	Preliminary U.S. tax (46% × (d))	1,012	1,150
(k)	Section 904(d) overall limitation $\left((j) \times \frac{(a) + (b) + (c)}{(d)}\right)$	690	828
(l)	Excess FOGEI taxes (or excess limitation) ((e) − (h))	(60)	198
(m)	Excess section 904 taxes (or excess limitation) ((i) − (k))	(50)	104

Y's foreign tax items for 1983 and 1984, had old sections 907(b) and (f) and 904(f)(4) applied, would have been as follows:

Table III

		1983	1984
(a)	FOGEI	$1,000	$1,200
(b)	Old FORI (less FOGEI)	300	450
(c)	Other foreign taxable income	200	150
(d)	Total taxable income (domestic and foreign)	2,200	2,500
(e)	FOGEI taxes	400	750
(f)	Old FORI taxes (less (e))	180	290
(g)	Other foreign taxes	60	90
(h)	Section 907(a) limitation (46% × (a))	460	552
(i)	Old FORI taxes (after section 907(a) limitation excluding carryovers)	580 ((f)+(e))	842 ((f)+(h))
(j)	Old section 904(d)(1)(C) taxes ((g))	60	90
(k)	Preliminary U.S. tax (46% × (d))	1,012	1,150
(l)	Old FORI section 907(b) limitation $((k) \times \frac{(a)+(b)}{(d)})$	598	759
(m)	Old section 904(d)(1)(C) limitation $((k) \times \frac{(c)}{(d)})$	92	69
(n)	Excess FOGEI taxes (or excess limitation) ((e)−(h))	(60)	198
(o)	Excess old FORI taxes (or excess limitation) ((i)−(l))	(18)	83
(p)	Excess old section 904(d)(1)(C) taxes (or excess limitation) ((j)−(m))	(32)	21

(ii) *Carryover from 1982 to 1983*—(A) *Unused FOGEI taxes.* For 1982, Y has no unused FOGEI taxes (Table I, 1982, line (n)) since FOGEI taxes paid, $300 (Table I, 1982, line (e)) is less than the section 907(a) limitation, $414 (Table I, 1982, line (h)).

(B) *Unused FORI taxes.* For 1982, Y has no unused old FORI taxes (Table I, 1982, line (o)) since the old FORI section 907(b) limitation, $529 (Table I, 1982, line (l)) exceeds old FORI taxes for 1982, $430 (Table I, 1982, line (i)).

(C) *Unused other foreign taxes.* For 1982, Y has $78 of unused old section 904(d)(1)(C) taxes (Table I, 1982, line (p)). The unused old section 904(d)(1)(C) taxes from 1982 are deemed accrued in 1983 only to the extent of the excess old section 904(d)(1)(C) limitation for 1983, $32 (Table III, 1983, line (p)). Thus, $32 of the unused old section 904(d)(1)(C) taxes for 1982 are deemed accrued in 1983 and $46 are available for carryover to 1984.

(iii) *Carryback of unused FOGEI taxes from 1984 to 1982.* Y has $198 of unused FOGEI taxes for 1984 (Table II, 1984, line (l)). These taxes are deemed accrued in 1982 only to the extent they would have been deemed accrued in 1982 had old section 907(f) remained in effect for 1984. Under old section 907(f), Y's carryback of unused FOGEI taxes would have been limited to $24, 2% of its FOGEI for 1984. All of the $24 is deemed accrued in 1982 because Y's excess section 907(a) limitation for 1982 is $114 (Table I, line (n)) and its excess old FORI section 907(b) limitation for 1982 is $99 (Table I, line (o)).

(iv) *Carryback of unused section 904(d)(1)(C) taxes from 1984 to 1982.* Y has $104 of unused section 904(d)(1)(C) taxes for 1984 (Table II, 1984, line (m)). Those taxes may be carried from 1984 to 1982 but only to the extent of the amount of unused old FORI taxes and unused old section 904(d)(1)(C) taxes from 1984 that would have been deemed accrued in 1982 had old sections 907(b) and (f) and 904(f)(4) remained in effect for 1984. The amount of unused old FORI taxes from 1984, $83 (Table III, 1984, line (o)), that would have been deemed accrued in 1982 is $75, the excess old FORI section 907(b) limitation for 1982, $99 (Table I, line (o)) less $24 of carryback of unused FOGEI taxes from subdivision (iii) above. Unused FOGEI taxes carried back to an excess limitation year are applied before unused other old FORI taxes. See §1.907(b)-2A(d)(1)(ii). Although Y has $21 of unused old section 904(d)(1)(C) taxes for 1984 (Table III, 1984, line (p)) none are deemed accrued in 1982 because there is no excess old section 904(d)(1)(C) limitation for 1982 (Table I, line (p)). Thus, only $75 of the $104 of unused section 904(d)(1)(C) taxes from 1984 are deemed accrued in 1982.

§1.907(f)-1T Carryback and carryover of credits disallowed by section 907(a) (for amounts carried between taxable years that each begin after December 31, 1982) (Temporary regulations).

(a) *In general.* If a taxpayer chooses the benefits of section 901, any unused FOGEI tax paid or accrued in a taxable year beginning after December 31, 1982, may be carried to the taxable years specified in section 907(f) under the carryback and carryover principles of this section and §1.904-2(b). See section 907(e) and §1.907(e)-1T for transitional rules that apply to unused FOGEI taxes carried back or forward between a taxable year beginning before January 1, 1983, and a taxable year beginning after December 31, 1982.

(b) *Unused FOGEI tax*—(1) *In general.* The "unused FOGEI tax" for purposes of this section is the excess of the FOGEI taxes for a taxable year (year of origin) over that year's limitation level (as defined in §1.907(a)-1T(b)).

(2) *Year of origin.* The term "year of origin" in the regulations under section 904 corresponds to the term "unused credit year" under section 907(f).

(c) *Tax deemed paid or accrued.* The unused FOGEI tax from a year of origin that may be deemed paid or accrued under section 907(f) in any preceding or succeeding taxable year ("excess limitation year") may not exceed the lesser of—

(1) The excess extraction limitation for the excess limitation year, or

(2) The excess general section 904 limitation for the excess limitation year.

(d) *Excess extraction limitation.* Under section 907(f)(2)(A), the "excess extraction limitation" for an excess limitation year is the amount by which that year's section 907(a) extraction limitation exceeds the sum of —

(1) The FOGEI taxes paid or accrued, and

(2) The FOGEI taxes deemed paid or accrued in that year by reason of a section 907(f) carryback or carryover from preceding years of origin.

(e) *Excess general section 904 limitation.* Under section 907(f)(2)(B), the "excess general section 904 limitation" for an excess limitation year is the amount by which that year's section 904 general limitation exceeds the sum of—

(1) The general limitation taxes paid or accrued (or deemed to have been paid under section 902 or 960) to all foreign countries and possessions of the United States during the taxable year,

(2) The general limitation taxes deemed paid or accrued in such taxable year under section 904(c) and which are attributable to taxable years preceding the unused credit year, plus

(3) The FOGEI taxes deemed paid or accrued in that year by reason of a section 907(f) carryover (or carryback) from preceding years of origin.

(f) *Section 907(f) priority*. If a taxable year is a year of origin under both section 907(f) and section 904(c), section 907(f) applies first. See section 907(f)-(3)(A).

(g) *Cross-reference*. In computing the carryback and carryover of disallowed credits under section 907(f), the principles of §1.904-2(d), (e), and (f) apply.

(h) *Example*. The following example illustrates the application of section 907(f).

Example. X, a U.S. corporation organized on January 1, 1983, uses the accrual method of accounting and the calendar year as its taxable year. X's only income is income which is not subject to a separate tax limitation under section 904 (d). X's preliminary U.S. tax liability indicates an effective rate of 46% for taxable years 1983-1985. X has the following foreign tax items for 1983-1985:

Example

			1983	*1984*	*1985*
1.		FOGEI	$15,000	$20,000	$10,000
2.		FOGEI taxes	7,500	9,200	4,200
3.		Other foreign taxable income	8,000	5,000	10,000
4.		Other foreign taxes	3,200	2,000	3,000
5.	(a)	Section 907(a) limitation (.46 × Line 1)	6,900	9,200	4,600
	(b)	General section 904 limitation (.46 × (line 1 plus line 3))	10,580	11,500	9,200
6.	(a)	Unused FOGEI taxes (excess of line 2 over line 5(a))	600	0	0
	(b)	Unused general limitation taxes (excess of line 4 plus lesser of line 2 or line 5(a) over line 5(b))	0	0	0
7.	(a)	FOGEI taxes from years preceding 1983 deemed accrued under section 907(f)	0	0	0
	(b)	Section 904 general limitation taxes from years preceding 1983 deemed accrued under section 904(c)	0	0	0
8.	(a)	Excess section 907(a) limitation (excess of line 5(a) over sum of line 2 and line 7(a))	0	0	400
	(b)	Excess section 904 general limitation (excess of line 5(b) over sum of line 4, lesser of line 2 and line 5(a), and line 7(b))	480	300	2,000
9.		Limit on FOGEI taxes that will be deemed accrued under section 907(f) (lesser of line 8(a) and line 8(b)	0	0	400

X has unused 1983 FOGEI taxes of $600. Since the excess section 907(a) limitation for 1984 is zero, the unused FOGEI taxes are carried to 1985. Of the $600 carryover, $400 is deemed accrued in 1985 and the balance of $200 is carried to following years (but not to a year after 1988). After the carryover from 1983 to 1985, the excess section 904 general limitation for 1985 (line 8(b)) is reduced by $400 to $1,600 to reflect the amount of 1983 FOGEI taxes deemed accrued in 1985 under section 907(f).

Par. 10. A new center heading is added to precede §1.911-1 to read as follows:

EARNED INCOME OF CITIZENS OR RESIDENTS OF UNITED STATES

Lawrence B. Gibbs,
Commissioner of Internal Revenue.

Approved September 15, 1988.

O. Donaldson Chapoton,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on January 19, 1989, 8:45 a.m., and published in the issue of the Federal Register for January 23, 1989, 54 FR. 3004)

Subpart F.—Controled Foreign Corporations

Section 954.—Foreign Base Company Income

26 CFR 1.954-3: Foreign base company sales income.
(Also Sections 701, 702, 703; 1.702-1.)

Controlled foreign corporations; foreign base company sales income. The character of an item of income included in a controlled foreign corporation's distributive share from a partnership includes such attributes of the income as would make it subpart F income if realized directly by the controlled foreign corporation.

Rev. Rul. 89-72

ISSUE

Is a portion of a controlled foreign corporation's distributive share of partnership income treated as foreign base company sales income in the circumstances described below?

FACTS

P, a domestic corporation, is engaged in the business of manufacturing machines in the United States. *PRS*, an entity classified as a partnership for United States federal tax purposes, is organized under the laws of Country *X*. *S*, a wholly owned Country *Y* subsidiary of *P* that is a control led foreign corporation (a CFC) as defined in section 957 of the Internal Revenue Code, owns a 25 percent interest in *PRS*. The remaining 75 percent interest in *PRS* is owned by an unrelated Country *X* corporation.

PRS purchased machines from *P* for sale and use in Country *X*. The income earned from the sale of machines in Country *X* is not subject to an effective rate of income tax imposed by a foreign country that is greater than 90 percent of the maximum rate of tax specified in section 11 of the Code.

In 1988, *S*'s distributive share of *PRS*'s income included income from the sale in Country *X* of machines purchased from *P*.

LAW AND ANALYSIS

Section 951(a) of the Code generally requires the United States shareholders of a CFC to include in income their pro rata shares of the CFC's subpart F income for each taxable year. *P* must therefore include *S*'s subpart F income in its income for 1988.

Under section 954(a) of the Code, subpart F income includes foreign base company sales income, including income derived from the purchase of property from a related person where the property is both manufactured and sold for use outside of the CFC's country of organization. *P* and *S* are related persons under section 954(d).

Under section 701 of the Code, a partnership as such is not subject to income tax. Persons carrying on business as partners are liable for income tax only in their separate or individual capacities. The partners of the partnership generally take into account their distributive shares of the partnership's income, gain, loss, deduction and credit as determined under section 704.

Under section 703 of the Code, a partnership must separately state certain items specified in section 702(a). These items are taken into account separately by the partners of the partnership, and under section 702(b) the character of each such item is determined as if it were realized directly by the partner from the source from which realized by the partnership. Among the items to be separately stated by the partnership and separately taken into account by the partners are items set forth in regulations prescribed by the Secretary under section 702(a)(7). Section 1.702-1(a)(8)(ii) of the Income Tax Regulations provides that, in addition to other items specified in section 702(a) and the regulations thereunder, each partner must also take into account separately his distributive share of any partnership item which if separately taken into account by any partner would result in an income tax liability for that partner different from that which would result if that partner did not take the item into account separately. See Rev. Rul. 85-60, 1985-1 C.B. 187. See, also, the district court opinion in *MCA, Inc. v. United States*, 502 F. Supp. 838, 841 (C.D. Cal. 1980), rev'd, 685 F.2d 1099 (9th Cir. 1982), where a dictum suggests that a CFC partner's distributive share of partnership income would be deemed to derive directly from the persons with whom a partnership transacted business.

S's gross income for 1988 includes its distributive share of partnership income from the sale of machines manufactured in the United States that *PRS* purchased from *P* and sold outside *S*'s country of organization. In accordance with sections 702(a) and (b) of the Code and section 1.702-1(a)(8)(ii) of the regulations, such income is taken into account separately by *S*, and the character of such income is determined as if it were realized directly by *S* from the source from which *PRS* realized such income. For purposes of section 954(a) of the Code, the character of an item of income included in a CFC partner's distributive share includes such attributes of the income as would make it subpart F income if realized directly by the CFC partner, including whether the person from whom the goods are purchased is a related person with respect to the CFC partner and whether the sale of the goods occurs outside the CFC partner's country of organization. Income from *PRS*'s sales of U.S.-manufactured machines purchased from *P* and sold outside Country *Y*, if realized directly by *S*, would constitute foreign base company sales income. Therefore, *S*'s distributive share of such income is foreign base company sales income in *S*'s hands.

HOLDING

S's distributive share of *PRS*'s income earned from the sale of machines purchased from *P* is treated as foreign base company sales income in these circumstances.

Section 956.—Investment of Earnings in U.S. Property

26 CFR 1.956-2: Definition of United States property.

Controlled foreign corporations; short term debt obligations. Under certain circumstances, the purchase of debt obligations by a CFC will constitute an investment of earnings in U.S. property under section 956(a) of the Code.

Rev. Rul. 89-73

ISSUE

Whether the purchase of debt obligations by the issuing domestic corporation's controlled foreign corporation, which mature and are repaid shortly before the end of the controlled foreign corporation's taxable year, followed by the purchase of new debt obligations issued by the domestic corporation shortly after the beginning of the controlled foreign corporation's succeeding taxable year, will constitute an investment of earnings in U.S. property under section 956(a) of the Internal Revenue Code of 1986.

FACTS

Example (1)

Corporation *X*, a domestic corporation, issues to the public debt obligations during 1987 and 1988. *CFC*, a subsidiary of *X* and a controlled foreign corporation as defined in section 957 of the Code, is not engaged in U.S. business activity and does not earn income effectively connected with a U.S. trade or business. Both *X* and *CFC* report income on a calendar year basis. *CFC* has accumulated earnings and profits of \$1000x as of December 31, 1987 and has never invested its accumulated profits in United States property as defined in section 956(b) prior to the 1987 taxable year.

On February 5, 1987, *CFC* purchased \$200x of debt obligations issued by *X* that matured and were repaid on November 15, 1987. *CFC* purchased \$225x of debt obligations issued by *X* on January 15, 1988 and sold the obligations to an unrelated third person on November 10, 1988.

Example (2)

The facts are the same as in Example (1) except for *CFC*'s purchases of obligations issued by *X*. On February 1, 1987, *CFC* purchased \$200x of debt obligations issued by *X*. The obligations matured and were repaid on June 30, 1987. On January 15, 1988, *CFC* purchased \$225x of obligations issued by *X* and sold the obligations to an unrelated third person on November 15, 1988.

LAW AND ANALYSIS

Section 951(a)(1)(B) of the Code provides that every person who is a United States shareholder under section 951(b) owning stock in a controlled foreign corporation on the last day of the foreign corporation's taxable year shall include in gross income a pro rata share of the corporation's increase in earnings invested in United States property for such year as determined under section 956(a)(2). The term "United States property" generally includes obligations issued by a United States shareholder of the controlled foreign corporation.

The House Report of the Revenue Act of 1962, which adopted section 956, stated that an objective of that section was "to prevent the repatriation of income to the United States in a manner which does not subject it to U.S. taxation. This objective also accounts for some of the features of this provision, which deny tax deferral where funds are brought back and invested in the United States in a manner which does not otherwise subject them to U.S. taxation." H.R. Rep. No. 1447, 87th Cong., 2d Sess., (1962), at 58, 1962-3 C.B. 405, 462.

The application of section 956 is concerned with the substance of a transaction, not its form. In *Gregory v. Helvering*, 293 U.S. 465 (1935), the Court stated that "the question for determination is whether what was done, apart from the tax motive, was the thing which the statute intended." More recently, in *Houchins v. Commissioner*, 79 T.C. 570, 589 (1982), the Court in discussing economic substance stated that "labels, semantic technicalities, and formal written documents do not necessarily control the tax consequences of a given transaction. Rather we are concerned with economic realities and not the form employed by the parties."

Courts have previously applied a form versus substance analysis to distinguish loans from dividends. *See, e.g., Meyer v. Commissioner*, 45 B.T.A. 228, 238-40 (1941); *Tollefson v. Commissioner*, 52 T.C. 671 (1969), *aff'd*, 431 F.2d 511 (2d Cir. 1970), *cert. denied*, 401 U.S. 908 (1971). However, the application of section 956 is not limited to the standard enunciated in these cases for treating an advance to a shareholder as a dividend, because section 956 is intended to prevent the tax-free repatriation of earnings even in circumstances that would not otherwise constitute a dividend distribution. The facts and circumstances of each case must be reviewed to determine if, in substance, there has been a repatriation of the earnings of the controlled foreign corporation. If a controlled foreign corporation lends earnings to its U.S. shareholder interrupted only by brief periods of repayment which include the last day of the controlled foreign corporation's taxable year, there exists, in substance, a repatriation of the earnings to the U.S. shareholder within the objectives of section 956. Because the substance of such a transaction must control the tax consequences, the lending of the controlled foreign corporation's earnings to the U.S. shareholder is a repatriation of earnings of a type which constitutes an investment in U.S. property under section 956. Such a repatriation will be treated as outstanding at the close of a controlled foreign corporation's taxable year for purposes of computing the amount of earnings invested in U.S. property under section 956(a)(1)-(A). This repatriation results in an investment in U.S. property under section 956 even though the two loans may be treated as separate obligations for other purposes of the Code, such as section 1001. In the case of a brief period of disinvestment in the obligations of a U.S. shareholder, the amount of the investment in U.S. property as of the last day of the CFC's taxable year is equal to the lesser of the amount of the investment in U.S. property in the CFC's first taxable year or the amount of the reinvestment in the next succeeding taxable year. Other factors in addition to the period of disinvestment may be indicative of a repatriation of earnings of the controlled foreign corporation that should be taken into account for section 956 purposes.

HOLDING

In Example (1), the brief period of time between the termination of *CFC*'s investment in U.S. property on November 15, 1987 and the reinvestment in obligations of *X* on January 15, 1988 will be disregarded in determining whether there is an investment in U.S. property as of the close of *CFC*'s 1987 taxable year. The investment by *CFC* in obligations issued by *X* and the reinvestment by *CFC* in *X* obligations will, therefore, be considered together as a $200x investment in U.S. property in 1987 under section 956.

In Example (2), the period of time between *CFC*'s termination of the investment in U.S. property on June 30, 1987 and its reinvestment in U.S. property on January 15, 1988 is not brief compared to the overall period the debt obligations are outstanding. The debt obligations are not, therefore, considered to represent an investment in U.S. property by *CFC* in 1987.

These holdings do not provide a taxpayer the right to compel the Internal Revenue Service to disregard the form of its transactions for Federal income tax purposes. *See Commissioner v. Alfalfa Dehydrating & Milling* 417 U.S. 134 (1974).

Section 960.—Special Rules for Foreign Tax Credit

Whether the limitation of section 901(j)(2)(C) of the Code applies prospectively to earnings derived in South Africa in taxable years beginning after December 31, 1987. See Rev. Rul. 89-44, page 237.

Subchapter O.—Gain or Loss on Disposition of Property
Part III.—Common Nontaxable Exchanges

Section 1033.—Involuntary Conversions

26 CFR 1.1033(a)-1: Involuntary conversions: nonrecognition of gain.

Involuntary conversions; destruction by chemical contamination; subsequent condemnation. Property rendered unsafe for its intended use as a result of chemical contamination is destroyed for purposes of section 1033(a) of the Code. In addition, the subsequent sale of contaminated property to a governmental authority after the passage of an ordinance authorizing eminent domain proceedings constitutes a sale under threat of condemnation for purposes of section 1033(a) and (g) to the extent that the taxpayer can establish that the proceeds represent compensation for taking of the property by the government.

Rev. Rul. 89-2

ISSUES

(1) If chemical contamination renders property unsafe for its intended use, is the property destroyed for purposes of section 1033(a) of the Internal Revenue Code?

(2) Does the sale of the contaminated property to a governmental authority to protect the public health constitute a sale under the threat of condemnation for purposes of section 1033(a) and section 1033(g) of the Code?

FACTS

The taxpayer owned improved real estate that it used in its trade or business in city *X*. Through no fault of the taxpayer, dangerous chemicals were released in the city where the taxpayer's property was located. After sampling the soil in the area, a governmental agency found widespread chemical contamination in concentration levels greatly exceeding the level that is deemed safe for habitation. Responsible health authorities determined that prolonged contact with the chemically contaminated soil represents a serious health risk. The health hazard caused by the chemical contamination is expected to continue indefinitely.

Consequently, the governmental agency announced that the residents and businesses of the city should be relocated to protect the public health. Pursuant to an agreement among the federal, state, and city governments, all residents and businesses were asked to sell their contaminated property. The amount of compensation offered was based on the appraised value of the property undiminished by the contamination. City *X* also passed an ordinance authorizing eminent domain proceedings, if necessary, to acquire the affected properties. After passage of the ordinance, the taxpayer accepted an offer from city *X* to purchase its property. The taxpayer realized a gain from this sale.

LAW AND ANALYSIS

Section 1033(a) of the Code provides for the nonrecognition of gain realized upon the involuntary conversion of property into money as a result of its destruction in whole or in part, or condemnation or threat or imminence thereof. Under section 1033(a)(2), if the taxpayer purchases other property similar or related in service or use to the converted property within a period generally ending 2 years after the first tax year in which gain is realized, then at the election of the taxpayer the gain is recognized only to the extent that the amount realized exceeds the cost of the replacement property.

Section 1033

Involuntary conversion, within the meaning of section 1033(a) of the Code, means that the taxpayer's property, "through some outside force or agency beyond his control, is no longer useful or available to him for his purposes." *C.G. Willis, Inc. v. Commissioner,* 41 T.C. 468, 476 (1964), *aff'd per curiam,* 342 F.2d 996 (3d Cir. 1965). Not all involuntary conversions fall within the scope of section 1033; to qualify, a conversion must result from one of the specified causes. *The Davis Co. v. Commissioner,* 6 B.T.A. 281 (1927), *acq.,* VI-2 C.B. 2 (1927).

Physical damage that renders property unfit for its intended use is a "destruction" for purposes of section 1033(a) of the Code. Rev. Rul. 66-334, 1966-2 C.B. 302, concerns the gradual salt water contamination of an underground fresh water supply that was used for irrigation. The ruling holds that the contamination, which was caused by a fault in the earthen pit containing the salt water, is a destruction of property.

In the present case, chemically contaminated soil in city *X* poses an irremediable hazard to human health. The taxpayer's property is essentially uninhabitable for the foreseeable future, and, consequently, is unfit for the taxpayer's intended use. Thus, the taxpayer's property is destroyed for purposes of section 1033(a) of the Code.

For purposes of section 1033(a) of the Code, it does not matter whether the conversion stems from destruction, or the threat of condemnation, or both. To the extent that the conversion is attributable to the threat of condemnation, however, the taxpayer is eligible for the generally more liberal replacement requirements of section 1033(g).

Section 1033(g)(1) of the Code provides that if real property held for productive use in trade or business or for investment is, as the result of condemnation or threat or imminence thereof, compulsorily or involuntarily converted, property of a like kind to be held either for productive use in trade or business or for investment shall be treated as property similar or related in service or use to the converted property for purposes of section 1033(a). Section 1033(g)(4) provides that in such a case the replacement period is determined by substituting "3 years" for "2 years." Section 1.1033(g)-1(a) of the Income Tax Regulations provides explicitly that section 1033(g) does not apply to conversions attributable solely to destruction.

As used in section 1033(a) and section 1033(g) of the Code, the term "condemnation" refers to the process by which private property is taken for public use, without the consent of the property owner but upon the award and payment of just compensation. Rev. Rul. 57-314, 1957-2 C.B. 523. Public use includes a use intended to conserve the safety and health of the public, even though individual members of the public are unable to use the property taken. Normally, the measure of just compensation is the fair market value of the property taken by the government. *See* Uniform Eminent Domain Code §1002 (1974).

Although a taking to protect the health of the public may qualify as a condemnation under section 1033 of the Code, the taxpayer must distinguish proceeds that are attributable to condemnation (that is, to the government's action in taking the property) from proceeds that compensate the taxpayer for destruction. In Rev. Rul. 74-206, 1974-1 C.B. 198, the taxpayer's property, which had been damaged by a flood, was condemned under a state eminent domain statute that disregarded flood damage in determining fair market value for purposes of establishing the amount of the condemnation award. Reasoning that the statute was designed to provide both fair compensation for the property and a reimbursement for loss resulting from the flood damage, Rev. Rul. 74-206 concludes that the taxpayer's property was involuntarily converted in part as a result of condemnation and in part as a result of destruction.

Here, city *X* purchased the taxpayer's property after passing an ordinance authorizing eminent domain proceedings. The passage of the ordinance satisfies the requirement that there be a threat of condemnation. Rev. Rul. 71-567, 1971-2 C.B. 309. The amount paid by city *X*, however, was based on an appraised value that did not take into account the diminution in value caused by the chemical contamination. As in Rev. Rul. 74-206, the portion of the proceeds that compensates the taxpayer for the destruction of its property must be distinguished from the portion allocable to the condemnation. The proceeds are attributable to the condemnation only to the extent of the fair market value of the property, if any, after taking into account the contamination. The taxpayer may treat the portion of the gain attributable to compensation for the governmental taking under section 1033(a) or 1033(g) of the Code.

HOLDINGS

(1) Property that is rendered unsafe for its intended use as a result of chemical contamination is destroyed for purposes of section 1033(a) of the Code.

(2) In addition, for purposes of section 1033(a), which generally applies to all types of property, and for purposes of section 1033(g), which applies to real property held either for productive use in trade or business or for investment, if that property is sold to a governmental authority after the passage of an ordinance authorizing eminent domain proceedings to protect the public health, then the sale constitutes a sale under the threat of condemnation to the extent that the taxpayer can establish that the proceeds represent compensation for the taking of the property by the government, rather than compensation for the destruction caused by the contamination.

Subchapter P.—Capital Gains and Losses
Part IV.—Special Rules for Determining Capital Gains and Losses

Section 1248.—Gain from Certain Sales or Exchanges of Stock in Certain Foreign Corporations

Whether the limitation of section 901(j)(2)(C) of the Code applies prospectively to earnings derived in South Africa in taxable years beginning after December 31, 1987. See Rev. Rul. 89-44, page 237.

Part V.—Special Rules for Bonds and Other Debt Instruments
Subpart A.—Original Issue Discount

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

(Also Sections 42, 280G, 382, 467, 468, 483, 1288, 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 January 1989.

Rev. Rul. 89-1

This revenue ruling provides various prescribed rates for federal income tax purposes for January 1989 (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). Finally, 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.

REV. RUL. 89-1 TABLE 1

Applicable Federal Rates (AFR) for January 1989

	Period for Compounding			
	Annual	*Semiannual*	*Quarterly*	*Monthly*
Short-Term				
AFR	9.01%	8.82%	8.72%	8.66%
110% AFR	9.94%	9.70%	9.59%	9.51%
120% AFR	10.86%	10.58%	10.44%	10.35%
Mid-Term				
AFR	9.22%	9.02%	8.92%	8.86%
110% AFR	10.17%	9.92%	9.80%	9.72%
120% AFR	11.11%	10.82%	10.68%	10.58%
Long-Term				
AFR	9.28%	9.07%	8.97%	8.90%
110% AFR	10.23%	9.98%	9.86%	9.78%
120% AFR	11.18%	10.88%	10.74%	10.64%

REV. RUL. 89-1 TABLE 2

Adjusted AFR for January 1989

	Period for Compounding			
	Annual	*Semiannual*	*Quarterly*	*Monthly*
Short-term adjusted AFR	5.94%	5.85%	5.81%	5.78%
Mid-term adjusted AFR	6.42%	6.32%	6.27%	6.24%
Long-term adjusted AFR	7.25%	7.12%	7.06%	7.02%

REV. RUL. 89-1 TABLE 3	
Rates Under Section 382 for January 1989	
Adjusted federal long-term rate for the current month	7.25%
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).	7.25%

REV. RUL. 89-1 TABLE 4	
Appropriate Percentages Under Section 42(b)(2) for January 1989	
Appropriate percentage for the 70% present value low-income housing credit	9.20%
Appropriate percentage for the 30% present value low-income housing credit	3.94%

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 February 1989.

Rev. Rul. 89-15

This revenue ruling provides various prescribed rates for federal income tax purposes for February 1989 (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). Finally, 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.

REV. RUL. 89-15 TABLE 1

Applicable Federal Rates (AFR) for February 1989

	Period for Compounding			
	Annual	*Semiannual*	*Quarterly*	*Monthly*
Short-Term				
AFR	9.30%	9.09%	8.99%	8.92%
110% AFR	10.25%	10.00%	9.88%	9.80%
120% AFR	11.21%	10.91%	10.77%	10.67%
Mid-Term				
AFR	9.42%	9.21%	9.11%	9.04%
110% AFR	10.39%	10.13%	10.00%	9.92%
120% AFR	11.36%	11.05%	10.90%	10.80%
Long-Term				
AFR	9.29%	9.08%	8.98%	8.91%
110% AFR	10.24%	9.99%	9.87%	9.79%
120% AFR	11.20%	10.90%	10.76%	10.66%

REV. RUL. 89-15 TABLE 2

Adjusted AFR for February 1989

	Period for Compounding			
	Annual	*Semiannual*	*Quarterly*	*Monthly*
Short-term adjusted AFR	5.98%	5.89%	5.85%	5.82%
Mid-term adjusted AFR	6.40%	6.30%	6.25%	6.22%
Long-term adjusted AFR	7.29%	7.16%	7.10%	7.06%

REV. RUL. 89-15 TABLE 3

Rates Under Section 382 for February 1989

Adjusted federal long-term rate for the current month	7.29%
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)	7.29%

REV. RUL. 89-15 TABLE 4

Appropriate Percentages Under Section 42(b)(2) for February 1989

Appropriate percentage for the 70% present value low-income housing credit	9.22%
Appropriate percentage for the 30% present value low-income housing credit	3.95%

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 March 1989.

Rev. Rul. 89-34

This revenue ruling provides various prescribed rates for federal income tax purposes for March 1989 (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). Finally, 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.

REV. RUL. 89-34 TABLE 1

Applicable Federal Rates (AFR) for March 1989

	Period for Compounding			
	Annual	*Semiannual*	*Quarterly*	*Monthly*
Short-Term				
AFR	9.30%	9.09%	8.99%	8.92%
110% AFR	10.25%	10.00%	9.88%	9.80%
120% AFR	11.21%	10.91%	10.77%	10.67%
Mid-Term				
AFR	9.31%	9.10%	9.00%	8.93%
110% AFR	10.26%	10.01%	9.89%	9.81%
120% AFR	11.22%	10.92%	10.77%	10.68%
Long-Term				
AFR	9.14%	8.94%	8.84%	8.78%
110% AFR	10.07%	9.83%	9.71%	9.63%
120% AFR	11.02%	10.73%	10.59%	10.50%

REV. RUL. 89-34 TABLE 2				
Adjusted AFR for March 1989				
		Period for Compounding		
	Annual	*Semiannual*	*Quarterly*	*Monthly*
Short-term adjusted AFR	6.07%	5.98%	5.94%	5.91%
Mid-term adjusted AFR	6.43%	6.33%	6.28%	6.25%
Long-term adjusted AFR	7.03%	6.91%	6.85%	6.81%

REV. RUL. 89-34 TABLE 3	
Rates Under Section 382 for March 1989	
Adjusted federal long-term rate for the current month	7.03%
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).	7.29%

REV. RUL. 89-34 TABLE 4	
Appropriate Percentages Under Section 42(b)(2) for March 1989	
Appropriate percentage for the 70% present value low-income housing credit	9.19%
Appropriate percentage for the 30% present value low-income housing credit	3.94%

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 April 1989.

Rev. Rul. 89-39

This revenue ruling provides various prescribed rates for federal income tax purposes for April 1989 (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). Finally, 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.

REV. RUL. 89-39 TABLE 1				
Applicable Federal Rates (AFR) for April 1989				
		Period for Compounding		
	Annual	*Semiannual*	*Quarterly*	*Monthly*
Short-Term				
AFR	9.62%	9.40%	9.29%	9.22%
110% AFR	10.61%	10.34%	10.21%	10.12%
120% AFR	11.60%	11.28%	11.13%	11.02%
Mid-Term				
AFR	9.60%	9.38%	9.27%	9.20%
110% AFR	10.59%	10.32%	10.19%	10.10%
120% AFR	11.58%	11.26%	11.11%	11.00%
Long-Term				
AFR	9.40%	9.19%	9.09%	9.02%
110% AFR	10.37%	10.11%	9.99%	9.90%
120% AFR	11.33%	11.03%	10.88%	10.78%

REV. RUL. 89-39 TABLE 2 Adjusted AFR for April 1989				
	Period for Compounding			
	Annual	*Semiannual*	*Quarterly*	*Monthly*
Short-term adjusted AFR	6.37%	6.27%	6.22%	6.19%
Mid-term adjusted AFR	6.81%	6.70%	6.64%	6.61%
Long-term adjusted AFR	7.32%	7.19%	7.13%	7.08%

REV. RUL. 89-39 TABLE 3 Rates Under Section 382 for April 1989	
Adjusted federal long-term rate for the current month	7.32%
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).	7.32%

REV. RUL. 89-39 TABLE 4 Appropriate Percentages Under Section 42(b)(2) for April 1989	
Appropriate percentage for the 70% present value low-income housing credit	9.26%
Appropriate percentage for the 30% present value low-income housing credit	3.97%

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 May 1989.

Rev. Rul. 89-65

This revenue ruling provides various prescribed rates for federal income tax purposes for May 1989 (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). Finally, 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.

REV. RUL. 89-65 TABLE 1 Applicable Federal Rates (AFR) for May 1989				
	Period for Compounding			
	Annual	*Semiannual*	*Quarterly*	*Monthly*
Short-Term				
AFR	9.82%	9.59%	9.48%	9.40%
110% AFR	10.83%	10.55%	10.41%	10.33%
120% AFR	11.84%	11.51%	11.35%	11.24%
Mid-Term				
AFR	9.69%	9.47%	9.36%	9.29%
110% AFR	10.69%	10.42%	10.29%	10.20%
120% AFR	11.68%	11.36%	11.20%	11.10%
Long-Term				
AFR	9.43%	9.22%	9.12%	9.05%
110% AFR	10.40%	10.14%	10.01%	9.93%
120% AFR	11.37%	11.06%	10.91%	10.81%

REV. RUL. 89-65 TABLE 2 Adjusted AFR for May 1989				
	Period for Compounding			
	Annual	*Semiannual*	*Quarterly*	*Monthly*
Short-term adjusted AFR	6.61%	6.50%	6.45%	6.41%
Mid-term adjusted AFR	6.93%	6.81%	6.75%	6.72%
Long-term adjusted AFR	7.39%	7.26%	7.20%	7.15%

REV. RUL. 89-65 TABLE 3 Rates Under Section 382 for May 1989	
Adjusted federal long-term rate for the current month	7.39%
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).	7.39%

REV. RUL. 89-65 TABLE 4 Appropriate Percentages Under Section 42(b)(2) for May 1989	
Appropriate percentage for the 70% present value low-income housing credit	9.27%
Appropriate percentage for the 30% present value low-income housing credit	3.97%

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 June 1989.

Rev. Rul. 89-77

This revenue ruling provides various prescribed rates for federal income tax purposes for June 1989 (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). Finally, 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.

REV. RUL. 89-77 TABLE 1 Applicable Federal Rates (AFR) for June 1989				
	Period for Compounding			
	Annual	*Semiannual*	*Quarterly*	*Monthly*
Short-Term				
AFR	9.39%	9.18%	9.08%	9.01%
110% AFR	10.36%	10.10%	9.98%	9.89%
120% AFR	11.32%	11.02%	10.87%	10.78%
Mid-Term				
AFR	9.34%	9.13%	9.03%	8.96%
110% AFR	10.29%	10.04%	9.92%	9.84%
120% AFR	11.26%	10.96%	10.81%	10.72%
Long-Term				
AFR	9.23%	9.03%	8.93%	8.86%
110% AFR	10.18%	9.93%	9.81%	9.73%
120% AFR	11.13%	10.84%	10.70%	10.60%

REV. RUL. 89-77 TABLE 2

Adjusted AFR for June 1989

	Period for Compounding			
	Annual	*Semiannual*	*Quarterly*	*Monthly*
Short-term adjusted AFR	6.55%	6.45%	6.40%	6.36%
Mid-term adjusted AFR	6.79%	6.68%	6.63%	6.59%
Long-term adjusted AFR	7.17%	7.05%	6.99%	6.95%

REV. RUL. 89-77 TABLE 3

Rates Under Section 382 for June 1989

Adjusted federal long-term rate for the current month	7.17%
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).	7.39%

REV. RUL. 89-77 TABLE 4

Appropriate Percentages Under Section 42(b)(2) for June 1989

Appropriate percentage for the 70% present value low-income housing credit	9.21%
Appropriate percentage for the 30% present value low-income housing credit	3.95%

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 January 1989. See Rev. Rul. 89-1, page 260.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of February 1989. See Rev. Rul. 89-15, page 262.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of March 1989. See Rev. Rul. 89-34, page 263.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of April 1989. See Rev. Rul. 89-39, page 264.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of May 1989. See Rev. Rul. 89-65, page 265.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of June 1989. See Rev. Rul. 89-77, page 266.

Subchapter S.—Tax Treatment of S Corporations and Their Shareholders
Part I.—In General

Section 1361.—S Corporation Defined

S corporation; permissible shareholder. A trust, the terms of which provide that a portion of its corpus may be used to fund a new trust for an "after-born" grandchild of the grantor, is not a "qualified subchapter S trust" under section 1361(d)(3) of the Code.

Rev. Rul. 89-45

ISSUE

Is a trust, which provides that a portion of its corpus may be used to fund a new trust for an "after-born" grandchild of the grantor, a "qualified subchapter S trust" within the meaning of section 1361(d)(3) of the Internal Revenue Code?

FACTS

A is a shareholder of *M*, a corporation that made in 1987 a valid election to be an S corporation. In 1988, *A* created a trust for *A*'s grandchild, *W*, and funded the trust with stock of *M*. *W* is the sole beneficiary of the trust, and, except for the "after-born" provision described below, the trust is a trust described in section 1361(d)(3) of the Code.

The trust agreement contains an "after-born" provision, which states that a new trust will be established with a newborn grandchild as its sole beneficiary each time a grandchild of *A* is born after the execution of the original trust. The new trust will be funded by transferring shares of *M* to the new trust from the existing trust or trusts so that all of the trusts for *A*'s grandchildren will have the same number of shares. No portion of the trust is treated (under the rules set forth in sections 671-677 of the Code) as owned by *A*.

LAW AND ANALYSIS

Section 1361(a)(1) of the Code provides that the term "S corporation" means with respect to any taxable year, a small business corporation for which an election under section 1362(a) is in effect for such year.

Section 1361(b)(1)(B) of the Code provides that a "small business corporation" may not have as a shareholder a person (other than an estate and other than a trust described in section 1361(c)(2)) who is not an individual.

Section 1361(c)(2)(A) of the Code provides that for purposes of section 1361(b)(1)(B) certain trusts may be shareholders of a small business corporation.

Section 1361(d)(1) of the Code provides that in the case of a qualified subchapter S trust for which an election is made by a trust beneficiary under section 1361(d)(2), such trust will be treated as a trust described in section 1361(c)(2)(A)(i), and for purposes of section 678(a), the beneficiary of the trust will be treated as the owner of that portion of the trust that consists of stock in a small business corporation for which an election has been made.

Section 1361(d)(3)(A)(ii) of the Code provides that the term "qualified subchapter S trust" means a trust the terms of which require that, during the life of the current income beneficiary, any corpus distributed may be distributed only to such beneficiary.

In this case, the requirements of section 1361(d)(3)(A)(ii) of the Code are not met because the terms of the trust do not require that during the life of the current income beneficiary, *W*, corpus of the trust may be distributed only to *W*. As a result of the "after-born" provision, corpus of the trust may be distributed to another person during the life of *W*.

HOLDING

A trust which provides that during the life of the current income beneficiary a portion of its corpus may be used to fund a new trust for the benefit of a person other than the current income beneficiary, in this case, an "after-born" grandchild of the grantor, is not a "qualified subchapter S trust" within the meaning of section 1361(d)(3) of the Code. Therefore, for any year in which the trust is a shareholder, *M* will not meet the definition of an S corporation under section 1361(a)(1).

Trusts; qualified subchapter S trusts. A trust is not a qualified subchapter S trust (QSST) if the terms of the trust instrument provide that in the event the trust does not hold shares of an S corporation, the trust may terminate during the life of the current income beneficiary and distribute its corpus to persons other than that beneficiary.

Rev. Rul. 89-55

ISSUE

Is a trust the terms of which provide that in the event the trust does not hold shares of an S corporation, the trust may terminate during the life of the current income beneficiary and distribute its corpus to persons other than the current income beneficiary a qualified subchapter S trust (QSST) under section 1361(d)(3) of the Internal Revenue Code?

FACTS

X is a small business corporation that made a valid election for 1986 to be an S corporation. In 1987, *A* transferred shares of *X* to a trust, *T*, for the benefit of *A*'s children, *C* and *D*. *C* and *D* are successive income beneficiaries of *T*. The terms of the trust instrument satisfy the requirements of sections 1361(d)(3)(A)(i) and (iii) and of 1361(d)(3)(B) of the Code for QSSTs.

The trust instrument provides that corpus is to be distributed only upon the termination of *T*, and generally, that *T* may not terminate while either *C* or *D* is alive. However, if *T* no longer holds any shares of *X*, then *T* may terminate and distribute its assets to *C* and *D* equally or to their issue per stirpes.

LAW AND ANALYSIS

Section 1361(a)(1) of the Code defines the term "S corporation" as a small business corporation for which an election under section 1362(a) is in effect for the taxable year. Section 1361(b)(1)(B) permits only individuals, estates, and certain trusts to be shareholders of a small business corporation. A QSST, defined in section 1361(d)(3), is one type of trust permitted to be a shareholder under section 1361(b)(1)(B).

Section 1361(d)(3)(A)(iv) of the Code provides that a trust is a QSST only if the trust instrument provides that, upon the termination of the trust during the life of the current income beneficiary, the trust must distribute all of its assets to that beneficiary. In this case the question presented is whether the *T* trust instrument complies with this requirement because it provides the income beneficiary with the exclusive asset distribution rights only if *T* holds shares of *X*.

The detailed requirements of section 1361(d)(3) of the Code restrict the permissible class of trusts that may be shareholders of an S corporation under that section to those that are subject to the income and corpus distribution rights of one individual at a time throughout the existence of the trust. This is accomplished by ensuring that during the life of the current income beneficiary, all of the assets of the trust, if distributed, can only be distributed to that individual.

In this case, if *T* no longer holds shares of *X*, then *T* could terminate during *C*'s lifetime, and the assets of *T* could be distributed to more than one individual (*C* and *D* or their issue). Thus, the terms of the *T* trust instrument do not ensure that *C* will be the only distributee of *T*'s assets during *C*'s lifetime.

HOLDING

A trust the terms of which provide that in the event the trust does not hold shares of an S corporation, the trust may terminate during the life of the current income beneficiary and distribute its corpus to persons other than the current income beneficiary is not a (QSST) under section 1361(d) of the Code.

Section 1363.—Effect of Election on Corporation

Under section 1363 of the Code, an electing small business corporation is not subject to the taxes imposed in Chapter 1 of the Code and, therefore, such corporation is not subject to the environmental tax imposed by section 59A which is a Chapter 1 tax. See Rev. Rul. 89-82, page 23.

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 1.1441-3: Exceptions and rules of special application.

Nonresidents; foreign partners distributive share of fixed and determinable

annual or periodical income. Domestic partnerships are required to withhold tax on a foreign partner's distributive share of fixed or determinable annual or periodical income which has not actually been distributed no later than the fifteenth day of the third month following the close of the partnerships taxable year.

Rev. Rul. 89-17

ISSUE

What is the proper time for a domestic partnership to withhold tax on a foreign partner's distributive share of fixed or determinable annual or periodical income that is not effectively connected with a trade or business within the United States and has not been actually distributed?

FACTS

P, a domestic partnership, earns fixed or determinable annual or periodical income during the taxable year that is not effectively connected with a trade or business within the United States. *P* has one or more nonresident alien partners. During the taxable year, *P* does not make any distribution to its partners. The accounting information necessary to compute the nonresident alien partner's distributive share of *P*'s income is not available until after the end of *P*'s taxable year. *P*'s foreign partners are not entitled to the benefits of an income tax treaty.

LAW AND ANALYSIS

Section 1441(a) of the Internal Revenue Code of 1986 provides for the withholding of a 30 percent tax upon items of fixed or determinable annual or periodical income of a nonresident alien individual. Section 1441(b) of the Code defines the types of income subject to withholding, providing that in the case of a nonresident alien individual who is a member of a domestic partnership, the income subject to withholding includes fixed or determinable income included in the nonresident alien's distributive share of partnership income. Section 1.1441-3(f) of the Income Tax Regulations further states: "Domestic partnerships are required to withhold the tax at source ... [on items of fixed or determinable annual or periodical income] that are included in the distributive share (including amounts that are not actually distributed) of a member of such partnership who is a nonresident alien...." Thus, items of fixed or determinable annual or periodical income included in a nonresident alien partner's distributive share, whether actually distributed or not, are subject to withholding unless an exception is provided by regulations.

Neither the Code nor the Regulations specifically state when a partnership must withhold and pay over with respect to amounts of fixed or determinable annual or periodical income that are deemed distributed on the last day of the partnership's taxable year. Under section 706(a), a partner is deemed to receive during his taxable year the partnership distributive share, as defined in section 702, for the partnership taxable year ending with or within the partner's year. Thus a distribution for section 1441 purposes is deemed to occur on the last day of the partnership's taxable year. Withholding should occur as soon as reasonably possible following the deemed receipt of the distribution. Accordingly, withholding on the distributive shares of a nonresident alien's partnership income subject to section 1441, not previously distributed to the partner, shall be made and paid over by the date on which Schedule K or K-1 is sent to that partner. In any event, withholding shall be made and paid over no later than March 15 following the close of the partnership's tax year if its accounting period is the calendar year, or in the case of a fiscal year partnership, by the fifteenth day of the third month following the close of the fiscal year.

HOLDING

A domestic partnership is required to withhold tax on a foreign partner's distributive share of fixed or determinable annual or periodical income that is subject to section 1441, but which has not actually been distributed, by the date on which partnership forms are sent to individual partners, but in any event no later than the fifteenth day of the third month after the taxable year of the partnership closes.

This ruling is not intended to address issues arising under section 1446 of the Code (regarding withholding on effectively connected income), nor does it address the application of any other section not specified.

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26 CFR 1.1441-3: Exceptions and rules of special application.

Nonresidents; withholding on partner's distributive share. A domestic partnership is required to withhold tax on undistributed amounts of a foreign partner's distributive share of fixed or determinable annual or periodical income.

Rev. Rul. 89-33

ISSUE

May a domestic partnership choose not to withhold tax on undistributed amounts of a foreign partner's distributive share of fixed or determinable annual or periodical income that is not effectively connected with a trade or business within the United States?

FACTS

A, a nonresident alien, is a member of *P*, a domestic partnership. *P* earns fixed or determinable annual or periodical income during the taxable year that is not effectively connected with a trade or business within the United States. At the end of the taxable year, *P* computes the distributive shares of individual partners on the basis of the partnership income. *P* does not make a distribution to its partners. *A* is not entitled to the benefits of an income tax treaty.

LAW AND ANALYSIS

Section 1441(a) of the Internal Revenue Code of 1986 provides that any person having the control, receipt, custody, disposal or payment of an item of fixed or determinable annual or periodical income of any nonresident alien individual must (except as otherwise provided in regulations) withhold a tax equal to 30 percent of the gross amount of the income. Section 1441(b) of the Code defines the types of income subject to withholding. In addition, that section provides that in the case of a nonresident alien individual who is a member of a domestic partnership, the items of income subject to withholding includes fixed or determinable income included in the nonresident alien's distributive share of partnership income. Thus, items of fixed or determinable annual or periodical income included in a nonresident alien partner's distributive share are subject to withholding unless an exception is provided by regulations.

Section 1.1441-3(f) of the Income Tax Regulations provides rules that apply to domestic partnerships and domestic fiduciaries of trusts. That section contains this sentence: "If a partnership or a fiduciary withholds under this section on a distributive partnership share or distributable net income of a trust or estate before the income is actually distributed to a partner or beneficiary, then withholding is not required when such income is subsequently distributed." This statement is intended merely to illustrate how section 1441 of the Code operates in the described circumstances and to prevent the imposition of additional withholding at the time of distribution to the partner. The statement does not make withholding on a nonresident alien individual's distributive share of the partnership's fixed or determinable annual or periodical income optional. Mandatory withholding is explicitly required by the first sentence of section 1.1441-3(f): "Domestic partnerships are *required* to withhold the tax at source ... [on items of fixed or determinable annual or periodical income] that are included in the distributive share *(including amounts that are not actually distributed)* of a member of such partnership who is a nonresident alien ... (emphasis added)."

HOLDING

A domestic partnership is required to withhold tax on undistributed amounts of a foreign partner's distributive share of fixed or determinable annual or periodical income.

This ruling is not intended to address issues arising under section 1446 of the Code (regarding withholding on effectively connected income).

Chapter 6.—Consolidated Returns
Subchapter A.—Returns and Payment of Tax

Section 1502.—Regulations

26 CFR 1.1502-14: Stock, bonds, and other obligations of members.

T.D. 8245

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1

Consolidated Return Regulations—Distributions After the Sale of Stock of a Subsidiary

AGENCY: Internal Revenue Service, Treasury.

ACTION: Temporary and final regulations.

SUMMARY: This document contains temporary and final regulations that provide rules under section 1502 relating to a dividend or other distribution subject to section 301 that is declared with respect to stock of a subsidiary member of an affiliated group filing consolidated federal income tax returns if the stock of that subsidiary member is disposed of before the distribution is made, but after the selling member becomes entitled to the distribution. The effect of these regulations is to ensure that appropriate adjustments to the basis of stock in a subsidiary are made before the sale of the stock of the subsidiary. The text of the temporary regulations set forth in this document also serves as the text of the proposed regulations cross-referenced in the notice of proposed rulemaking in * * * [CO-5-89, page 924, this Bulletin].

EFFECTIVE DATE: These regulations are effective for distributions subject to section 301 that are declared in taxable years for which the due date (without extensions) of the federal income tax return is after March 14, 1989.

SUPPLEMENTAL INFORMATION:

This document amends temporary regulation §1.1502-32T and adds cross-references to §§1.1502-14(a) and 1.1502-32(b) and (c). The temporary and final regulations added by this document will remain in effect until superseded by later temporary or final regulations relating to these matters.

Background

A principal purpose of the investment adjustment rules under §1.1502-32 is to ensure that the income and losses of members are taken into account only once in computing taxable income of a group. Accordingly, §1.1502-32(b)(1)(i) provides for a positive adjustment to increase a member's basis in the stock of a subsidiary member to reflect that subsidiary's allocable part of the undistributed earnings and profits arising during a consolidated return year as determined under §1.1502-33. In general, §1.1502-32(b)(2)(iii) provides for a negative adjustment to decrease a member's basis in the stock of a subsidiary member to reflect distributions of these earnings and profits.

For similar reasons, to avoid the double counting of income in computing the taxable income of a group, §1.1502-14(a)(1) provides that a dividend, described in section 301(c)(1), distributed by one member to another member during a consolidated return year is eliminated. Likewise, §1.1502-14(a)(2) provides that no gain shall be recognized to the distributee on a nondividend distribution, described in section 301(c)(2) or (3), with respect to stock from one member to another member during a consolidated return year. Section 1.1502-14(a)(2) requires the distributee to take account of a nondividend distribution by reducing its basis in the stock of the distributing corporation or increasing its excess loss account for such stock.

One purpose of the negative adjustment under §1.1502-32(b)(2)(iii) is to ensure that taxable gain is not reduced or taxable loss increased on a member's sale of the stock of its subsidiary solely on account of the reduction in the stock's value because of a declared dividend. For example, assume that in 1987, corporation P forms subsidiary S with $1,000 capital. For 1987, P and S file a consolidated return and S has undistributed earnings and profits of $50. As of the end of the 1987 consolidated return year, P's basis in the stock of S is increased by $50 to $1,050 due to the investment adjustment rules of §1.1502-32. In 1988, S has zero earnings and profits and declares and pays a dividend to P of $50. Under §1.1502-14(a)(1), the dividend is eliminated. Under §1.1502-32(b)(2)(iii)(a), P reduces its basis in the stock of S by $50. The negative adjustment to the basis of the S stock equals the reduction in value of S as a result of the $50 dividend distribution. Without the negative adjustment P could sell the stock of S for $1,000 (S's fair market value) and recognize a $50 loss. This loss would be unwarranted because no economic loss was realized by P on its investment in the S stock.

Assume, however, that in 1988 P sells the stock of S after the shareholder record date, but before S pays the dividend. The distribution would then occur in a separate return year of S. The fair market value of S is reduced by $50 before the sale of the stock of S as a result of S's obligation to pay the dividend. Some commentators contend that the basis adjustment rules do not apply, and P would recognize a $50 loss on the sale of S. While under this view the dividend distribution would not be eliminated under §1.1502-14(a)(1), P would claim a dividends received deduction on the amount distributed under section 243(a). Again, if P were to recognize a loss on the sale of the S stock, the result would be unwarranted because no economic loss is realized by P on its investment in the S stock.

This regulation is not intended to affect the principles of existing case law under which certain pre-sale dividends are recharacterized as part of the purchase price of the distributing subsidiary. *See, e.g., Waterman Steamship Corpo-*

ration v. Comm'r, 430 F.2d 1185 (5th Cir. 1970), *rev'g* 50 T.C. 650 (1968), *cert. denied* 401 U.S. 939 (1971).

Explanation of Provisions

The temporary regulations provide that, if a member of an affiliated group during a consolidated return year declares a distribution described in section 301 on a share of its stock owned by another member, and the share is disposed of before the distribution, but after the disposing member becomes entitled to the distribution, then for all federal tax purposes the distribution is deemed to be made immediately before the disposition of that share. To the extent the distribution is a dividend, it is eliminated under §1.1502-14(a)(1), and the distributee makes any negative basis adjustment applicable under §1.1502-32(b)(2)(iii) in the stock of the distributor immediately before the disposition. To the extent the distribution is not a dividend, §1.1502-14(a)(2) applies so that no gain or loss is recognized by the distributee, and the distributee reduces its basis (or increases its excess loss account) in the distributor by the amount of the nondividend distribution.

Special Analyses

These rules are not major rules as defined in Executive Order 12291. Therefore, a Regulatory Impact Analysis is not required. These rules, if issued, will not have a significant economic impact on a substantial number of small entities. These rules apply only to affiliated groups of corporations that have elected to file consolidated returns, which tend to be larger businesses. These rules would not significantly alter the reporting or record keeping duties of small entities. Therefore, an initial Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. Chapter 6) is not required.

* * * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR Part 1 is amended as follows:

PART 1— INCOME TAX; TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1986

Paragraph 1. The authority citation for Part 1 is amended by adding the following citation:

Authority: 26 U.S.C. 7805; * * * §1.1502-32T also issued under 26 U.S.C. 1502.

Par. 2. Section 1.1502-14 is amended by adding new paragraph (a)(5) to read as follows:

§1.1502-14 Stock, bonds, and other obligations of members.

(a) * * *

(5) *Distributions after the disposition of stock of a member.* For rules relating to certain distributions subject to section 301, declared before but paid after the disposition of stock of a member, see §1.1502-32T(b).

* * * * *

Par. 3. Section 1.1502-32 is amended by adding new paragraphs (b)(3) and (c)-(4) to read as follows:

§1.1502-32 Investment adjustment.

* * * * *

(b) * * *

(3) *Distributions after the disposition of stock of a member.* For rules relating to adjustments for certain distributions subject to section 301, declared before but paid after the disposition of stock of a member, see §1.1502-32T(b).

(c) * * *

(4) *Distributions after the disposition of stock of a member.* For rules relating to adjustments for certain distributions subject to section 301, declared before but paid after the disposition of stock of a member, see §1.1502-32T(b).

* * * * *

Par. 4. Section 1.1502-32T is amended by redesignating paragraph (b) as paragraph (a)(6) and redesignating the subparagraphs (b)(1) and (b)(2) as paragraphs (a)(6)(i) and (a)(6)(ii), respectively; by changing in the newly redesignated paragraph (a)(6)(ii) the reference to "this paragraph (b)(2)" to "this paragraph (a)(6)(ii)"; and by adding a new paragraph (b) to read as follows:

§1.1502-32T Investment adjustments (temporary).

* * * * *

(b) *Distributions after the disposition of stock of a member*—(1) *General rule.* If a member disposes of a share of stock of another member after a distribution subject to section 301 has been declared on that share and after the date the disposing member becomes entitled to the distribution, but before the distribution has been made, the distribution is deemed to be made for all federal tax purposes immediately before the disposition. For example, the year of realization of the distribution by the shareholder under section 301 and by the distributing member under section 311 is the year of the disposition of the share. The taxable status of the distribution and its effect on earnings and profits of the distributing member is determined with respect to the earnings and profits of the distributing member accrued to the date of the disposition.

(2) *Example.* Paragraph (b)(1) of this section may be illustrated by the following example:

Example. (i) Corporation P forms subsidiary S in 1987 with a capital contribution of $5,000 in exchange for all of S's stock. P and S file consolidated returns. For calendar year 1987, S has undistributed earnings and profits of $100. Under §1.1502-32(b)(1)(i), P increases its basis in its S stock by $100 to $5,100. For 1988, S has $80 of earnings and profits. On December 1, 1988, S declares a cash distribution of $200 to be paid on January 10, 1989, to shareholders of record on December 20, 1988. On December 31, 1988, P sells all of its S stock to Z, an unrelated corporation, for $4,980 (S's fair market value, reduced as a result of S's obligation to pay $200). On January 10, 1989, S pays P the declared distribution of $200. For 1989, S has $90 of earnings and profits.

(ii) On December 31, 1988, when P sells its S stock, P is entitled to the $200 distribution on the S stock which was declared but not paid. Therefore, the distribution is deemed made on December 31, 1988, immediately before the sale. As of December 31, 1988, S has $180 of current and accumulated earnings and profits; therefore, $180 of the distribution is a dividend under section 301(c)(1) and is eliminated under §1.1502-14(a)(1). Under §1.1502-14(a)(2), P recognizes no gain or loss on the remaining $20 of the distribution.

(iii) P's basis of $5,100 in the S stock is reduced by $120 to $4,980 (by $100 under §1.1502-32(b)-(2)(iii)(*a*) and by $20 under §1.1502-14(a)(2)). Since S's 1988 current earnings and profits of $80 are distributed, neither those earnings and profits nor the deemed distribution thereof gives rise to a basis adjustment under §1.1502-32. Accordingly, P recognizes no gain or loss on the sale of the S stock. Immediately after the sale, S has zero earnings and profits. Because the distribution is deemed made on December 31, 1988, S's 1989 earnings and profits are not affected by the distribution. Thus, S has $90 of undistributed earnings and profits for 1989.

(3) *Effective date.* This paragraph (b) applies to distributions described in section 301 that are declared in taxable years for which the due date (without extensions) of the federal income tax return is after March 14, 1989.

* * * * *

The provisions contained in this Treasury decision are needed to provide appropriate adjustments to the basis of stock of a subsidiary member to reflect the subsidiary's fair market value when the subsidiary's stock is sold and a distribution under section 301, declared but unpaid, has reduced the value of the subsidiary. These basis adjustments prevent the unwarranted reduction in taxable gain or increase in taxable loss which would otherwise result. The amendments are needed immediately to respond to recent transactions in which taxpayers have attempted to create these unwarranted reductions in gain or increases in losses. It is therefore found impracticable and contrary to the public interest to issue this Treasury decision with notice and public procedure under section 553(b) of Title 5 of the United States Code or subject to the effective date limitations of section 553(d) of Title 5, United States Code.

Lawrence B. Gibbs,
Commissioner of Internal Revenue.

Approved March 8, 1989.

Dennis E. Ross,
Acting Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on March 14, 1989, 8:45 a.m., and published in the issue of the Federal Register for March 16, 1989, 5 F.R. 10980)

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26 CFR 1.1502-34: Special aggregate stock ownership rules.
(Also Sections 332, 351, 7805; 1.332-2, 1.351-1, 301.7805-1.)

Consolidated returns; affiliated group; aggregate stock ownership rules. The aggregate stock ownership rules of section 1.1502-34 of the regulations apply regardless of actual stock ownership by a member of an affiliated group. Rev. Rul. 74-598 modified.

Rev. Rul. 89-46

ISSUE

If a member of an affiliated group that files a consolidated income tax return owns stock of another corporation, do the aggregate stock ownership rules of section 1.1502-34 of the Income Tax Regulations attribute that stock to other members that do not actually own any stock in the corporation?

FACTS

P is the common parent of an affiliated group of corporations that files a consolidated federal income tax return. *P* has two wholly owned subsidiaries, *X* and *Y*, that are members of the *P* group. On June 1, 1988, *X* transferred certain property to *Y* in exchange for a security of *Y*. The face amount and fair market value of the security equaled the fair market value of the property transferred, but the basis of the property in the hands of *X* did not equal its fair market value.

LAW AND ANALYSIS

Section 1.1502-34 of the regulations provides that, for purposes of sections 1.1502-1 through 1.1502-80, in determining the stock ownership of a member of the group in another corporation (the "issuing corporation") for purposes of determining the application of section 332(b)(1) or 351(a) (among other sections) in a consolidated return year, there shall be included stock owned by all other members of the group in the issuing corporation. Paragraphs (2) and (3) of section 332(b) are not among the sections whose application is determined according to this special attribution rule.

Section 332(a) of the Internal Revenue Code provides that no gain or loss shall be recognized on the receipt by a corporation of property distributed in complete liquidation of another corporation. Section 332(b)(1) provides that section 332(a) applies only if the corporate distributee satisfies an 80-percent ownership requirement with respect to the liquidating corporation. Further, under section 332(b)(2) and (3), section 332(a) applies only if the liquidating distribution is in complete cancellation or redemption of all the liquidating corporation's stock.

Section 351(a) of the Code provides that no gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in the corporation and immediately after the exchange the person or persons are in control (as defined in section 368(c)) of the corporation.

Section 368(c) of the Code generally provides that the term "control" means the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation.

Rev. Rul. 74-598, 1974-2 C.B. 287, *amplified by* Rev. Rul. 75-383, 1975-2 C.B. 127, concerns an affiliated group filing a consolidated income tax return in which a wholly owned foreign subsidiary *(S-1)* of one member of the group *(P)* was to transfer all of its assets to another member of the group *(S-2)* that did not own any stock of the foreign corporation. The ruling holds that section 1.1502-34 of the regulations applies to attribute stock owned by members of an affiliated group to other members of the group only if the other members actually own some of the stock. The ruling concludes that because *S-2* did not actually own any stock of *S-1*, section 1.1502-34 does not attribute stock ownership to *S-2*, and thus section 332 of the Code does not prevent recognition of gain on the transfer. This holding is incorrect. Such an interpretation is not required by the plain language of section 1.1502-34 and would not further the purpose of that section.

Rev. Rul. 74-598 is correct, however, in its ultimate conclusion that section 332 of the Code does not apply to *S-2*'s receipt of property from *S-1* as described in that ruling. Although section 1.1502-34 of the regulations applies to satisfy the 80-percent ownership requirement of section 332(b)(1), it does not apply to satisfy the requirement of section 332(b)(2) or (3) that the distribution be in complete cancellation or redemption of the liquidating corporation's stock. Since *S-2* actually owned no stock in *S-1*, none of the property received by *S-2* from *S-1* was received in such a distribution. However, the transaction described in Rev. Rul. 74-598 still may qualify as a reorganization under section 368(a)(1)(D). *See* Rev. Rul. 75-383.

In the present situation, *X*, a member of the *P* group, transferred property to *Y*, the "issuing corporation," solely in exchange for a security of *Y*. Thus, the requirements of section 351(a) of the Code, other than the control requirement, are satisfied by the exchange. Under section 1.1502-34 of the regulations, even though *X* has no actual stock ownership in *Y*, *X* is considered, for purposes of section 351(a), the owner of the *Y* shares owned by *P*. Because *P* owns 100 percent of the stock of *Y*, *X* is in control of *Y* immediately after the exchange. Therefore, section 351(a) applies to the exchange, and *X* recognizes no gain or loss on the exchange. *See* Rev. Rul. 73-473, 1973-2 C.B. 115. *Cf.* Rev. Rul. 73-472, 1973-2 C.B. 114. If *X* were not a member of an affiliated group filing a consolidated income tax return, section 351(a) would not prevent recognition of gain or loss on the transfer of property from *X* to *Y* because *X* did not own at least 80 percent of the *Y* stock and thus would not be in control of *Y* immediately after the transaction.

HOLDING

If a member of an affiliated group that files a consolidated income tax return owns stock of another corporation, the aggregate stock ownership rules of section 1.1502-34 of the regulations attribute that stock to other members of the group, regardless of whether the other members actually own any stock in the corporation.

EFFECT ON OTHER REVENUE RULINGS

Rev. Rul. 74-598 is modified to hold that the attribution rules of section 1.1502-34 of the regulations apply for the purpose of determining whether a member satisfies the 80-percent ownership requirement of section 332(b)(1) of the Code, regardless of whether the member actually owns stock in the "issuing corporation." Section 1.1502-34 does not apply, however, for purposes of determining whether the other requirements of section 332 are met.

PROSPECTIVE APPLICATION

Any taxpayer that (1) desires to treat a transaction in accordance with the position in Rev. Rul. 74-598 that section 1.1502-34 of the regulations does not apply absent actual ownership of stock in a corporation and (2) entered into such transaction prior to April 3, 1989, the date of publication of this revenue ruling in the Internal Revenue Bulletin, or pursuant to a binding contract that was in effect on such date and at all times thereafter until the consummation of such transaction, may request retroactive relief from the holding of this ruling pursuant to section 7805(b) of the Code.

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26 CFR 1.1502-75: Filing of consolidated returns. (Also Section 381; 1.381(c)(1)-1.)

Consolidated returns; carryback of consolidated net operating losses following the consolidation of two unrelated common parent corporations. Pursuant to the reverse acquisition rules of section 1.1502-75(d)(3) of the regulations, the portion of a consolidated net operating loss attributable to a newly formed common parent, following the consolidation of two unrelated common parents under section 368(a)(1)(A) of the Code, may be carried back to prior years of the affiliated group which is treated as continuing in existence. No portion of the consolidated net operating loss attributable to the newly formed common parent may be carried back to the prior years of the affiliated group which is treated as terminating.

Rev. Rul. 89-80

ISSUE

After a consolidation described in section 368(a)(1)(A) of the Internal Revenue Code, to what extent may the transferor corporations carry back consolidated net operating losses that are attributable to the newly formed common parent corporation?

FACTS

X and *Y* were the common parent corporations of separate affiliated groups, each of which filed consolidated federal income tax returns. Pursuant to a plan of consolidation, *X* and *Y* consolidated into *P*, a newly formed corporation, in a transaction qualifying as a reorganization within the meaning of section 368(a)(1)(A) of the Code. The shareholders of *X* and *Y* each exchanged their stock for stock of *P*. Upon consummation of the consolidation, *X* and *Y* ceased to exist. The subsidiary members of the former *X* and *Y* groups became subsidiary members of the *P* affiliated group. After the consolidation, the former *X* shareholders, as a result of having owned stock in *X*, owned more than 50 percent of the fair market value of the outstanding stock of *P*.

P filed a consolidated federal income tax return on a calendar year basis with the members of the *P* affiliated group. The *P* affiliated group incurred a net operating loss for the first tax year after the consolidation.

LAW AND ANALYSIS

Section 381(a)(2) of the Code provides, in part, that, in a transfer of assets to which section 361 applies and which is in connection with a reorganization described in section 368(a)(1)(A), the acquiring corporation succeeds to and takes into account the items of the transferor corporation described in section 381(c). Section 361 provides for the nonrecognition of gain or loss in a statutory merger or consolidation described in section 368(a)(1)(A).

Section 381(b)(1) of the Code provides that the tax year of the distributor or transferor corporation ends on the date of distribution or transfer. Section 381(b)(3) provides that the corporation (acquiring corporation) acquiring property in a distribution or transfer described in section 381(a) is not entitled to carry back a net operating loss or a net capital loss, for a tax year ending after the date of distribution or transfer, to a tax year of the corporation (transferor corporation) distributing property.

Section 1.1502-75(d)(1) of the Income Tax Regulations provides that as a general rule an affiliated group of corporations is considered as remaining in existence if the common parent corporation remains as the common parent and at least one subsidiary remains affiliated with it.

Section 1.1502-75(d)(3)(i) of the regulations describes a class of transactions (reverse acquisitions) and provides for them an exception to the general rule of section 1.1502-75(d)(1). Specifically, this exception provides that if a corporation (the first corporation) or any member of the group of which the first corporation is the common parent, acquires:

(a) stock of another corporation (the second corporation), and as a result the second corporation becomes (or would become but for the application of section 1.1502-75(d)(3)(i)) a member of a group of which the first corporation is the common parent, or

(b) substantially all of the assets of the second corporation, in exchange (in whole or in part) for the stock of the first corporation, and the stockholders (immediately before the acquisition) of the second corporation, as a result of owning stock in the second corporation, own (immediately after the acquisition) more than 50 percent of the fair market value of the outstanding stock of the first corporation, then any group of which the first corporation was the common parent immediately before the acquisition ceases to exist as of the date of acquisition, and any group of which the second corporation was the common parent immediately before the acquisition is treated as remaining in existence with the first corporation becoming the common parent of the group.

Section 1.1502-75(d)(3)(v)(*b*)(1) of the regulation provides, in general, that if, in an acquisition described in section 1.1502-75(d)(3)(i), the first corporation files a consolidated federal income tax return for the first tax year ending after the date of acquisition, and if the acquisition is described in section 381(a)(2) of the Code, then, for purposes of section 381, all tax years ending on or before the date of acquisition, of the first corporation and of each corporation that immediately before the acquisition is a member of the group of which the first corporation is the common parent, are treated as tax years of the "transferor corporation" that is referred to in section 381(a). The second corporation does not close its tax year merely because of the acquisition. Tax years ending on or before the date of acquisition, of the second corporation and of each corporation that immediately before the acquisition is a member of any group of which the second corporation is the common parent, are treated as tax years of the "acquiring corporation" that is referred to in section 381(a). *See* section 1.1502-75(d)(3)(v)-(*b*)(2).

Section 1.1502-79(a)(1)(i) of the regulations provides, in general, that if a consolidated net operating loss can be carried under the principles of section 172(b) of the Code and section 1.1502-21(b) of the regulations to a separate return year of a corporation that was a member in the year in which such loss arose, then the portion of such consolidated net operating loss attributable to such corporation is apportioned to such corporation and is a net operating loss carryover or carryback to such separate return year; accordingly, such portion is not included in the consolidated net operating loss carryovers or carrybacks to the equivalent consolidated return year.

Section 1.1502-1(e) of the regulations provides that the term "separate return year" means a tax year of a corporation for which it files a separate return or for which it joins in the filing of a consolidated return by another group.

In the present situation, the consolidation of *X* and *Y* into *P* and the issuance of more than 50 percent of the stock of *P* to the shareholders of *X* constitutes a "reverse acquisition" as described in section 1.1502-75(d)(3)(i) of the regulations. For purposes of section 1.1502-75(d)(3)(i), *P* qualifies as the "first corporation" since *P* acquired substantially all of the assets of the transferor corporations in exchange for *P* stock. The fact that *P* did not exist before the transaction does not change this result. *X* qualifies as the "second corporation" because *X* shareholders (immediately before the consolidation), as a result of owning stock in *X*, own (immediately after the consolidation) more than 50 percent of the fair market value of the outstanding stock of *P*. Accordingly, the *X* group remains in existence (with *P* becoming its common parent). Section 1.1502-75(d)(3)(i). As a result, the *X* group does not close its tax year. Section 1.1502-75(d)(3)(v). Because the *X* group remains in existence, tax years of the *X* group ending on or before the consolidation are not "separate return years" unless they would have been such in the absence of the consolidation.

Section 1.1502-75(d)(3)(v)(*b*)(2) of the regulations reverses the application of section 381(b)(3) of the Code such that tax years of *X* (the second corporation) ending on or before the consolidation, and of each corporation that immediately before the consolidation is a member of any group of which *X* is the common parent, are treated as tax years of the acquiring corporation. Therefore, *X* is not treated as a transferor corporation, and, under section 172(b) of the Code and section 1.1502-21(b) of the regulations, consolidated net operating losses of the *P* group that are attributable to *P* may be carried back to tax years of *X* and the former *X* group ending on or before the date of the consolidation. Furthermore, consolidated net operating losses of the *P* group that are attributable to the subsidiary members of the former *X* group (which continues as the *P* group) may be carried back to prior tax years of the former *X* group ending on or before the consolidation to the extent permitted under section 172(b) and section 1.1502-21(b).

Y is treated as a transferor corporation for purposes of section 381(b) of the Code because its shareholders did not acquire more than 50 percent of the fair market value of the stock of *P*; therefore, the *Y* group ceases to exist and its tax year ends on the date of the consolidation. Thus, tax years of *Y* and the former *Y* group ending on or before the effective date of the consolidation are treated as separate return years. Consolidated net operating losses of the *P* group that are attributable to *P* may not be carried back to prior tax years of *Y* and the former *Y* group.

Section 381(b)(3).

Consolidated net operating losses of the *P* group that are attributable to the subsidiary members of the former *Y* group, to the extent permitted by section 172(b) of the Code and section 1.1502-21(b) of the regulations, may be carried back to the separate return years of the subsidiary members of the former *Y* group ending on or before the consolidation. Section 1.1502-79(a)(1).

HOLDING

The portion of consolidated net operating losses attributable to *P*, the newly formed entity, may be carried back to the prior tax years of *X* and the *X* group. None of the consolidated net operating losses attributable to *P* may be carried back to prior tax years of *Y* and the former *Y* group.

Chapter 11.—Estate Tax
Subchapter A.—Estates of Citizens or Residents
Part III.—Gross Estate

Section 2032A.—Valuation of Certain Farm, etc., Real Property

Will the sale of qualified property valued under section 2032A of the Code to a person, not a qualified heir, to allay impending foreclosure on the remaining encumbered qualified property, constitute a disposition within the meaning of section 2032A, triggering the imposition of the recapture tax under section 2032A(c)? See Rev. Rul. 89-4, page 298.

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26 CFR 20.2032A-4: Method of valuing farm real property.

Valuation; special use; method of valuation. An executor electing to value farm property under section 2032A(e)(8) of the Code must apply all of the factors stated in section 2032A(e)(8) that are relevant in that particular valuation.

Rev. Rul. 89-30

ISSUE

In specially valuing farm property under section 2032A of the Internal Revenue Code, may an executor select one of the five valuation factors provided in section 2032A(e)(8) as the exclusive basis for the farm valuation?

FACTS

D died in 1987 owning a farm. On the federal estate tax return filed for D's estate, the executor elected to value the farm as qualified real property under section 2032A of the Code. In addition, the executor elected under section 2032A(e)-(7)(C) to value the farm, for farming purposes, using the method provided in section 2032A(e)(8), rather than using the method provided in section 2032A-(e)(7)(A). The executor stated a farm use value that was based exclusively on the assessed land value factor, one of the five valuation factors provided in section 2032A(e)(8).

Upon the Service's examination of the federal estate tax return, the executor contended that section 2032A(e)(8) provides an election with respect to the prescribed valuation factors to be used in valuing farm property. Further, having selected the assessed land value as the sole valuation factor for D's farm, the executor contended that none of the other section 2032A(e)(8) factors was applicable.

LAW AND ANALYSIS

Section 2032A of the Code provides that, if certain conditions are satisfied, real property includible in a decedent's gross estate that was used for farming purposes may be valued on the basis of its current use value rather than its fair market value.

Section 2032A(e)(7)(A) of the Code provides that, with certain exceptions, the value of a farm for farming purposes shall be determined by dividing i) the excess of the average annual gross cash rental for comparable land used for farming purposes and located in the locality of such farm over the average annual state and local real estate taxes for such comparable land, by ii) the average annual effective interest rate for all new Federal Land Bank loans.

Section 2032A(e)(7)(C) of the Code provides that the formula in section 2032A(e)(7)(A) shall not be used where the executor elects to have the value of the farm for farming purposes determined under section 2032A(e)(8).

Section 2032A(e)(8) of the Code provides that, in any case to which section 2032A(e)(7)(A) does not apply, the following factors shall apply in determining the value of any qualified real property:

(A) The capitalization of income that the property can be expected to yield for farming purposes over a reasonable period of time under prudent management using traditional cropping patterns for the area, taking into account soil capacity, terrain configuration, and similar factors,
(B) The capitalization of the fair rental value of the land for farmland purposes,
(C) Assessed land values in a state that provides a differential or use value assessment law for farmland,
(D) Comparable sales of other farmland in the same geographical area far enough removed from a metropolitan or resort area so that nonagricultural use is not a significant factor in the sales price, and
(E) Any other factor that fairly values the farm value of the property.

In addition to the initial election to value farm property, based on its use for farming purposes, as qualified real property under section 2032A(a) of the Code, section 2032A provides another election under which the executor may choose to value the farm property in accordance with either the method provided for in section 2032A(e)(7)(A) or the method provided in section 2032A(e)(8). Rev. Rul. 83-115, 1983-2 C.B. 155. The section 2032A(e)(7)(A) method of valuation is based, in part, on information on rental of comparable property and the application of a formula. Rev. Rul. 83-115 at 156.

The section 2032A(e)(8) method is based on the application of five valuation factors. That section expressly states that such "factors" shall apply and uses the conjunction "and" to interconnect such factors. This statutory language is further explained by the accompanying legislative history which provides that all the relevant factors prescribed in section 2032A(e)(8) are taken into account when the multiple factor method of valuation in section 2032A(e)(8) is elected. *See* S. Rep. No. 938 (Part 2), 94th Cong., 2d Sess. 15 (1976), 1976-3 (Vol. 3) C.B. 643, 657; H.R. Rep. No. 1380, 94th Cong. 2d Sess. 24, 1976-3 (Vol. 3) C.B. 758. However, in each case, only those factors that are relevant are applied in the respective valuation and, depending upon the circumstances, certain factors may carry more weight than others. See Rev. Rul. 59-60 (Sec. 5), 1959-1 C.B. 237. Consequently, section 2032A(e)(8) does not allow an executor to elect one valuation factor to the exclusion of the other valuation factors provided.

In this case, because the executor elected to value D's farm using the method provided for in section 2032A(e)(8), the farm was to be valued based upon the multiple factors therein. Therefore, notwithstanding the executor's selection of the assessed land value as the exclusive basis for the farm value stated on the federal estate tax return, the other valuation factors provided for in section 2032A(e)(8) are applicable to determine the value of the farm used for farming purposes.

HOLDING

In specially valuing farm property under section 2032A of the Code, an executor may not select one of the five valuation factors provided in section 2032A(e)(8) as the exclusive basis for the farm valuation.

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26 CFR 20.2032A-4: Method of valuing farm real property.

Special use value; farms: interest rates. The 1989 interest rates to be used in computing the special use value of farm real property for which an election is made under section 2032A of the Code are listed for estates of decedents.

Rev. Rul. 89-58

This revenue ruling contains a list of the average annual effective interest rates on new Farm Credit Bank loans. Prior to 1988, the Farm Credit Banks were known as Federal Land Banks. As a result of the Agriculture Credit Act of 1987, Pub. L. No. 100-233, each Federal Land Bank merged into a newly created Farm Credit Bank.

Under section 2032A(e)(7)(A)(ii) of the Internal Revenue Code, rates on new Farm Credit Bank loans are used in computing the special use value of real property used as a farm for which an election is made under section 2032A. This revenue ruling also contains a list of the states within each Farm Credit Bank District. The rates in this revenue ruling may be used by estates that value farmland under section 2032A as of a date in 1989.

Average annual effective interest rates, calculated in accordance with section 2032A(e)(7)(A) of the Code and section 20.2032A-4(e) of the Estate Tax Regulations, to be used under section 2032A(e)(7)(A)(ii), are set forth in the accompanying Table of Interest Rates. The states within each Farm Credit Bank District are set forth in the accompanying Table of Farm Credit Bank Districts.

Rev. Rul. 81-170, 1981-1 C.B. 454, contains an illustrative computation of an average annual effective interest rate. The rates applicable for valuation in 1988 are in Rev. Rul. 88-59, 1988-2 C.B. 332. For rate information for years prior to 1988, see the citations in Rev. Rul. 88-59.

REV. RUL. 89-58 TABLE 1

TABLE OF INTEREST RATES
(Year of Valuation 1989)

Farm Credit Bank District in which property is located	
Baltimore	11.44
Columbia	11.76
Jackson	11.60
Louisville	12.28
Omaha	12.07
Sacramento	12.03
St. Louis	11.50
St. Paul	11.87
Spokane	11.79
Springfield	11.66
Texas	11.09
Wichita	11.74

REV. RUL. 89-58 TABLE 2

TABLE OF FARM CREDIT BANK DISTRICTS

District	States
Baltimore	Delaware, District of Columbia, Maryland, Pennsylvania, Virginia, West Virginia.
Columbia	Florida, Georgia, North Carolina, South Carolina.
Jackson	Alabama, Louisiana, Mississippi.
Louisville	Indiana, Kentucky, Ohio, Tennessee.
Omaha	Iowa, Nebraska, South Dakota, Wyoming.
Sacramento	Arizona, California, Hawaii, Nevada, Utah.
St. Louis	Arkansas, Illinois, Missouri.
St. Paul	Michigan, Minnesota, North Dakota, Wisconsin.
Spokane	Alaska, Idaho, Montana, Oregon, Washington.
Springfield	Connecticut, Maine, Massachusetts, New Hampshire, New Jersey, New York, Rhode Island, Vermont.
Texas	Texas.
Wichita	Colorado, Kansas, New Mexico, Oklahoma.

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26 CFR 20.2032A-8: Election and agreement to have certain property valued under section 2032A for estate tax purposes.

Valuation; special use; disposition by qualified heir. A qualified heir's disposition of specially valued property to a transferee who is not a member of the qualified heir's family results in the imposition of the additional estate tax under section 2032A(c)(1) of the Code even though the transferee is a member of the decedent's family.

Rev. Rul. 89-22

ISSUE

If a qualified heir, as defined in section 2032A(e)(1) of the Internal Revenue Code, disposes of specially valued property to a transferee who is a member of the decedent's family, but who is not a member of the qualified heir's family, does the exception to the additional estate tax imposed by section 2032A(c)(1), on the early disposition of specially valued property, apply?

FACTS

The decedent, who died in 1984, devised farmland to A, a child of the decedent's older sibling. The property was qualified real property for purposes of section 2032A(b) of the Code. On the federal estate tax return filed for the decedent's estate, the executor elected under section 2032A to value the farmland at its qualified use value. The election, in all material respects, complied with the provisions of section 2032A and section 20.2032A-8 of the Estate Tax Regulations. In the agreement attached to the return, A consented to personal liability for any additional estate tax imposed in the event of an early disposition of the farmland. In 1987, A sold the farmland to B, a child of another sibling of the decedent.

LAW AND ANALYSIS

Section 2032A(a) of the Code provides that, if the executor elects the application of section 2032A and files the agreement referred to in section 2032A(d)(2), the value of qualified real property shall be its qualified use value rather than its fair market value.

Section 2032A(c)(1) of the Code provides, for estates of decedents dying after December 31, 1981, that if, within 10 years after the decedent's death and before the death of the qualified heir, the qualified heir disposes of any interest in qualified real property, other than by a disposition to a "member of his family," there is imposed an additional estate tax.

Section 2032A(e)(1) of the Code provides, for estates of decedents dying after December 31, 1981, that the term "qualified heir" means, with respect to any property, a member of the decedent's family who acquired such property (or to whom such property passed) from the decedent. If a qualified heir disposes of any interest in qualified real property to any "member of his family," such member shall thereafter be treated as the qualified heir with respect to such interest.

Section 2032A(e)(2) of the Code provides that the term "member of the family" means, with respect to any individual, only (A) an ancestor of such individual, (B) the spouse of such individual, (C) a lineal descendant of such individual, of such individual's spouse, or of a parent of such individual, or (D) the spouse of any lineal descendant described in (C).

Under section 2032A(c)(1) of the Code, a qualified heir's transfer of specially valued farm property during the ten year period after the decedent's death generally results in the imposition of an additional estate tax. Section 2032A(c)(1)(A) provides an exception from the additional tax for a transfer by a qualified heir to a "member of his family."

In this case, B is a member of the decedent's family under section 2032A(e)(2)(C), as a lineal descendant of the decedent's parent. However, the phrase "member of his family" in section 2032A(c)(1)(A) refers to the qualified heir's family, not the decedent's family. Thus, property can only be disposed of during the recapture period without imposition of a recapture tax if the transfer is to a member of the qualified heir's family. *See* S. Rep. No. 176 (Conf. Rep.), 97th Cong., 1st Sess. 253 (1981). Notwithstanding B's relationship to A (as a cousin), B is not a member of A's family under the definition provided in section 2032A(e)(2). Therefore, the sale of the farmland by A to B is subject to the additional estate tax imposed by section 2032A(c)(1).

HOLDING

If a qualified heir disposes of specially valued property to a transferee who is a member of the decedent's family, but who is not a member of the qualified heir's family, the exception to the additional estate tax imposed by section 2032A(c)(1), on the early disposition of specially valued property, does not apply.

Section 2055.—Transfers for Public, Charitable and Religious Uses

26 CFR 20.2055-2 Transfers not exclusively for charitable purposes.

Charitable deduction; interest passing directly to charity; settlement agreement. An estate is entitled to a charitable deduction under section 2055(a) of the Code for a remainder interest in a split interest trust passing directly to a named charity pursuant to a settlement of a will contest, where the split interest trust did not meet the requirements of section 2055(e)(2). Rev. Rul. 77-491 revoked and Rev. Rul. 78-152 modified.

Rev. Rul. 89-31

ISSUE

If, in settlement of a bona fide will contest, a decedent's estate makes an immediate payment to a qualifying charity in satisfaction of the charity's claim to a split interest remainder that would not be deductible under section 2055(e)(2)(A) of the Code, is the estate entitled to a charitable deduction under section 2055?

FACTS

The decedent died testate in 1987. Under the will, which was executed in 1986, the decedent bequeathed the residue of the estate to a trust under which the trust income was payable to *A* for life with the remainder payable to *B* charity, an organization described in sections 170(c) and 2055(a) of the Code. *A* was the decedent's child.

The bequest to *B* did not comply with the requirements of section 2055(e)(2)(A) of the Code. That section allows a deduction for a bequest of a remainder interest to a charity only if the remainder interest is in a trust that is a charitable remainder annuity trust or a charitable remainder unitrust (described in section 664) or a pooled income Fund (described in section 642(c)(5)).

A in good faith contested the validity of the will. As the result of a bona fide settlement of *A*'s challenge, the estate made an immediate payment of 100x dollars to *A* and distributed the balance of the residuary estate to *B*.

LAW AND ANALYSIS

Section 2055(a) of the Code allows a deduction from the gross estate for the amount of all bequests, legacies, devises, or transfers to specified beneficiaries, including certain charitable institutions.

Prior to the Tax Reform Act of 1969, a deduction generally was allowable for a charitable remainder if the value of the remainder interest was ascertainable and the possibility that the charitable transfer would not become effective was so remote as to be negligible. *See* section 20.2055-2(a) and (b) of the Estate Tax Regulations. Congress perceived that there was often no correlation between the allowable estate tax deduction and the amount ultimately received by the charity because the trustee might favor the income beneficiary over the charitable remainderman by methods such as the exercise of a power of invasion or by manipulating the trust's investments to maximize the income interest. Congress concluded that to correct these abusive situations the annual payment to the income beneficiary must be stated in terms of either a fixed dollar amount or as a fixed percentage of the value of the trust property each year. Section 2055(e)(2)(A) of the Code was enacted by the 1969 Act to achieve this result. *See* H.R. Rep. No. 413 (Part I), 91st Cong., 1st Sess. (1969), 1969-3 C.B. 200, 237, and *Estate of Gillespie v. Commissioner,* 75 T.C. 374, 376-78 (1980). As amended, section 2055(e)(2)(A) provides, in part, that where a remainder interest in property passes or has passed from the decedent for a charitable purpose, and an interest in the same property passes or has passed from the decedent for a noncharitable use, no deduction is allowed under section 2055(a) unless the charitable remainder interest is in a trust that is a charitable remainder annuity trust or a charitable remainder unitrust (described in section 664) or a pooled income fund (described in section 642(c)(5)).

Section 2055(e)(3) was added to the Code in 1974 and amended several times thereafter to establish relief procedures that allow governing instruments to be amended or reformed to comply with the requirements of section 2055(e)(2).

Rev. Rul. 77-491, 1977-2 C.B. 332, deals with a situation in which the decedent had executed two wills. Under each will a charity was to receive a remainder interest that would not have been deductible because the interest did not comply with the requirements of section 2055(e)(2)(A). As the result of the settlement of a will contest, the later will was probated, and the charitable remainderman received an accelerated outright payment in lieu of the remainder interest. The ruling concludes that a charitable deduction was not allowable under section 2055(a) of the

Code because the accelerated payment to the charity pursuant to the settlement was in effect a post mortem modification of the will that did not satisfy the requirement of section 2055(e)(3) of the Code that the charitable interest created be placed in a charitable remainder annuity trust, a charitable remainder unitrust, or a pooled income fund.

Rev. Rul. 78-152, 1978-1 C.B. 296, discusses an additional reason for denying the deduction at issue in Rev. Rul. 77-491. Under *Lyeth v. Hoey,* 305 U.S. 188 (1938), a settlement payment is traceable to the rights that are the source of the compromise, and hence the interest passing to charity pursuant to a compromise of a will contest is deductible to no greater extent than the interest that would have passed had the contest proceeded to judgment and the charity prevailed in its maintenance or defense of the action. Therefore, a charitable deduction was not allowable with respect to the payment to the charity in Rev. Rul. 77-491 since it was in settlement of rights under one or the other of the two wills, and neither will provided for a charitable interest that was deductible under section 2055(e)(2)(a) of the Code.

The Service has reconsidered the position taken in Rev. Rul. 77-491 and the portion of Rev. Rul. 78-152 in support thereof and has concluded that it will no longer adhere to that position in view of adverse decisions in *Flanagan v. U.S.*, 810 F.2d 930 (10th Cir. 1987); *Estate of Strock v. U.S.*, 655 F. Supp. 1334 (W.D Pa. 1987); *Northern Trust Co. v. U.S.*, 78-1 USTC para. 13,229, 41 AFTR2d 78-1523 (N.D. Ill. 1977). In each of these cases a charity received an outright accelerated payment in lieu of a nondeductible remainder interest as the result of the settlement of a bona fide will contest. In each case it was held that a deduction was allowable under section 2055(a) of the Code, and that section 2055(e)(2)(A) of the Code did not apply because the settlement did not create split interests. In other words, section 2055(e)(2)(A) did not operate to disallow the deductions because the interests passing to the charitable and non-charitable beneficiaries were not interests in the same property. Once it has been determined that section 2055(e)(2) of the Code does not apply to a given case, it follows that section 2055(e)(3) of the Code is also inapplicable because the only purpose of the latter section is to allow remedial action to be taken when a deduction would otherwise be disallowed by reason of the former section.

In situations involving settlements of bona fide will contests the Service will no longer challenge the deductibility of immediate payments to charities solely on the ground that they were made in lieu of a split interest that would not constitute an allowable deduction under section 2055(e)(2) of the Code. However, settlements of will contests will continue to be scrutinized in order to assure that the settlement in question is not an attempt to circumvent section 2055(e)(2) by instituting and settling a collusive contest.

HOLDING

If, in settlement of a bona fide will contest, a decedent's estate makes an immediate payment to a qualifying charity in satisfaction of the charity's claim to a split interest remainder that would not be deductible under section 2055(e)(2)(A) of the Code, the estate is entitled to a charitable deduction under section 2055.

EFFECT ON OTHER REVENUE RULINGS

Rev. Rul. 77-491 is revoked.

Rev. Rul. 78-152 is modified.

Chapter 12.—Gift Tax
Subchapter A.—Determination of Tax Liability

Section 2501.—Imposition of Tax

26 CFR 25.2501-1: Imposition of tax.

If a recapitalization that qualifies under section 368(a)(1)(E) increases the value of the stock held by a trust and reduces the value of the stock held by the controlling shareholder, who is the original grantor of the trust, has a gift been made to the trust beneficiaries for federal gift tax purposes, and has an addition to corpus been made for purposes of the generation-skipping transfer tax? See Rev. Rul. 89-3, this page.

Subchapter C.—Deductions

Section 2522.—Charitable and Similar Gifts

26 CFR 25.2522(c)-3: Transfers not exclusively for charitable, etc. purposes in the case of gifts made after July 31, 1969.

The Service ordinarily will not issue rulings as to whether a transfer to an inter vivos charitable remainder trust described in section 664 of the Code that provides for annuity or unitrust payments for one measuring life qualifies for a charitable deduction under section 2522(c)(2)(A) of the Code. See Rev. Proc. 89-19, page 841.

26 CFR 25.2522(c)-3: Transfers not exclusively for charitable, etc. purposes in the case of gifts made after July 31, 1969.

Contributions to a qualifying inter vivos charitable remainder unitrust providing for unitrust payments during one life are deductible for gift tax purposes, assuming that all other applicable requirements for a charitable contribution are met. See Rev. Proc. 89-20, page 841.

26 CFR 25.2522(c)-3: Transfers not exclusively for charitable, etc. purposes in the case of gifts made after July 31, 1969.

Contributions to a qualifying inter vivos charitable remainder annuity trust providing for annuity payments during one life are deductible for gift tax purposes, assuming that all other applicable requirements for a charitable contribution are met. See Rev. Proc. 89-21, page 842.

Chapter 13.—Tax on Certain Generation-Skipping Transfers
Subchapter A.—Tax Imposed

Section 2601.—Tax Imposed

26 CFR 26.2601-1: Effective dates.

If a recapitalization that qualifies under section 368(a)(1)(E) increases the value of the stock held by a trust and reduces the value of the stock held by the controlling shareholder, who is the original grantor of the trust, has a gift been made to the trust beneficiaries for federal gift tax purposes, and has an addition to corpus been made for purposes of the generation-skipping transfer tax? See Rev. Rul. 89-3, this page.

Subchapter B.—Generation-Skipping Transfers

Section 2612.—Taxable Termination; Taxable Distribution; Direct Skip

(Also Sections 354, 368, 2501, 2601; 1.354-1, 1.368-2, 25.2501-1, 26.2601-1.)

Termination; transfer; recapitalization. A donor has made a transfer subject to gift tax and an addition to trust corpus for generation-skipping transfer tax purposes, where, pursuant to a plan of recapitalization, the donor exchanges voting common stock for stock with voting rights that terminate at the donor's death, and the balance of the outstanding stock is held by a generation-skipping trust.

Rev. Rul. 89-3

ISSUE

If a recapitalization that qualifies under section 368(a)(1)(E) of the Internal Revenue Code increases the value of the stock held by a trust and reduces the value of the stock held by a controlling shareholder, who is the original grantor of the trust, has a gift been made to the trust beneficiaries for federal gift tax purposes and has an addition to the corpus of the trust been made for purposes of the federal generation-skipping transfer tax?

FACTS

G created an irrevocable generation-skipping trust in 1982 and funded the trust by transferring to it 100 voting common shares of X Corporation stock. G retained the balance of X Corporation stock, which consisted of 800 voting common shares. At the time of the 1982 funding, the 100 shares transferred to the trust had a value of 500x dollars. The trust instrument provides that income is payable to G's child, C, for life and that only upon C's death is the trust corpus distributable to G's grandchild, D.

In November, 1987, pursuant to a plan of recapitalization, X Corporation issued 800 shares of a new class of B voting common stock to G in exchange for G's 800 shares of regular voting common stock. The Class B common stock had all of the same rights as the stock previously held by G except that, upon the death of G, the voting rights of the Class B common stock would be extinguished. The 100 shares of common stock held by the trust were exchanged for 100 shares of new Class A regular voting common stock. None of the rights of the stock held by the trust was altered. Immediately prior to the recapitalization, the 100 common shares held by the trust had a value of 900x dollars. The recapitalization of X Corporation diminished the value of the stock held by G and increased the value of the stock held by the trust by 100x dollars. Thus, after the recapitalization the stock held by the trust had a value of 1000x dollars. The recapitalization of X Corporation is described in section 368(a)(1)(E) of the Code, and the exchange of common stock for common stock resulted in no recognition of gain or loss to G or to the trust under section 354(a).

LAW AND ANALYSIS

Section 2501(a)(1) of the Code imposes a tax for each calendar year on the transfer of property by gift. Section 2511 applies the gift tax to transfers that are in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible. All transactions whereby property or property rights or interests are gratuitously passed or conferred upon another, regardless of the means or device employed, constitute gifts subject to tax. Section 25.2511-1(c) of the Gift Tax Regulations. However, the gift tax generally is not applicable to transfers for full and adequate consideration in money or money's worth or to transactions at arm's length in the ordinary course of business.

Rev. Rul. 86-39, 1986-1 C.B. 300, described the tax consequences of an acquiescence by a beneficiary of a trust in the recapitalization of a closely-held corporation. The trust owned stock of the corporation and the beneficiary possessed a general power of appointment over the assets of the trust. Because the recapitalization shifted value from stock held by the trust to stock held by another shareholder, the ruling held that the shift resulted in a transfer for federal gift tax purposes.

Section 2601 of the Code imposes a tax on generation-skipping transfers. Section 2611(a) defines a "generation-skipping transfer" to mean a taxable termination, a taxable distribution, or a direct skip.

Section 2612(a) of the Code defines a "taxable termination" to mean the termination (by death, lapse of time, release of a power, or otherwise) of an interest in property held in a trust unless (a) immediately after such termination, someone other than a skip person has an interest in such property, or (b) at no time after such termination may a distribution (including a distribution on termination) be made from such trust to a skip person. A "skip person" is defined by section 2613 to include a person assigned to a generation that is two or more generations below the generation assignment of the transferor, as well as a trust if all interests in such trust are held by skip persons.

Section 2612(b) of the Code provides that a taxable distribution is defined as any distribution from a trust to a skip person except for a taxable termination or a direct skip.

Section 2612(c) of the Code provides that a direct skip is defined as a transfer of an interest in property to a skip person that is subject to either the gift or estate tax.

Under the definition in section 2652(c)(1) of the Code, an individual has an interest in property held in trust if the individual has a right (other than a future right) to receive income or corpus from the trust or is a permissible current recipient of income or corpus from the trust.

Section 1433(b)(2)(A) of the Tax Reform Act of 1986 provides that the amendments made to the generation-skipping transfer tax by the Act do not apply to any transfers from a trust that was irrevocable on September 25, 1985, but only to the extent that such transfers are not made out of corpus added to the trust after September 25, 1985. If an addition to the corpus of an irrevocable trust is made after September 25, 1985, a proportionate amount of any future distribution from, or termination of, interests in property held in the trust is subject to the generation-skipping transfer tax when the distribution or termination occurs.

Under the effective date rules for the generation-skipping transfer tax, generation-skipping transfers from G's trust, which was irrevocable in 1982, are exempt from the tax on generation-skipping transfers to the extent such transfers are not attributable to additions to the trust corpus after September 25, 1985. In general, ordinary appreciation in the value of the corpus of a trust and undistributed income added thereto will not be considered to be an addition to the corpus of a trust.

In this case the recapitalization of X Corporation caused an increase of 100x dollars in the value of the stock held by the trust for the benefit of C and D. Thus, G made an aggregate gift in the amount of 100x dollars to C and D. *See* Rev. Rul. 86-39, cited above, at 301.

Additionally, because G made a gift to the beneficiaries of a generation-skipping trust, the increase in value of 100x dollars constitutes an addition to the corpus of an irrevocable trust for purposes of applying the tax on generation-skipping transfers. The increase in value is treated as a transfer in trust (and is not an increase caused by ordinary appreciation). This transfer generates no generation-skipping transfer tax liability when made because C, who is not a skip person, has an interest in the trust, and D, who is a skip person, does not have an interest in property in the trust within the meaning of section 2652(c)(1) of the Code.

Accordingly, when the trust terminates upon the death of C, that portion of the trust corpus distributable to D, a skip person, that is allocable to the addition to the corpus of the trust will be subject to the tax on generation-skipping transfers. See section 26.2601-1(b)(1)(iv) of the Temporary Generation-skipping Transfer Tax Regulations for the rules describing the taxation of additions to irrevocable trusts.

HOLDING

The recapitalization of X Corporation results, for federal gift tax purposes, in a taxable gift by G to the beneficiaries of the trust and constitutes an addition to the corpus of an irrevocable trust for purposes of the generation-skipping transfer tax because the recapitalization reduces the value of the stock held by G and increases the value of the stock held by the trust. This ruling does not address any issues regarding the application of section 2036(c) of the Code to property transfers occuring after December 17, 1987. No inference is intended by this ruling as to the application of section 2036(c) to recapitalizations occuring after December 17, 1987.

Subtitle C.—Employment Taxes
Chapter 21.—Federal Insurance Contribution Act
Subchapter A.—Tax on Employees

Section 3101.—Rate of Tax

26 CFR 31.3101-2: Rate and computation of employee tax.

Whether back wages paid to an employee by the employee's employer pursuant to the settlement of a discrimination suit are subject to the taxes imposed by section 3101 of the Code for the year in which the award was received or for the years to which the back wages related? See Rev. Rul. 89-35, below.

Section 3102.—Deduction of Tax from Wages

26 CFR 31.3102-1: Collection of, and liability for, employee tax; in general.
(Also Sections 3101, 3111, 3121; 31.3101-2, 31.3111-2, 31.3121(a)-2.)

Payment of social security taxes for back wages. The Service will not follow *Bowman v. United States*, 824 F. 2d 528 (6th Cir. 1987), which held that back wages paid to the taxpayer were subject to social security taxes for the years to which the back wages related and not for the year in which the back wages were received.

Rev. Rul. 89-35

In *Bowman v. United States*, 824 F.2d 528 (6th Cir. 1987), the court considered whether back wages paid to the taxpayer by his employer pursuant to the settlement of a discrimination suit were subject to the taxes imposed by section 3101 of the Internal Revenue Code (Federal Insurance Contributions Act (FICA) or social security taxes) for the year in which the award was received or for the years to which the back wages related. The court held that the back wages paid to the taxpayer were subject to social security taxes for the years to which the back wages related and not for the year in which the award was received.

Section 3101 of the Code imposes social security taxes on an individual on wages received with respect to employment. Section 3101(a) and (b) provides that the rate of tax depends on the calendar year in which the wages are received by the individual. Section 3111 imposes social security taxes on an employer on wages paid with respect to employment. Section 3111(a) and (b) provides that the rate of tax depends on the calendar year in which the wages are paid by the employer.

Section 3102 of the Code requires the employer to deduct the tax imposed by section 3101 from the employee's wages as and when paid.

Section 31.3101-2(c) of the Employment Tax Regulations provides that the employee tax is computed by applying to the wages received by the employee the rate in effect at the time such wages are received. See the example set forth in section 31.3101-2(c) of the regulations. See also Rev. Rul. 55-203, 1955-1 C.B. 114, which holds that liability for social security taxes is computed on an "as paid" basis when the taxpayer receives unpaid minimum wages or unpaid overtime compensation pursuant to the Fair Labor Standards Act; and Rev. Rul. 78-336, 1978-2 C.B. 255, which holds that a back pay award ordered by a court is wages in the year paid, not in the year or years earned, and is subject to a federal income tax withholding at the rates in effect at the time the award is paid.

Based upon the Code provisions, regulations and revenue rulings discussed above, the Service will not follow the decision in *Bowman*. The employee portion of the taxes under section 3101 of the Code should be computed by applying the tax rate in effect at the time the back wages are received by the employee. The employer portion of the tax under section 3111 should be computed by applying the tax rate in effect at the time the back wages are paid.

Subchapter B.—Tax on Employers

Section 3111.—Rate of Tax

26 CFR 31.3111-2: Rates and computation of employer tax.

Whether back wages paid to an employee by the employee's employer pursuant to the settlement of a discrimination suit are subject to the taxes imposed by section 3111 of the Code for the year in which the award was received or for the years to which the back wages related? See Rev. Rul. 89-35, this page.

Subchapter C.—General Provisions

Section 3121.—Definitions

26 CFR 3121(a)-2: Wages; when paid and received.

Whether back wages paid to an employee by the employee's employer pursuant to the settlement of a discrimination suit are subject to the taxes imposed by sections 3101 and 3111 of the Code for the year in which the award was received or for the years to which the back wages related? See Rev. Rul. 89-35, this page.

Chapter 24.—Collection of Income Tax at Source on Wages
Subchapter A.—Witholding from Wages

Section 3406.—Backup Withholding

26 CFR 35a.3406-1: Imposition of backup withholding due to notification of an incorrect taxpayer identification number

T.D. 8248

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 35a

Imposition of Backup Withholding Due To Notification of an Incorrect Taxpayer Identification Number and the Due Diligence Exception to the Imposition of a Penalty for a Missing or an Incorrect Taxpayer Identification Number

AGENCY: Internal Revenue Service, Treasury.

ACTION: Temporary regulations.

SUMMARY: This document contains temporary regulations that would clarify the rules concerning the requirement for payors to backup withhold due to notification of an incorrect taxpayer identification number and the actions that payors must take to exercise due diligence with respect to a missing or an incorrect taxpayer identification number. These regulations also amend those rules in order to conform them to the changes announced in Notice 88-77, 1988-2 C.B. 392, and Notice 88-89, 1988-2 C.B. 413.

Further, the regulations provide new due diligence standards for payors of certain accounts with post-1987 awaiting-TIN certifications, for payors of certain life-insurance beneficiaries, and for payors of certain payees who are exempt from the payment of the tax on self-employment income under Code section

1401 or the Federal Insurance Contributions Act tax on employers or employees under Code sections 3111 or 3101, respectively. These regulations affect payors, brokers, and payees of certain reportable payments and provide them with the guidance necessary to comply with the law.

The text of the temporary regulations set forth in this document also serves as the text of the proposed regulations cross-referenced in the notice of proposed rulemaking in * * * [IA-104-88, page 1020, this Bulletin].

EFFECTIVE DATE: These regulations are effective for reportable payments made after December 31, 1983, and to information returns filed after December 31, 1984. However, the requirements of §35a.3406-1 are effective on and after January 1, 1989. Thus, a payor is only required to notify payees and backup withhold on payee accounts as required by these regulations if the payor receives a notice of an incorrect taxpayer identification number from the Internal Revenue Service on or after January 1, 1989.

SUPPLEMENTARY INFORMATION:

Background

This document contains temporary regulations relating to the requirement that a payor or broker backup withhold 20 percent from any reportable payment under section 3406(a)(1)(B) of the Internal Revenue Code of 1986. This provision was added to the Code by section 104 of the Interest and Dividend Tax Compliance Act of 1983 (Pub. L. 98-67, 97 Stat. 369, 371 [1983-2 C.B. 352]). This document also contains temporary regulations relating to due diligence requirements under section 6676(b) of the Code as amended by section 105 of the Act (Pub. L. 98-67, 97 Stat. 369, 380).

On October 4, 1983, the Federal Register published Temporary Employment Tax Regulations under the Interest and Dividend Tax Compliance Act of 1983 (26 CFR Part 35a) under sections 3406 and 6676(b) of the Internal Revenue Code of 1954 (26 CFR Part 35a.9999-1; T.D. 7916, 48 FR 45362 [1983-2 CB. 272], as amended on November 25, 1983, by T.D. 7922, 48 FR 53111 [1983-2 C.B. 282], and on November 23, 1987, by T.D. 8163, 52 FR 44861 [1987-2 C.B. 226]). Additional temporary regulations were published in the Federal Register on November 25, 1983 (26 CFR Part 35a.9999-2; T.D. 7922, 48 FR 53106, as amended on December 20, 1983, by T.D. 7929, 48 FR 56342 [1984-1 C.B. 285], on March 13, 1984, by T.D. 7922, 49 FR 9417, and on November 23, 1987, by T.D. 8163, 52 FR 44861), on December 20, 1983 (26 CFR Part 35a.9999-3; T.D. 7929, 48 FR 56330, as amended on January 3, 1984, by T.D. 7933, 49 FR 63 [1984-1 C.B. 300], on August 22, 1984, by T.D. 7966, 49 FR 33236 [1984-3 C.B. 324], and on November 23, 1987, by T.D. 8163, 52 FR 44861), on February 28, 1984 (26 CFR Part 35a.9999-3A; T.D. 7946, 49 FR 7227 [1984-1 C.B. 302]), on August 22, 1984 (26 CFR Part 35a.9999-4T, T.D. 7966, 49 FR 33237 [1984-2 C.B. 324], as amended on August 29, 1984, by T.D. 7972, 49 FR 34340 [1984-2 C.B. 327]; and 26 CFR Part 35a.9999-5; T.D. 7967, 49 FR 33240 [1984-2 C.B. 329], as amended on September 19, 1984, by T.D. 7973, 49 FR 36645 [1984-2 C.B. 170], on August 20, 1985, by T.D. 8046, 50 FR 33526 [1985-2 C.B. 61], on April 3, 1986, by T.D. 8046, 51 FR 11447, on December 19, 1986, by T.D. 8110, 51 FR 45453 [1987-1 C.B. 81], and on May 19, 1988, by T.D. 8202, 53 FR 17927 [1988-1 C.B. 78]), on April 23, 1987 (26 CFR Part 35a.3406-2; T.D. 8137, 51 FR 13430 [1987-1 C.B. 302]), and on November 23, 1987 (26 CFR Part 35a.3406-1; T.D. 8163, 52 FR 44861). Those regulations were published primarily to provide guidance under the Interest and Dividend Tax Compliance Act of 1983.

This document contains temporary regulations that would clarify the rules in §35a.3406-1 and §§35a.9999-1 and 35a.9999-3 concerning the requirement to backup withhold due to an incorrect taxpayer identification number under section 3406(a)(1)(B) and the actions that payors must take to exercise due diligence under section 6676(b) as published in the Federal Register on November 23, 1987 (§§35a.9999-1 and -3; T.D. 8163, 52 FR 44861). Also, this document would amend those rules in order to conform them to the changes announced in Notice 88-77, 1988-2 C.B. 392, and Notice 88-89, 1988-2 C.B. 413. Further, this document revises Q/A-10 in §35a.9999-1 (concerning substitute Forms W-9) which was published in the Federal Register on October 4, 1983 (26 CFR Part 35a.9999-1; T.D. 7916, 48 FR 45362) and adds new questions and answers to §35a.9999-3 on actions that payors may take to exercise due diligence. The temporary regulations in this document will remain in effect until superseded by final regulations on this subject. See the Proposed Rules section of * * * [IA-104-88, page 1020, this Bulletin] under which persons may provide written comments to the Internal Revenue Service on the regulations contained in this document.

These temporary regulations are necessary to provide immediate guidance to payors, brokers, and payees when there is notification of an incorrect taxpayer identification number. The Internal Revenue Service intends to publish a notice of proposed rulemaking in the Federal Register in the near future that will provide comprehensive rules regarding backup withholding. Generally, the pertinent provisions of all the temporary regulations with respect to backup withholding will be incorporated in the notice of proposed rulemaking. The notice of proposed rulemaking will provide the public an opportunity to comment on all the regulations sections issued under 3406 and 6676(b). However, the notice and any hearing that might be scheduled will not cover any of the rules set forth in INTL-52-86. See 53 FR 5991 and 54 FR 11236 [1988-1 C.B. 892].

Explanation of Provisions

On November 23, 1987, the Service published Treasury Decision 8163, temporary regulations under sections 3406(a)(1)(B), requiring payors to backup withhold on accounts of payees when notified by the Service that such payees provided an incorrect taxpayer identification number. That Treasury decision also contains temporary regulations under section 6676(b) on the actions that payors must take to exercise due diligence and thereby avoid the $50 penalty for filing an information return of reportable interest or dividends with a missing or an incorrect taxpayer identification number. Payors expressed concern with some of these rules and in particular with their administrability. As a result of this concern the Service issued two notices in 1988 to clarify those areas where confusion existed and to ease the administrability of the rules. See Notice 88-77, 1988-2 C.B. 392, and Notice 88-89, 1988-2 C.B. 413. This document conforms the rules in the Treasury decision to those set forth in the notices. In addition this document contains other clarifying rules to the Treasury decision plus several new substantive rules for the actions that payors must take to exercise due diligence. These new clarifying and substantive rules are as follows.

Backup Withholding Due To Notification Of An Incorrect Taxpayer Identification Number

In response to comments this document makes several minor changes to the notice set forth in the Treasury decision described in §35a.3406-1(c) that payors must send to their payees informing them that their accounts contain an incorrect taxpayer identification number and the actions that payees must take to prevent backup withholding from commencing or to stop it once it has begun.

For example, upon being notified that a payee provided an incorrect taxpayer identification number which is currently used on an account, a payor is required to send a Form W-9 (or an acceptable substitute form) so that the payee can furnish a taxpayer identification number or name (or both) to the payor (or refurnish the existing taxpayer identification number or name (or both) currently on the payee's account) to prevent backup withholding from starting or stop it once it has begun. Many payors informed the Service that in order to change a taxpayer identification number or name (or both) on an account it may be necessary for the payee to execute other documents of the payor in addition to the Form W-9. In response to this comment, this document revises the notice that payors must send to their payees so that it informs the payee of other documents that the payee must send to the payor in order to change a taxpayer identification number or name (or both) on an account. This change is reflected in §35a.3406-1(c)(1), (c)(3)(iv) and (vii), and the paragraph in the notice (which is an Appendix to §35a.3406-1) entitled "Remember".

Several payors informed the Service that they had already purchased or designed a substitute notice in reliance on the Treasury decision. Thus, although the requirements of the notice are being changed by this document, the notice in the Treasury decision as described in §35a.3406-1(c)(3) and set forth in the Appendix to the Treasury decision (or an acceptable substitute thereof) will be considered an acceptable substitute notice under this document.

The Treasury decision requires a payor to send the notice described in §35a.3406-1(c)(*i.e.*, the notice concerning potential backup withholding on the payee's account and requesting a certified taxpayer identification number) to the payee within 5 business days after receiving such notice from the Service or a broker. The date a payor receives the notice is crucial because (1) payors are required to begin backup withholding, when required, after the close of the 30th business day after the date the payor receives the notice, and (2) to exercise due diligence after being notified of an incorrect taxpayer identification number, a payor is required to send the notice as prescribed in §35a.3406-1(c), *i.e.*, within 5 business days after the notice is received. In order for the Service to determine whether backup withholding was applied, when required, and whether a payor exercised due diligence, the Service will date-stamp the notices. That date will be considered the effective date of the notice, *i.e.*, the date that the payor receives the notice.

To avoid a large number of disputes arising between the Service and payors wherein payors contend that due to mail delays or change of addresses, they received the notice later than the notice's effective date, the Service will send the notices to payors approximately 2 or 3 weeks before their effective date. This 2-to-3-week period should be ample time to cover any mail delays.

Thus, the Service anticipates that there will be only a few instances in which a payor will receive a notice after its effective date. In such instances, the effective date of the notice is the actual date of receipt. This change is reflected in §35a.3406-1(c)(1).

Under a literal reading of the Treasury decision a payor is required to send a notice to a payee with respect to each account of the payee for which the Service or a broker notified the payor that such account contained an incorrect taxpayer identification number. Conceivably, a payee could have several accounts with a payor with incorrect taxpayer identification numbers which would require the payor to send multiple notices to a payee during a calendar year. To avoid this result, this document provides that a payor may send one notice to the payee provided that the one notice contains all the information required by the regulations. This change is reflected in §35a.3406-1(c)(2)(ii) and (f).

The Treasury decision also provides that if a payor is notified twice within 3 calendar years that a payee provided an incorrect taxpayer identification number and that incorrect taxpayer identification number is used on the account at the time the payor receives the second notice, the payor is required to impose backup withholding on the account. The payor may not stop backup withholding until the payor has been notified by the Internal Revenue Service pursuant to §35a.3406-1(h) that the payee has provided a correct taxpayer identification number to the Service.

This document amends §35a.3406-1(h) to provide that the Service will notify payors by providing the payee with a Form W-9 on which the payee has certified, under penalties of perjury, that his taxpayer identification number is correct and on which the Service places a stamp verifying that the taxpayer identification number is correct (as associated with the listed surname or business name on the form). A payee may take the Form W-9 to his payors or brokers, and the payors and brokers may obtain a copy of this Form W-9 or require the payee to execute a substitute Form W-9 in order to prevent backup withholding from starting under §35a.3406- 1(f)(3) or to stop it once it has begun. This revised procedure for notifying payors or brokers that a payee has provided a correct taxpayer identification number is reflected in this document in §35a.3406-1(h) and (j) *Example (6)* and *Example (7)*.

A question arose as to whether a notice from the Service or a broker as described in §35a.3406-1(b)(1) or (2) that did not match the information on the payee's account when the notice is received (*i.e.*, same name on each but different taxpayer identification numbers) counts as a "first" notice for determining whether a payor has received two notices of an incorrect taxpayer identification number within 3 calendar years. This document clarifies that only a notice from the Service (or a broker) that contains the same payee information as that on the payee's account is considered a "first" notice. This provision is reflected in this document in §35a.3406-1(f)(1).

This document revises A-20 and A-27 of §35a.9999-3 which concerns the application of backup withholding on payments that are reportable under section 6045. Generally, under A-20 and A-27 backup withholding applies on the sale date as defined under §1.6045-1(d)(4) of the Income Tax Regulations. Section 1.6045-1(d)(4) provides that a broker may report a sale as occurring on the date the sale is entered on the books of the broker or the date the customer becomes entitled to the gross proceeds.

A problem arises with the existing A-20 and A-27 because, effective for information returns filed with respect to sales of property occurring after December 31, 1987, §1.6045-1(d)(4) will be amended to provide that a broker shall report a "sale" as occurring on the date the "sale" is entered on the books of the broker (and not the date the customer becomes entitled to the gross proceeds). See Announcement 88-6, 1988-3 I.R.B. 52. Therefore, A-20 and A-27 are revised to require backup withholding on the "sale" date in accordance with the new rule that will be issued under section 6045.

The revised A-27 retains the provision under which a broker that is also the obligor on a debt security may elect to apply backup withholding on the payment date. However, this provision is modified under this document for "sales" of property after December 31, 1987, to allow the broker-obligor to apply backup withholding on the payment date if the payment date is later than the "sale" date.

Due Diligence

This document amends Q/A-10 of §35a.9999-1 to provide that the forms that members of certain religious groups provide to the Service to become exempt from employment taxes will be deemed an acceptable substitute certified Form W-9. These forms contain the payee's name, address, and taxpayer identification number, as provided by the Service. This provision is added because, due to religious beliefs, these groups will not obtain a taxpayer identification number from the Social Security Administration.

This document also revises the administrative-relief rule under A-56 of §35a.9999-1. Under the rule a payor who wanted to qualify for administrative relief from the penalty under section 6676(b) for filing an information return for the 1988 or a subsequent calendar year with a missing or an incorrect taxpayer identification number for a pre-1984 account for which the payor failed to undertake the mailings as described in A-5 and A-6 and in the related questions and answers on due diligence must have sent a separate mailing by June 30, 1988, to *all* payees of pre-1984 accounts and instruments who have not provided a certified taxpayer identification number to the payor and undertake nonseparate annual mailings on such accounts in subsequent calendar years. The Service announced a revision to this rule in Notice 88-77, 1988-2 C.B. 392, to provide that a payor will not be ineligible for administrative relief (for those accounts for which the required mailing was made) due to an inadvertent failure to make a mailing with respect to a few accounts that could not be located using reasonable care.

This document further revises this rule. Also, a payor will not be ineligible for administrative relief in a calendar year (on those accounts for which the required mailing was made) due to the failure to make a mailing in such year on a *de minimis* number of accounts. A *de minimis* number of accounts is the lesser of 5,000 accounts or one percent (or less) of the total number of accounts for which a mailing should have been made under A-56 in such year.

Further, in its administrative discretion the Service will not enforce the penalty for a calendar year with respect to a *de minimis* number of accounts and those accounts that could not be located using reasonable care if the payor has undertaken a mailing as described in Q/A-5 in such year. Answer 56 is being revised in response to concerns of payors that they might be subject to annual penalties under section 6676(b) because of a failure to mail to such accounts in any one year.

Thus, under the revised rules of A-56 a payor who did not make a mailing to a *de minimis* number of accounts (or those accounts that could not be located using reasonable care) would be subject to a $50 penalty for each account where no mailing was made. To avoid penalties in future years, that payor must make a separate mailing to such accounts in the following year and nonseparate mailings in all following years until a payee furnishes a certified taxpayer identification number. A payor must make a mailing at least annually with respect to *all de minimis* accounts (and *all* accounts that could not be located using reasonable care at the time of the required mailing under A-56 of section 35a.9999-1) in order to obtain administrative relief in any calendar year.

To obtain administrative relief from the penalty the Treasury decision provides that the payor must make an affirmative showing to the satisfaction of the district director or the director of the Internal Revenue Service Center that the person otherwise liable for the penalty under section 6676(b) fulfilled the requirements of Q/A-56. Many payors inquired exactly how payors are supposed to make the "affirmative showing" and by what date. Therefore, this document further amends A-56 to provide that the payor must make a written statement, under penalties of perjury, affirmatively showing to the satisfaction of the district director or director of the Internal Revenue Service Center that the payor fulfilled the requirement of A-56.

This document also amends A-38 of §35a.9999-3 which concerns the refunding of amounts that have been withheld erroneously due to an error by the payor. Several cases have come to the attention of the Service in which certain payees are subjected to backup withholding under section 3406(a)(1)(C) due to notified payee underreporting. Although these payees receive reportable interest or dividend income, that income is usually not subject to income tax due to the low income level of the payees. Therefore, withholding on their interest and dividend income under section 3406(a)(1)(C) usually occurs in error, in part, because these payees have failed to respond to the notices that the Service sends them about potential backup withholding.

Although the Service responds quickly to stop withholding in cases like these, presently there is no refund mechanism for the amounts withheld under A-39. Only amounts that are withheld erroneously can be refunded to a payee. Withholding is erroneous only if the withholding is the result of an error of the payor. Therefore, this document amends A-39 to provide that a payor will be considered to have withheld erroneously if the Service directs the payor to refund an amount withheld pursuant to section 3406(a)(1)(C).

Answer 51 of §35a.9999-3 provides that a payor of a post-1983 account or instrument who permits a payee to open an account without obtaining the payee's taxpayer identification number under penalties of perjury and files an information return with the Service with a missing or an incorrect taxpayer identification number will be liable for the $50 penalty under section 6676(b). Several payors commented that the penalty should not be imposed with respect to a calendar year if the payor has received the Form W-9 even though it was received after the account was opened.

In response to this suggestion, this document amends A-51 to provide that in its administrative discretion the Service will not enforce the penalty with respect to a calendar year if the certified taxpayer identification 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 taxpayer identification number 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. A payor is still liable for the amount that should have been withheld under section 3406(a)(1)(A) due to the payee's failure to provide a certified taxpayer identification number.

This document also revises Q/A-54 of §35a.9999-3 to clarify the rules applicable to a grantor trust with ten or fewer grantors under sections 3406 and 6676(b). Under the revised rules, a grantor trust with ten or fewer grantors is not a payor for purposes of backup withholding. Thus, such a grantor trust is not required to impose backup withholding when it receives a reportable payment. Rather, the trustee of a grantor trust having ten or fewer grantors may not certify, under penalties of perjury, that the trust is not subject to backup withholding due to notified payee underreporting (when required) or that the taxpayer identification number provided by the trustee is correct unless each grantor has furnished the trustee with each such certifica tion, and the trustee uses the taxpayer identification number on any Form 1041 that is filed by the trustee. Only grantor trusts that have more than ten grantors are con sidered payors for purposes of backup withholding.

This document also clarifies in A-54 the legal obligations under section 6676(b) of grantor trusts with ten or fewer grantors.

This document also adds a new Q/A-70A to §35a.9999-3. Question and Answer 70A contains an exception to the general rules of due diligence for payors of reportable interest to life-insurance beneficiaries. The Service received several comments asserting that it is impractical to obtain a taxpayer identification number from a beneficiary prior to the time payment is required to be made to such beneficiary. This result obtains because an insured or annuitant has the unrestricted right to change the beneficiary up to the moment of death. Moreover, in many cases a taxpayer identification number cannot be obtained in advance because the beneficiaries may be designated by class, *e.g.*, issue, heirs, surviving children, rather than by name. When the identity of the beneficiary is known at the time payment is required, the payor does request the taxpayer identification number from the payee. However, in some cases, it is not provided. In such cases the payor proceeds to make a lump-sum payment to the beneficiary as required under State law and has no further contact with the beneficiary. As a result, the payor has little or no opportunity to obtain the number and files an information return with a missing taxpayer identification number for which the payor is subject to the $50 penalty. As a result of the problems experienced in this area, this document adds an exception to the due diligence rules for payors of reportable interest to life-insurance beneficiaries.

Answer 89 of §35a.9999-3 provides, in part, that in order to exercise due diligence after two notifications of an incorrect taxpayer identification number within 3 calendar years, a payor must code all subsequent information returns that are filed with the words "2nd Notice". Answer 89 further provides that the manner in which the words "2nd Notice" should be set forth on the information return will be provided in a revenue procedure issued by the Internal Revenue Service.

This provision is added to the regulations so that a payor will not be renotified a third or subsequent time that the affected payee provided the same incorrect taxpayer identification number. Because payors will not be renotified under such circumstances, payors will not have to search their records with respect to the payee.

The Service expects that setting forth the 2nd-notice indication on the information return will ease some of the administrative burdens on payors. However, the Service has not received many comments from payors on the provision. The Service is interested in receiving comments on whether or not this provision is beneficial. If the provision would not result in a net benefit to payors, the Service will consider its removal.

Special Analyses

These rules are not major rules as defined in Executive Order 12291. Therefore, a Regulatory Impact Analysis is not required. A general notice of proposed rulemaking is not required by 5 U.S.C. §553 for temporary regulations. Therefore, these rules do not constitute regulations subject to the Regulatory Flexibility Act (5 U.S.C. Chapter 6) and a Regulatory Flexibility Analysis is not required.

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Adoption of Amendments to the Regulations

Accordingly, 26 CFR Part 35a is amended as follows:

PART 35a—TEMPORARY EMPLOYMENT TAX REGULATIONS UNDER THE INTEREST AND DIVIDEND TAX COMPLIANCE ACT OF 1983

Paragraph 1. The authority for Part 35a continues to read in part:

Authority: 26 U.S.C. 7805; * * * §35a.3406-1 also issued under 26 U.S.C. 3406(a), (b), (e), (g), (h), and (i); 26 U.S.C. 6109; and 26 U.S.C. 6676.

Par. 2. Section 35a.3406-1 is amended as follows:

1. Paragraph (a)(1) is amended by removing the words "December 31, 1987" in the first sentence and by adding in their place the words "December 31, 1988".

2. Paragraph (a)(2)(ii)(A) is amended by removing the words "sections 6041(a) and" and by adding in their place the words "either sections 6041(a) or".

3. Paragraph (a)(3)(ii) is amended by removing the word "and" in the heading and in the text and by adding in its place the word "or".

4. Paragraph (d)(2)(ii) amended by removing the words "such certification" and by adding in their place the word "it".

5. Paragraph (e) is amended by adding the words "unless Q/A-48 of §35a.9999-3 applies with respect to the accounts of a payee "immediately after the words "Internal Revenue Service pursuant to paragraph (b)(1) or (2) of this section".

6. Paragraph (j) is amended by removing the words "following examples:" in the first sentence and adding in their place the words "following examples in which it is assumed that a notice from the Internal Revenue Service is effective as of January 1, 1988, and that the payor backup withholds under paragraph (d)(1)(i) or (ii), or under paragraph (f)(3)(i) or (ii) of this section:".

7. Paragraph (j) *Example (1)* is amended by removing the word "certification" in the sixth sentence and adding in its place the words "certified Form W-9 or an acceptable substitute form (hereinafter "certification")".

8. Paragraph (j) *Example (2)* is amended by removing the words "certified taxpayer identification number" in the second sentence and adding in their place the word "certification".

9. The first paragraph of the Appendix to §35a.3406-1 is amended by adding the words "the notice published in the Federal Register on November 23, 1987 (52 FR 44871) or to" immediately after the words "similar in content to", and by adding the words " *You Must Provide Us With A Form W-9 (Even If We Already Have One On File For You).*" immediately after the words "*Important Tax Information Please Read Carefully*".

10. The fifth paragraph of the Appendix to §35a.3406-1 entitled "*What to do*" is amended by removing the words "page 3" in the first sentence immediately after the words "(listed on" and adding in their place the words "page (insert correct page number)", by adding the words "if you have never been assigned a SSN," in the third sentence immediately after the word "Also,".

11. The fourth line from the end of the Appendix to §35a.3406-1 captioned "Date" is amended by adding immediately below such line the words "(The portion below must be completed by the payor)".

12. Paragraphs (b)(5)(i), (c), (d)(1) and (2)(i), (f), (h), (j) *Example (6)* and *Example (7)*, and the paragraph in the Appendix to §35a.3406-1 entitled "Remember" are revised to read as follows:

§35a.3406-1 Imposition of backup withholding due to notification of an incorrect taxpayer identification number.

* * * * *

(b) *Notice regarding an incorrect taxpayer identification number.* * * *

(5) *Reasonable care exception*—(i) *Payors.* Payors are not required to withhold on reportable payments made to an account of a payee that could not be located with reasonable care. A payor who satisfies the following two-part facts-and-circumstances test will be considered to have exercised reasonable care for purposes of this paragraph (b)(5).

(A) Part one of the test is satisfied if the payor identifies and uses the appropriate computer or other record system on which to locate accounts of the payee subject to backup withholding under section 3406(a)(1)(B). A payor with a centralized and fully integrated computer system containing all product lines of the payor that pay reportable payments will have identified and used the appropriate system if the payor searches on such system for all accounts of the payee described in paragraph (a)(1) of this section that are subject to backup withholding. A payor whose product lines paying reportable payments are on separate computer or records systems will have identified and used the appropriate system if the payor searches for accounts of the payee on the computer or record system that contains the product line with respect to which the payor received a notification of an incorrect taxpayer identification number pursuant to paragraph (b)(1) or (2) of this section.

(B) Part two of the test is satisfied if the payor uses or inputs the appropriate data or criteria into the system that is correctly identified under paragraph (b)(5)(i)(A) of this section. In general, a payor who uses or inputs the name, taxpayer identification number, and the account number provided on the notice from the Internal Revenue Service or a broker as described in paragraph (b)(1) or (2) of this section will satisfy part two of the test. In some cases the system of a payor cannot utilize the data enumerated in the preceding sentence for locating all accounts of the payee subject to backup withholding under section 3406(a)(1)(B). In such cases the payor must use or input the appropriate data or criteria, as determined by the capability of the payor's computer or record system.

* * * * *

(c) *Notice from payors of backup withholding due to an incorrect taxpayer identification number*—(1) *In general.* If the name and taxpayer identification number listed on the notice from the Internal Revenue Service or a broker as described in paragraph (b)(1) or (2) of this section matches the name and taxpayer identification number used on the payee's account at the time the payor receives the notification of an incorrect taxpayer identification number—

(i) The payor who receives a notice from the Internal Revenue Service is required under section 3406(h)(8) to send a copy of the notice required by paragraph (b)(1) of this section or a substitute notice as described in paragraph (c)(3) of this section to the payee of the account in accordance with paragraph (c)(2) of this section (an example of the notice from the Internal Revenue Service required by section 3406(h)(8) and paragraph (b)(1) of this section is set forth in the Appendix to these temporary regulations), and

(ii) The payor who receives notification of an incorrect taxpayer identification number from a broker as described in paragraph (b)(2) of this section must send a substitute notice as described in paragraph (c)(3) of this section to the payee in accordance with paragraph (c)(2) of this section.

However, a payor is not required to send a notice as described in this paragraph (nor backup withhold under paragraph (d) of this section) with respect to any account of a payee where, due to an error of the payor, the taxpayer identification number on such account is not the number that was provided to the payor on the applicable Form W-9 (or acceptable substitute form) because, for example, the payor transposed the identification number when incorporating it into its business records. If a payor sends a substitute notice, such notice must include all the information set forth in paragraph (c)(3) of this section or must be an acceptable substitute of the notice set forth in the Federal Register on November 23, 1987 (52 FR 44871). The notice set forth in the Federal Register on November 23, 1987 (52 FR 44871) is considered an acceptable substitute notice under paragraph (c)(3) of this section. In addition to the copy of the notice required by paragraph (b)(1) of this section or the substitute notice described in paragraph (c)(3) of this section, the payor must include a Form W-9 or an acceptable substitute form (as described in A-10 of §35a.9999-1) with the notice for the payee to use to provide his name and taxpayer identification number and to certify that the taxpayer identification number is correct, or to provide his name and the taxpayer identification number that was originally furnished and to certify that such taxpayer identification number is correct. The payor is required to include a reply envelope (self-addressed) with the notice to the payee which may be, but is not required to be, postage prepaid. The envelope containing the notice and the Form W-9 (or an acceptable substitute form) must state on the outside in a bold and conspicuous manner: "Important Tax Document Enclosed". The mailing may not include any material other than the notice, the Form W-9 (or an acceptable substitute form), any documents of the payor that are necessary to change the name or taxpayer identification number (or both) on the account of the payee, and the reply envelope of the payor. The notice required by paragraph (c) of this section, and not the notice required by A-39 of

§35a.9999-1 and in the Appendix to §35a.9999-2, shall apply to those payors notified by a broker that a payee is subject to backup withholding under section 3406(a)(1)(B). For purposes of this section, the date set forth on the notice from the Internal Revenue Service (or a broker) shall be considered the date of receipt by and of notification to the payor. However, in the case of a dispute, if the payor demonstrates to the satisfaction of the Internal Revenue Service that the date of actual receipt of the notice is later than the date on the notice, the actual date shall be considered the date of receipt by and of notification to the payor.

(2) *Procedures*—(i) *In general.* The payor must send the notice described in paragraph (c) of this section to the payee within 5 business days after the date that the Internal Revenue Service or a broker notifies the payor pursuant to paragraph (b)(1) or (2) of this section. The payor must mail the notice to the payee's last known address by first-class mail. If it is the customary practice of the payor not to mail any correspondence to a payee, the payor may furnish the notice by personal delivery, by intra-office mail, or by any other means reasonably expected to furnish the notice to the payee promptly. A payor is not required to send the notice to the payee if there is currently a "do not mail" or a "stop mail hold" instruction with respect to the payee's account subject to backup withholding under section 3406(a)(1)(B). However, the payor must handle the notice in the same manner that the payor handles other correspondence of the payee.

(ii) *Two or more notices for a payee in the same calendar year.* A payor who receives, under the same payor employer identification number (or social security number), two or more notices described in paragraph (b)(1) or (2) of this section in a calendar year with respect to a payee may satisfy the requirements of this paragraph (c) with respect to such notices by sending one notice to the payee that satisfies the requirements of paragraph (c)(3) of this section.

(3) *Requirements of substitute notice to the payee.* If the payor does not send a copy of the notice received from the Internal Revenue Service pursuant to paragraph (b)(1) of this section or if the payor is notified by a broker as described in paragraph (b)(2) of this section that the payee provided an incorrect taxpayer identification number, the payor may send a substitute notice as provided for in this paragraph (c)(3). A notice to the payee will satisfy the requirements of section 3406(h)(8) and paragraph (c)(1) of this section if the notice is identical to the one set forth in the Federal Register on November 23, 1987 (52 FR 44871) (or is an acceptable substitute thereof) or if the notice—

(i) Informs the payee that the payor has been notified that the taxpayer identification number furnished by the payee is an incorrect taxpayer identification number (as defined in paragraph (a)(6) of this section);

(ii) Advises the payee of the name and taxpayer identification number combination that the Internal Revenue Service has determined to be incorrect;

(iii) Informs the payee that the payee must either—

(A) Correct the surname (or business name) or taxpayer identification number (or both) and certify, under penalties of perjury, that the newly provided taxpayer identification number is correct, or

(B) State—

(*1*) Under penalties of perjury that the taxpayer identification number originally furnished to the payor is correct and provide that number and the corresponding listed surname (or business name),

(*2*) That the Social Security Administration (or the local office of the Internal Revenue Service in the case of an incorrect employer identification number) has been contacted by the payee to resolve the problem giving rise to the notification of an incorrect taxpayer identification number, or

(C) In the case of a notification of an incorrect taxpayer identification number of an individual payee due to a name change by the payee when the payee has not communicated the change of name to the Social Security Administration—

(*1*) Contact the Social Security Administration and reassign the taxpayer identification number to the surname that is used on the account with the payor, certify under penalties of perjury, that the existing taxpayer identification number shown on the account is correct (and provide the corresponding surname used with that number), and provide a statement that the Social Security Administration has been contacted to reassign the taxpayer identification number to the surname shown on the account, or

(*2*) Use both surnames on the account with the payor (the surname currently shown on the account and the surname shown on the payee's Social Security Administration card if the payee is unable to contact the Social Security Administration at this time), provide the surnames, and certify under penalties of perjury that the furnished taxpayer identification number is correct, and

(*3*) Follow either paragraph (c)(3)(iii)(C)(*1*) or (*2*) of this section consistently with respect to all accounts with the payor;

(iv) Advises the payee of other necessary documentation (*i.e.*, account creation documents) that the payee must provide to the payor in order to change the name or taxpayer identification number (or both) on the account and how to provide such information and the information described in paragraph (c)(3)(iii) of this section to the payor;

(v) Advises the payee to contact the Social Security Administration to obtain a social security card if the payee was never assigned a social security number or to obtain a replacement social security card if the payee lost his card and does not remember his social security number;

(vi) Advises the payee that as a result of providing an incorrect taxpayer identification number, the payor is required under section 3406(a)(1)(B) of the Internal Revenue Code to begin backup withholding 20 percent of—

(A) Reportable payments made to the payee no later than after the close of the day 30 business days after the date that the payor is notified of the incorrect taxpayer identification number if the payor has not received the required Form W-9 (or an acceptable substitute form) as described in paragraph (e) of this section, and either—

(B) Any withdrawals of reportable payments by the payee (or a joint payee in the case of a joint account) that occur after the close of 7 business days after the date that the payor received notice of the incorrect taxpayer identification number and before the day that is 31 business days after the day that the payor received notice of the incorrect taxpayer identification number, if the payee has not provided the payor with the required certified Form W-9 (or an acceptable substitute form) prior to any such withdrawals, or

(C) All reportable payments made to the payee (or a joint payee in the case of a joint account) after the close of 7 business days after the date that the payor received notice of the incorrect taxpayer identification number and prior to the beginning of the period described in paragraph (c)(3)(vi)(A) of this section, if the payor has not received the required certified Form W-9 (or an acceptable substitute form) at the time of the reportable payments;

(vii) Gives the payee the date that the payor received the notice that the payee provided an incorrect taxpayer identification number;

(viii) States that the payee must complete and return the enclosed Form W-9 (or an acceptable substitute form), and, if necessary, other documents of the payor as described in paragraph (c)(3)(iv) of this section, and the statement that the payee contacted the Social Security Administration (or the Internal Revenue Service) before the time described in paragraph (c)(3)(vi) of this section in order to prevent backup withholding under section 3406(a)(1)(B) from starting, or after the time described in paragraph (c)(3)(vi) of this section to stop backup withholding once it has begun and to avoid the imposition of the penalty for failure to provide a correct taxpayer identification number; and

(ix) Advises the payee that the payor may, at its option, refund the amount withheld under section 3406(a)(1)(B) and paragraph (d)(1)(iii) of this section in accordance with the procedures described in Q/A-39 of §35a.9999-3 if the payor receives a certified Form W-9 (or an acceptable substitute form) before the beginning of the period described in paragraph (c)(3)(iv)(A)(and paragraph (d)(1)(i)) of this section.

(4) *Payor must use newly provided certified number.* If the payor receives a certified Form W-9 (or an acceptable substitute form) from the payee in the manner required in paragraph (e) of this section before the end of a calendar year, the payor shall use the name and certified taxpayer identification number on the Form W-9 (or acceptable substitute form) on information returns that the payor is required to file for reportable payments made with respect to the payee for that year and subsequent calendar years. A payor who uses the name and certified taxpayer identification number on an information return as described in this paragraph will satisfy the requirement to provide this information to the Internal Revenue Service as prescribed in section 3406(h)(9).

(d) *Period during which backup withholding is required due to notification of an incorrect taxpayer identification number*—(1) *In general.* Except as provided in paragraph (d)(2) of this section, upon receiving a notice described in paragraph (b)(1) or (2) of this section, the payor must impose backup withholding on all reportable payments made to the payee that are subject to backup withholding during the following periods:

(i) After the close of the 30th business day after the date the payor receives the notice described in paragraph (b)(1) or (2) of this section and on or before the close of the 30th calendar day after the day the payor receives from the payee the certified Form W-9 (or acceptable substitute form) as described in paragraph (e) of this section, and either—

(ii) At the time of any withdrawal by the payee (or a joint payee in the case of a joint account) that occurs after the close of 7 business days after the date the payor receives the notice described in paragraph (b)(1) or (2) of this section to the extent of reportable payments made after receiving the notice described in paragraph (b)(1) or (2) of this section and before the earlier of—

(A) The date the payor imposes backup withholding under paragraph (d)(1)(i) of this section,

(B) The date the payor receives the certified Form W-9 (or an acceptable substitute form) described in paragraph (e) of this section, or

(C) The date of the withdrawal, or

(iii) 7 business days after the date that the payor receives a notice described in paragraph (b)(1) or (2) of this section on all reportable payments made after the close of such 7 business days and prior to the beginning of the period described in paragraph (d)(1)(i) of this section.

For purposes of paragraph (d)(1)(ii), all cash withdrawals of an amount up to the amount of reportable payments made during the period beginning after the day that the payor receives the notice described in paragraph (b)(1) or (2) of this section to the end of the period described in paragraph (d)(1)(ii)(A), (B), or (C) of this section are treated as reportable payments. At the option of the payor, the term "cash" for purposes of this section may be limited to currency or a check issued to close out the account of a payee. Further, under this limitation, the term does not include a cash disbursement from an automatic teller machine nor an electronic transfer. The payor is required to backup withhold 20 percent of all reportable payments subject to backup withholding under section 3406(a)(1)(B) that are made with respect to any account of the payee where that incorrect taxpayer identification number is used (or will be used) by a payor on an information return. However, the payor is not required to backup withhold on any account that could not be located using reasonable care. See paragraph (b)(5) of this section for the definition of reasonable care. At the option of the payor, the payor may refund the amount withheld during the period described in paragraph (d)(1)(iii) if the payor receives a certified Form W-9 (or an acceptable substitute form) from the payee during such period provided that the account of the payee subject to backup withholding under this section is not also subject to backup withholding under section 3406(a)(1)(C) or (D) during such period. For purposes of the preceding sentence, the amounts withheld are deemed to be erroneously withheld as described in Q/A-39 of §35a.9999-3. If a certified Form W-9 (or an acceptable substitute form) is not received by the payor prior to the period described in paragraph (d)(1)(i), *i.e.*, within the 30-business-day period, the amounts withheld shall not be refunded unless the amounts are erroneously withheld without regard to paragraph (d)(1) of this section.

(2) *Grace periods*—(i) *Starting backup withholding.* Pursuant to section 3406(e)(5)(A), the payor may elect, on a payee-by-payee basis or in general, to begin backup withholding at any time during the 30-business-day period described in paragraph (d)(1)(i) of this section. However, a payor electing to impose backup withholding under paragraph (d)(1)(ii) of this section must withhold on a withdrawal from the account of the payee as described in paragraph (d)(1)(ii) of this section.

* * * * *

(f) *Notification of two incorrect taxpayer identification numbers within a 3-year period*—(1) *In general.* If, with respect to a payee, a payor receives a notification as described in paragraph (b)(1) or (2) of this section twice within 3 calendar years, and if an existing account of the payee reflects the incorrect taxpayer identification number when the payor receives the second notice described in paragraph (b)(1) or (2) of this section, then the payor shall—

(i) Disregard any future certified Forms W-9 or acceptable substitute forms (described in paragraph (e) of this section) furnished by the payee with respect to existing accounts with the payor unless the Form W-9 (or acceptable substitute form) is furnished pursuant to paragraph (h) of this section,

(ii) Send the notice described in paragraph (f)(2) of this section to the payee (and not the notice required under paragraph (c) of this section) within 5 business days after the date that the payor receives the notice described in this paragraph (f), and

(iii) Impose backup withholding on any account containing the incorrect taxpayer identification number for the period described in paragraph (f)(3) of this section.

For purposes of this paragraph (f), a payor shall not count any notice as a first notice unless the payor was required to notify the payee about the incorrect taxpayer identification number pursuant to paragraph (c)(1) of this section. Additionally, a payor shall treat the receipt of two or more notices in a calendar year as described in paragraph (b)(1) or (2) of this section with respect to the a payee as the receipt of one notice for purposes of this paragraph. The preceding sentence applies only with respect to a payor who received such two or more notices under the same payor employer identification number (or social security number). The payor who receives such two or more notices may satisfy the requirements of this paragraph by sending one notice to the payee that contains all the information described in paragraph (f)(1) of this section. The payor shall maintain sufficient records to determine whether the payor has received notices described in this paragraph and paragraph (b)(1) or (2) of this section twice within 3 calendar years with respect to a payee as described in this paragraph (f). The envelope containing the notice must state on the outside in a bold conspicuous manner: ''Important Tax Document Enclosed''. The payor is not required to include a Form W-9, nor is the payor required to include a reply envelope in the mailing of the notice to the payee. The payor may not include any material in the mailing of the notice described in this paragraph (f). The notice requirements provided in this paragraph (f), and not the notice requirements provided in A-39 of §35a.9999-1 and in the Appendix to §35a.9999-2, shall apply to a payor notified by a broker that a payee is subject to backup withholding under section 3406(a)(1)(B). The mailing procedure described in paragraph (c)(2) of this section shall apply to the mailing of the notice described in paragraph (f) of this section. A payor is not required to send a notice described in paragraph (f)(2) of this section (nor backup withhold under paragraph (f)(3) of this section) with respect to any account of a payee where, due to an error of the payor, the taxpayer identification number on such account is not the number that was provided to the payor on the applicable Form W-9 (or acceptable substitute form) because, for example, the payor transposed the taxpayer identification number when incorporating it into its business records.

(2) *Notice to payee who has provided two incorrect taxpayer identification numbers within 3 years.* The notice to the payee required by paragraph (f)(1) of this section must list, in a bold and conspicuous manner, the date the payor was notified of the second incorrect taxpayer identification number, the payee's name, address (including street, city, state (or country), and zip or mailing code), and such other information that may be required by revenue procedures and revenue rulings. In addition the notice must state that—

(i) The payor has been notified that the taxpayer identification number furnished by the payee is incorrect, setting forth the name and taxpayer identification number that the Internal Revenue Service has determined to be incorrect and the specific account number that contains the incorrect taxpayer identification number;

(ii) The payor has been notified twice within 3 calendar years that the payee has furnished an incorrect taxpayer identification number on an account with the payor;

(iii) The payor is required to disregard any future taxpayer identification numbers, whether or not certified under penalties of perjury, received from the payee with respect to existing accounts with the payor unless the Internal Revenue Service has notified the payor that such taxpayer identification number is correct;

(iv) As a result of providing an incorrect taxpayer identification number, the payor is required under section 3406(a)(1)(B) with respect to any existing account of the payee that contains that incorrect taxpayer identification number when the payor is notified that the number is incorrect as described in paragraph (f) of this section, to begin backup withholding 20 percent of—

(A) Reportable payments made to the payee no later than after the close of the day 30 business days after the date that the payor is notified of the incorrect taxpayer identification number, and—

(B) Either (*1*) any withdrawals of reportable payments by the payee (or a joint payee in the case of a joint account), or (2) all reportable payments that occur after the close of 7 business days after the date that the payor received the second notice of an incorrect taxpayer identification number and before the day that is 31 business days after the date that the payor received such notice if the Internal Revenue Service has not notified the payor that the payee provided a correct taxpayer identification number to the Internal Revenue Service as described in paragraph (h) of this section; and

(v) The payee must contact the Internal Revenue Service Center where the payee is required to file his income tax return in order to prevent backup withholding under section 3406(a)(1)(B) from starting or to stop it once it has begun.

(3) *Period during which backup withholding is required due to a second notification of an incorrect number within 3 years.* Upon receiving the second notice of an incorrect taxpayer identification number from the Internal Revenue Service or a broker as described in paragraph (f)(1) of this section, the payor must backup withhold on all reportable payments subject to backup withholding (as described in this paragraph) made to the payee—

(i) After the close of the 30th business day after the day on which the payor receives a notice described in paragraph (b)(1) or (2) of this section and ending as of the close of the 30th calendar day after the payor receives the notification from the Internal Revenue Service as described in paragraph (h) of this section and either—

(ii) At the time of any withdrawal by the payee (or a joint payee in the case of a joint account) that occurs after the close of 7 business days after the date the payor receives the notice described in paragraph (b)(1) or (2) of this section and before the earlier of—

(A) The date the payor imposes backup withholding as described in paragraph (f)(3)(i) of this section,

(B) The date the payor receives notification from the Internal Revenue Service as described in paragraph (h) of this section, or

(C) The date of withdrawal, or

(iii) 7 business days after the date that the payor receives a notice described in paragraph (f)(1) of this section on all reportable payments made after the close of such 7 business days and prior to the beginning of the period described in paragraph (f)(3)(i) of this section.

For purposes of paragraph (f)(3)(ii) of this section, all cash withdrawals, as described in paragraph (d)(1) of this section, in an amount up to the amount of the reportable payments made during the period beginning from the day after the day that the payor received the notice described in paragraph (b)(1) or (2) of this section to the end of the period described in paragraph (f)(3)(ii)(A), (B), or (C) are treated as reportable payments. The payor is required to withhold 20 percent of all reportable payments that are made with respect to accounts that the payee maintains with the payor at the time the payor received the second notice of an incorrect taxpayer identification number if that incorrect taxpayer identification number is used by the payor on the account. However, the payor is not required to backup withhold on any account that could not be located using reasonable care. See paragraph (b)(5) of this section for the definition of reasonable care. The payor may not stop backup withholding under paragraph (f)(3) of this section unless the payor has been notified pursuant to paragraph (h) of this section.

(4) *Grace periods*—(i) *Starting backup withholding*. Pursuant to section 3406(e)(5)(A), the payor may elect, on a payee-by-payee basis or in general, to begin backup withholding at any time during the 30-business-day period described in paragraph (f)(3)(i) of this section. However, a payor electing to impose backup withholding as described in paragraph (f)(3)(ii) of this section must backup withhold if there is a withdrawal from the account of the payee.

(ii) *Stopping backup withholding*. Pursuant to section 3406(e)(5)(B), the payor may elect, on a payee-by-payee basis or in general, to treat the notification from the Internal Revenue Service as described in paragraph (h) of this section as having been received at any time within 30 calendar days after such notification is provided and to stop backup withholding at any time within 30 calendar days of receiving such notice. See A-31 of §35a.9999-1 for the application of the rule contained in this paragraph (f)(4)(ii).

* * * * *

(h) *Notice from the Internal Revenue Service to stop backup withholding*. A payor who received a notice pursuant to paragraph (f) of this section will be notified by the Internal Revenue Service to stop backup withholding after the Internal Revenue Service receives a correct taxpayer identification number from the payee. A broker who received a notice pursuant to paragraph (b) of this section will be notified by the Internal Revenue Service that the payee is no longer subject to backup withholding under section 3406(a)(1)(B) and that the broker is no longer required to provide notices to payors under paragraph (b)(2) of this section. A broker who receives a notice under this paragraph (h) from the Internal Revenue Service is not required to provide the notice to any payor to which the broker has previously provided the notice required under paragraph (b)(2) of this section. The Internal Revenue Service will notify a payor or a broker pursuant to this paragraph by providing the payee with a Form W-9 on which the payee has certified, under penalties of perjury, that his taxpayer identification number is correct. The Form W-9 will bear an official stamp of the Internal Revenue Service verifying that the taxpayer identification number on the Form W-9 is correct as associated with the listed surname or business name. A payee may provide a copy of the Form W-9 to his payors or brokers in order to prevent backup withholding under paragraph (f)(3) of this section from beginning or to stop it under paragraph (f)(4)(ii) once it has begun. In lieu of receiving a copy of the Form W-9 described in this paragraph, in its discretion, a payor or broker may require the payee to set forth his name and certify, under penalties of perjury, that his taxpayer identification number is correct (as set forth on the Form W-9 verified by the Internal Revenue Service) on the payor's or broker's substitute Form W-9 in order to prevent backup withholding under paragraph (f)(3) from beginning or to stop it under paragraph (f)(4)(ii) once it has begun.

(j) *Examples*. * * *

* * * * *

Example (6). Assume the same facts as in *Example (4)* except that the Internal Revenue Service notifies P again on November 9, 1990, that E's taxpayer identification number is incorrect. P is required to maintain its business records in a manner that P can determine that the Internal Revenue Service has notified P twice within a 3-year period that E's taxpayer identification number is incorrect. P is required to send the notice described in paragraph (f)(2) of this section to E. E does not make any withdrawal from the account after November 9, 1990. Under paragraph (f) of this section, P is required to begin backup withholding on reportable payments made after December 24, 1990 (after the close of the 30th business day after the day the Internal Revenue Service notifies P). P is required to continue backup withholding until P receives from the payee a copy of the notice from the Internal Revenue Service as described in paragraph (h) of this section.

Example (7). Individual F has three post-1983 accounts with Bank R that pay reportable interest: a checking account, a savings account, and a money market account. The checking and money market accounts were opened in 1986, and the savings account was opened in October of 1988. R treats each of these accounts as a separate account with the Bank. F provided R with the certifications as described under A-32 of §35a.9999-1 at the time each account was opened. On June 1, 1988, the Internal Revenue Service notified R pursuant to paragraph (b)(1) of this section that F furnished an incorrect taxpayer identification number. From its business records, R determined that only the money market account contains the incorrect taxpayer identification number. R timely sends F the notice required under paragraph (b)(1) of this section and receives the certification required under paragraph (e) of this section from F on June 30, 1988. On November 15, 1990, the Internal Revenue Service notifies R that F furnished an incorrect taxpayer identification number. R checks all accounts of F and determines that only the savings account contains the incorrect taxpayer identification number. Further, R determines from its business records that two notifications of an incorrect taxpayer identification number have been received with respect to F within 3 calendar years. R must send F the notice required under paragraph (f)(2) of this section and must commence backup withholding on reportable interest paid on the savings account pursuant to paragraph (f)(3) of this section after December 31, 1990. R must continue to backup withhold on the savings account until R receives from the payee a copy of the notice that was provided to the payee by the Internal Revenue Service as described in paragraph (h) of this section.

Appendix to §35a.3406-1 * * *

* * * * *

Remember

YOU MUST SEND US A SIGNED FORM W-9 WITHIN 30 CALENDAR DAYS FROM THE DATE SHOWN AT THE TOP OF PAGE 1 even if the name and number (SSN or EIN) on your account with us match the name and number (SSN or EIN) on your social security card or the document issuing you an EIN. If we do not receive your Form W-9, any other documents that are necessary for us to change the name or TIN (or both) on your account to reflect the name and number on the newly provided Form W-9, and, if necessary, the statement that you contacted SSA or IRS within the 30-day period, we may be required to withhold 20 percent from any reportable payment that we pay to your account until we receive the necessary documents. Also, if you make a withdrawal from your account before the end of a 30-business-day period beginning after the close of 7 business days after the date that we receive notice of the incorrect taxpayer identification number and before we receive the necessary documents, we may be required to withhold 20 percent of reportable payments made to your account during such period.

Please complete the form below if you are required to contact SSA or the IRS.

* * * * *

Par. 3. Section 35a.9999-1 is amended by revising A-10 and A-56 to read as follows:

§35a.9999-1 Questions and answers concerning the due diligence requirement and the certification requirements in connection with backup withholding and other related issues.

* * * * *

A-10. Yes. A substitute form must include space for the payee to provide his name, address, and taxpayer identification number. The form also must include space for the payee to certify under, penalties of perjury, that he is furnishing his correct taxpayer identification number to the payor. The wording of the certification must be substantially similar to the following: "Under penalties of perjury, I certify that the number shown on this form is my correct taxpayer identification number." If a payor uses a substitute form, the payor must provide either the Internal Revenue Service's instructions for Form W-9 or the substance of those instructions on or with the substitute form.

A signed copy of the Form 4029 or Form 8812 which contains the payee's name, address, and taxpayer identification number is deemed to be an substitute Form W-9 signed under penalties of perjury with respect to such number. However, the penalties associated with the penalties of perjury statement will not apply with respect to the taxpayer identification number on such form.

* * * * *

A-56. Yes. The payor is liable for the penalty under section 6676(b) for each year the payor files an information return with a missing or an incorrect taxpayer identification number for a pre-1984 account or instrument if the payor has not exercised due diligence as described in A-5 and A-6 and in the related questions and answers on due diligence under this section or obtained a certified taxpayer identification number from the payee. However, in its administrative discretion the Internal Revenue Service will not impose the penalty on a payor for an information return filed for calendar years after 1987 if the payor makes or has made a separate mailing of the type described in A-5 (as applicable under such Q and A) on or before June 30, 1988, and makes or has made the nonseparate mailing described in A-5 (as applicable under such Q and A) in each year subsequent to the year of the separate mailing claimed as the basis for administrative relief. Such separate and nonseparate mailings must be made with respect to all pre-1984 accounts or instruments of payees to whom the payor will make a reportable payment in 1988 or a subsequent calendar year if such payees have not previously certified, under penalties of perjury, that the taxpayer identification number furnished to the payor is the payee's correct taxpayer identification number or established the payee's foreign status (under §1.6049-5(b)(2)(iv)) with respect to interest payments or under Q and A 36 of §35a.9999-3 with respect to dividend payments). If a reportable payment will not be made to a pre-1984 account or instrument in 1988, the mailing with respect to the account or instrument may be made, in the discretion of the payor, by (1) June 30, 1988, or (2) the later of October 1 of the calendar year in which the payment to the account or instrument is subsequently reportable or within 30 days after such reportable payment occurs.

A payor will not be ineligible for administrative relief under this Q/A-56 with respect to a calendar year (for those accounts for which mailings were made as described in this A-56) due to a failure to make a mailing with respect to a *de minimis* number of accounts. A *de minimis* number of accounts is the lesser of 5,000 accounts or one percent (or less) of the total number of accounts for which a mailing should have been made under this Q/A-56. In addition, a payor will not be ineligible for administrative relief with respect to a calendar year (for those accounts for which mailings were made as described in this A-56) due to an inadvertent failure to make a mailing for a few accounts that could not be located using reasonable care.

In its administrative discretion, the Internal Revenue Service will not impose the penalty under section 6676 (b) on those *de minimis* accounts or on those accounts that could not be located using reasonable care in any calendar year for which a payor undertakes a mailing, as described in Q-5 in this section, with respect to *all* such accounts.

The rules described in A-5 and the related questions and answers on due diligence under this section shall apply, to the extent not inconsistent with this Q and A 56, as shall the rules described in A-8, A-9, A-10, A-11, A-12, A-14, A-15, and A-16. Further, the special rules in A-17, A-18, A-19, A-20, A-21, A-22, A-23, A-24, and A-25 also shall apply to the mailing described in A-56 of this section.

In order to receive administrative relief each year, a payor must make a written statement, under penalties of perjury, affirmatively showing to the satisfaction of the district director or the director of the Internal Revenue Service Center that the person otherwise liable for such penalty fulfilled the requirements of this paragraph. A payor should make the request from the Internal Revenue Service ninety days before the due date of the Form 8210. A payor will remain liable for any applicable penalties under section 6676(b) for years prior to 1988.

* * * * *

Par. 4. Section 35a.9999-2 is amended by adding the sentence "See Q/A-54 of §35a.9999-3 which revises the rule in this paragraph." at the end of the third paragraph in A-20.

Par. 5. Section 35a.9999-3 is amended as follows:

1. In A-4 the following words, "(and Announcement 88-6, 1988-3 I.R.B. 52)", are added to the third sentence in the sixth paragraph immediately after the words, "See §1.6045-1(d)(4) and (f)(3) of the Income Tax Regulations".

2. In Q-16 the words "section 6041?" are removed and the words "section 6041 or effective for royalty payments made after December 31, 1986, section 6050N?" are added in their place.

3. The following sentence is added at the end of A-48, "The payee must provide the actual Form W-9 or acceptable substitute form to the fund (or payor) in order for this A-48 to apply."

4. In Q-59 the words "and before July 1, 1988" are added immediately after the words "awaiting-TIN certification")".

5. In A-60 the words "was acquired by the payee through a post-1983 brokerage account" in the first sentence are removed and the words "is not a pre-1984 account of the payor" are added in their place.

6. In Q/A-85 the word "1988" is removed in each place that it appears and the word "1989" is added in its place.

7. In Q-87 the word "1988" is removed and the word "1989" is added in its place.

8. In A-87 the word "or" is removed and the word "order" is added in its place.

9. In Q-88 the word "1988" is removed and the word "1989" is added in its place.

10. In A-93 the words "1984 and 1985" are removed from the second sentence and the words "1984, 1985, 1986, and 1987" are added in their place, and the word "1986" is removed from the last sentence and the word "1988" is added in its place.

11. In A-95 the words "1984 and 1985" are removed from the first sentence and the words "1984, 1985, 1986, and 1987" are added in their place.

12. Question and Answer 104 is renumbered as Q/A-105.

13. Answer 27, A-38, A-51, Q/A-54, A-59, A-62, A-86. A-89 and A-97 are revised, in addition, a new Q/A-59A, a new heading and a Q/A-70A, and a new Q/A-104 are added immediately after Q/A-59, Q/A-70, and Q/A-103, respectively. The revised and added provisions read as follows:

§35a.9999-3 Questions and answers concerning backup withholding.

* * * * *

A-27. With respect to the retirement or redemption of a debt security before January 1, 1988, backup withholding applies on the sale date under §1.6045-1(d)(4) of the Income Tax Regulations. Additionally, a broker that is also the obligor on a debt security may elect to apply backup withholding on the payment date.

With respect to the retirement or redemption of a debt security after December 31, 1987, backup withholding applies on the date the "sale" is entered on the books of the broker. Additionally, a broker that is also the obligor on a debt security may elect to apply backup withholding on the payment date if later than the "sale" date.

A broker must determine whether backup withholding applies on the same date (either the date entered on the books of the broker or the payment date) for all similarly situated payees receiving payments on the same type of debt security.

* * * * *

A-38. If a payor erroneously withholds tax or withholds more than the proper amount of the tax, the payor may refund the amount withheld as provided in section 6413 and A-39. A payor shall be considered to have withheld erroneously only if (1) the amount is withheld because of an error by the payor (*e.g.*, an error in "flagging" or identifying an account that is subject to backup withholding), or (2) the Internal Revenue Service directs the payor to refund an amount withheld pursuant to section 3406(a)(1)(C). If the payor requires a payee described in §31.3452(c)-(1)(b) through (p) of the Employment Taxes and Collection of Income Tax at Source Regulations (*e.g.*, a corporation)(See T.D. 7880, 1983-1 C.B. 242, 251, Removed by T.D. 7949, 1984-1 C.B. 204) to certify as to its status as exempt from backup withholding, the payee fails to make the required certification, and the payor subsequently withholds the tax from a payment to such payee, the payor may, in its discretion, treat the amount withheld as an amount erroneously withheld and refund it to the payee. The result is the same if the payor does not require such a payee to certify as to its status and the payor withholds.

If a payor withholds from a payee after the payee provides a taxpayer identification number or required certification to the payor but before the payor has processed the number or required certification (*i.e.*, prior to the time that the payor is treated as having received the number or certification under A-17 of §35a.9999-2), the payor may, in its discretion, treat the amount withheld as an amount erroneously withheld and refund it to the payee. If a payor withholds, however, because the payor has not received a taxpayer identification number or required certification and the payee subsequently provides a taxpayer identification number or the required certification to the payor, the payor may not refund the tax to the payee because the payor properly imposed backup withholding. The amount withheld is a credit against tax that the payee may take into account in computing estimated tax payments and may claim on the payee's income tax return.

* * * * *

A-51. In general, the payor of an account or instrument that is not a pre-1984 account (see A-34 of §35a.-9999-1 and A-20 of §35a.9999-3) nor a window transaction (as defined in A-42 of §35a.9999-1 and A-9 of §35a.9999-2) must use a taxpayer identification number provided by the payee under penalties of perjury on information returns filed with the Internal Revenue Service to satisfy the due diligence requirement. Therefore, if, after 1983, a payor permits a payee to open an account without obtaining the payee's taxpayer identification number under penalties of perjury and files an information return with the Internal Revenue Service with a missing or an incorrect taxpayer identification number, 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 Internal Revenue Service will not enforce the penalty with respect to a calendar year if the certified taxpayer identification number 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 taxpayer identification number 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. See Q/A-73 of this section.

Once notified by the Internal Revenue Service (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. See A-56 through A-70A of this section for the exceptions to due diligence. A pre-existing certified taxpayer identification number does not constitute an exercise of due diligence after the Internal Revenue Service or a broker notifies the payor that the number is incorrect if the Internal Revenue Service or a broker notifies the payor on or after January 1, 1989, unless the payor undertakes the actions specified in A-88 of this section.

* * * * *

Q-54. What are the legal obligations with respect to a grantor trust with ten or fewer grantors under sections 3406 and 6676(b)?

A-54. Backup withholding will apply to a reportable payment to a grantor trust with ten or fewer grantors that was established on or after January 1, 1984, if one of the conditions for imposing backup withholding exists with respect to the trust. The trustee of a grantor trust with ten or fewer grantors may not certify either that the trust is not subject to backup withholding due to notified payee underreporting or that the trust's taxpayer identification number provided by the trustee is correct unless each grantor has furnished the trustee with certifications, signed under penalties of perjury, that the grantor is not subject to backup withholding due to notified payee underreporting and that the grantor's taxpayer identification number provided to the trustee is correct, and the trustee uses such taxpayer identification numbers provided by the grantors on any Form 1041 that is filed by the trustee pursuant to section 671.

Effective June 12, 1989, a trustee of a grantor trust with ten or fewer grantors is not considered a payor for purposes of backup withholding. Therefore, distributions by the trust of amounts to beneficiaries will not be considered payments of reportable amounts subject to backup withholding. With respect to reportable payments (except gross proceeds reportable under section 6045) made prior to the above period, see Q/A-20 of section 35a.9999-2 under which a grantor trust with ten or fewer grantors is considered a payor for purposes of backup withholding.

However, a grantor trust with ten or fewer grantors may be a payor under the respective information reporting sections. As such, the trust may be subject to the penalty under section 6676(b) for filing an information return with a missing or an incorrect taxpayer identification number. No penalty, however, will be imposed on the trust with respect to information returns filed for the 1987 or 1988 calendar year.

* * * * *

A-59. In order to exercise due diligence a payor who receives a post-1987 awaiting-TIN certification from a payee before July 1, 1988, must: (1) Obtain a certified taxpayer identification number from the payee within 60 days after the date that the payor receives the awaiting-TIN certification, and (2) backup withhold on any withdrawals made after the close of 7 business days after the date the awaiting-TIN certification is received and before the earlier of (i) the date that the payor receives a certified taxpayer identification number from the payee, (ii) the date the account is closed, or (iii) the date backup withholding commences on all reportable payments made to the account, instrument, or relationship. For purposes of subsection (ii) in this A-59, a payor is also required to backup withhold on any reportable payment made at the time the account or relationship is closed. For purposes of subsection (2) in this A-59, all cash withdrawals in an amount up to the reportable payments made from the day after the date of receipt of the awaiting-TIN certification to the date of withdrawal are treated as reportable payments. For purposes of this Q/A-59, the term "cash" has the same meaning as the term "cash" set forth in §35a.3406-1(d)(1) of T.D. 8163, 52 Federal Register 44867. Thus, a payor who receives a post-1987 awaiting-TIN certification (as described in this Q/A-59) from a payee who does not provide the payor with a certified taxpayer identification number within the 60 days described in A-18 of §35a.9999-2 is liable for the penalty if reportable payments are paid to the account after the 60 days and the payor files an information return with respect to the account with a missing taxpayer identification number. The payor is liable for the penalty whether or not the payor backup withholds on the reportable payments made after the 60-day period.

However, in its administrative discretion, the Internal Revenue Service will not enforce the penalty for a calendar year against a payor who has properly withheld under this Q/A-59 if the payor (A) obtains the certified taxpayer identification number after the 60-day period (described above) and before December 31 of such calendar year, provided that the payor exercises due diligence in processing such number on the information return filed for such year, *i.e.*, the payor uses the same care in processing the taxpayer identification number 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 (See Q/A-73 of this section), or (B) effective with respect to the 1988 and subsequent calendar years, undertakes an annual mailing as described in Q/A-59A of this section. The 1988 annual mailing must be made between January 1, 1988, and June 12, 1989.

Q-59A. What actions must a payor take in order to exercise due diligence on an account, instrument, or relationship for which the payor receives a post-1987 awaiting-TIN certification on or after July 1, 1988?

A-59A. In order to exercise due diligence a payor who receives a post-1987 awaiting-TIN certification on or after July 1, 1988, may elect on a payee-by-payee basis or in general to: (1) Follow the rules for due diligence as set forth in Q/A-59 above, (2) follow such due diligence rules but apply the definition of the term "cash" set forth in §35a.3406-1(d)(1), or (3) commence backup withholding on the account no later than 7 business days after the date the payor receives the awaiting-TIN certification on reportable payments thereafter made to the account (whether or not the payee makes a cash withdrawal). Under (3) above the payor must backup withhold until the earlier of (i) the date the payor receives a certified taxpayer identification number from the payee, (ii) the date the account is closed, or (iii) the date backup withholding commences on all reportable payments made to the account, instrument, or relationship. In addition with respect to (3), a payor must obtain a certified taxpayer identification number from a payee within 60 days after the date that the payor receives the awaiting-TIN certificate or undertake a mailing each year as described in Q/A-5 and 6 of §35a.9999-1 (except that the first required mailing may be, but need not be, a separate mailing) soliciting the certified taxpayer identification number from the payee. The payor must make a mailing each year until the earlier of (i) the calendar year that the certified taxpayer identification number is received, or (ii) the calendar year in which the account is closed. However, if the account is closed in December of a calendar year, the mailing must be made after the account is closed and before January 31 of the subsequent calendar year.

Effective August 16, 1988, a payor who has elected to apply subsection (3) above must refund the amounts withheld during the 60-day period in accordance with the procedures described in Q/A-39 of this section if the payor receives the certified taxpayer identification number from the payee on or after August 16, 1988, and within the 60-day period, provided that the payee is not subject to backup withholding under section 3406(a)(1)(C) or (D) during any part of such period. For purposes of the preceding sentence, the amounts withheld are deemed to be withheld erroneously as described in Q/A-39 of this section. If a certified taxpayer identification number is not received by the payor within the 60-day period, the amounts withheld shall not be refunded unless the amounts are erroneously withheld without regard to the rules described in this Q/A-59A. The payor is also required to backup withhold after the 60-day period until the payor receives a certified taxpayer identification number from the payee or the account is closed.

* * * * *

A-62. A payor who is notified by a broker that a payee failed to certify or furnish a taxpayer identification number to the broker will be considered to have exercised due diligence if the payor: (1) Imposes backup withholding if the payee did not certify his taxpayer identification number to the payor, (2) provides notice to the payee as provided in A-39 of §35a.9999-1 and A-18 of §35a.9999-2, and (3) encloses a postage-paid reply envelope (self-addressed) in the mailing of the notice. A payor described in this A-62 will be liable for the penalty under section 6676(b) for filing an information return with a missing taxpayer identification number for the 1988 or subsequent calendar years unless the payor complies with the procedures described in this A-62 in each such calendar year until the payor receives a certified taxpayer identification number from the payee or until the account is closed. A subsequent mailing is required to contain a reply envelope which may, but is not required to be, postage prepaid. For years prior to 1988, no penalty will be imposed on a payor who has complied with the requirements in this A-62 in the year the payor was notified by a broker.

A payor as described in this A-62 who receives a noncertified taxpayer identification number from a broker may be liable for the penalty under section 6676(b) for the 1988 or subsequent calendar years with respect to which the number provided by a payor on an information return filed with the Internal Revenue Service is determined to be incorrect unless the payor complies with the procedures described in this A-62 in each such calendar year until the payor receives a certified taxpayer identification number from the payee, the account is closed, or the payor undertakes the actions described in A-88 of this section after being notified of the incorrect taxpayer identification number.

(8) Life-Insurance Beneficiaries

Q-70A. Under what circumstances will a payor of reportable interest to a beneficiary of a life-insurance contract be considered to have exercised due diligence?

A-70A. Generally, a payor of reportable interest to a beneficiary of a life-insurance contract under which payment to the beneficiary commenced on or before December 31, 1983, will be considered to have exercised due diligence with respect to a calendar year if: the payor (1) uses a taxpayer identification number provided by the payee beneficiary under penalties of perjury as described in Q/A-51 of this section on the information return filed for such year, or (2) undertakes a mailing as described in Q/A-5 or 6 (or Q/A-56) of §35a.9999-1 prior to or at the time of payment, and (3) backup withholds on the reportable interest paid to the account if no taxpayer identification number has been provided (See Q/A-34 of §35a.9999-1) .

A payor of reportable interest to a beneficiary of a life-insurance contract under which payment to the beneficiary commenced on or after January 1, 1984, will be considered to have exercised due diligence with respect to a calendar year if the payor: (i) uses a taxpayer identification number provided by the payee-beneficiary under penalties of perjury as described in Q/A-51 of this section on the information return filed for such year, or (ii) effective with respect to the 1989 and subsequent calendar years, undertakes a mailing as described in Q/A-5 and 6 of §35a.9999-1 prior to or at the time of payment.

With respect to payments of reportable interest in calendar years prior to the 1989 calendar year (on a life-insurance contract under which payments to the beneficiary commenced on or after January 1, 1984), a payor will be considered to have exercised due diligence if the payor requested a certified taxpayer identification number from the payee beneficiary prior to, or at the time of, the reportable interest payment provided that at the time of such request the payor had in effect written procedures or policies that required the solicitation of the certified taxpayer identification number of the payee beneficiary prior to or at the time of payment.

* * * * *

A-86. No. A payor of a pre-1984 account or instrument is not required to undertake the mailings prescribed in A-5 and A-6 of §35a.9999-1 (or A-56 of §35a.9999-1) in any year in which the payor is also required to send the notice prescribed in §35a.3406-1(c)(or in §35a.3406-1(f)(2)). Thus, for example, assume that Payor X pays reportable interest on a pre-1984 account and has undertaken all the prescribed mailings in A-5 and A-6 by December 31, 1989, for the account of Payee A. Also assume that Payor X filed the calendar year 1984 return on February 28, 1985, with respect to Payee A with an incorrect taxpayer identification number and the 1985, 1986, 1987, and 1988 calendar year information returns on February 28, 1986, March 2, 1987, February 29, 1988, and February 28, 1989, respectively, with the same incorrect taxpayer identification number. Payor X has filed neither a Form 8210 for any of these years to remit the penalty under section 6676(b) nor the certification statement set forth in CP2100 (or letter 2137) for calendar years before 1988. In October of 1989 the Internal Revenue Service notifies Payor X that the number set forth on the 1988 calendar year information return (*i.e.*, filed in 1989 with respect to Payee A) was filed with an incorrect taxpayer identification number. Under these facts, Payor X is not liable for the penalty for filing the 1988 information return with an incorrect taxpayer identification number because (1) Payor X filed the information return before being notified by the Internal Revenue Service of the incorrect taxpayer identification number, and (2) Payor X exercised due diligence in 1988 through the prescribed annual mailing (*i.e.*, Payor X made the separate mailing in 1983 and the nonseparate mailings in 1984, 1985, 1986, 1987, and 1988 with respect to Payee A).

Similarly, Payor X is not liable for the penalty for the 1984, 1985, 1986, and 1987 calendar year information returns filed on February 28, 1985, February 28, 1986, March 2, 1987, and February 29, 1988, respectively.

Payor X will be liable for the penalty, however, for filing the 1989 calendar year information return with the same incorrect taxpayer identification number (*i.e.*, the number that the Internal Revenue Service notified was incorrect) unless Payor X (1) sends the notice information as described in §35a. 3406-1(c), and (2) uses the certified taxpayer identification number that is furnished by the payee, if one is received before the end of 1989, on the information return that is filed for the 1989 calendar year. If Payor X sends the notice described in §35a.3406-1(c) in the 1989 calendar year, Payor X is not also required to send the mailing described in A-5 and A-6 (or A-56) of §35a.9999-1 in 1989. If the payee does not provide a new taxpayer identification number to the payor, the payor must continue to use the existing taxpayer identification number on information returns filed for such payee.

* * * * *

A-89. The payor (1) must send the notice to the payee as prescribed in §35a.3406-1(f)(2), (2) must code all subsequent information returns that are filed in the calendar year after the calendar year in which the second notice is received with the words "2ND

NOTICE'', and (3) must, if the payor receives from the payee a copy of the notice from the Internal Revenue Service that the payee has provided a correct taxpayer identification number as described in paragraph (h) of §35a.3406-1, obtain and use such name and taxpayer identification number combination on the information returns that are filed after the calendar year in which the name and number are received.

A payor shall not count any notice received from the Internal Revenue Service or a broker prior to January 1, 1990, as the second of two notices within 3 calendar years. Further, a payor shall treat two or more notices received in a calendar year with respect to a payee as one notice received in that calendar year for that payee. The preceding sentence applies only with respect to a payor who receives such two or more notices under the same payor employer identification number (or social security number). See §35a.3406-1(f).

* * * * *

A-97. No. See Q/A-23 of §35a.9999-2.

* * * * *

Q-104. Is a payor required to retain the ''statement of SSA or IRS contact'' (as described in the Appendix to §35a.3406-1) that a payee has returned to the payor?

A-104. No. A payor is not required to retain the ''statement of SSA or IRS contact''.

* * * * *

There is a need for immediate guidance with respect to the provisions contained in this Treasury decision. For this reason, it is found impracticable to issue it with notice and public procedure under subsection (b) of section 553 of Title 5 of the United States Code or subject to the effective date limitation of subsection (d) of that section.

Lawrence B. Gibbs,
Commissioner of Internal Revenue.

Approved January 31, 1989.

O. Donaldson Chapoton,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on April 10, 1989, 8:45 a.m., and published in the issue of the Federal Register for April 11, 1989, 54 F.R. 14341)

Subtitle D.—Miscellaneous Excise Taxes
Chapter 31.—Retail Excise Taxes
Subchapter A.—Special Fuels

Section 4041.—Imposition of Tax

26 CFR 48.4041-1: Taxes on diesel fuel, special motor fuel, and fuel used in noncommercial aviation.

Under what conditions may diplomatic and consular personnel purchase gasoline and diesel fuel free of federal excise taxes. See Rev. Rul. 89-8, below.

Chapter 32.—Manufacturers Excise Taxes
Subchapter A.—Automotive and Related Items
Part III.—Petroleum Products
Subpart A.—Gasoline

Section 4081.—Imposition of Tax

26 CFR 48.4081-1: Imposition and rates of tax. (Also Section 4041, 4091; 48.4041.-1.)

Diplomatic and counsular personnel; exemption for fuels taxes. Effective August 1, 1986, where the Department of State has certified to an oil company that a certain individual is eligible for tax exemption such individual may make tax-exempt purchases of gasoline or diesel fuel throughout the U.S. by purchasing the fuel with a credit card issued by such company.

Rev. Rul. 89-8

SECTION 1. PURPOSE

The State Department has instituted a reciprocal fuels tax exemption program for diplomatic and consular personnel of foreign governments. The manner in which such individuals may purchase gasoline and diesel fuel exempt from federal excise taxes is set forth below.

SEC. 2. BACKGROUND

Section 4081(a) of the Internal Revenue Code imposes a tax on gasoline equal to the sum of the Highway Trust Fund financing rate and the Leaking Underground Storage Tank Trust Fund financing rate. For years before 1988, the tax is imposed on gasoline sold by the producer or importer thereof, or by any producer of gasoline. After 1987, the tax is imposed on the earlier of (A) the removal, or (B) the sale, of gasoline by the refiner or importer thereof or the terminal operator.

Effective for sales after March 31, 1988, section 4091(a) of the Code imposes a tax on the sale of diesel fuel by the producer or importer thereof. The rate of tax under section 4091 is the sum of the Highway Trust Fund financing rate and the Leaking Underground Storage Tank Trust Fund financing rate.

Where no tax has been imposed under section 4091 of the Code, section 4041(a)(1) of the Code imposes a tax of 15 cents a gallon on diesel fuel (1) sold by any person to an owner, lessee, or other operator of a diesel-powered highway vehicle for use as fuel in such vehicle, or (2) used by any person as a fuel in a diesel-powered highway vehicle. An additional tax of 0.1 cent a gallon is imposed on the sale or use of diesel fuel under section 4041(d)(1) to fund the Leaking Underground Storage Tank Trust Fund.

Historically, certain exemptions from federal excise taxes for diplomatic and consular personnel have been made available by virtue of consular conventions, treaties and executive orders. Such exemptions are based on the diplomatic position of the individual. *See* Rev. Rul. 73-198, 1973-1 C.B. 424, and Rev. Rul. 65-100, 1965-1 C.B. 452.

Under section 201(c) of the Foreign Missions Act, 22 U.S.C. section 4301 (1982), the Secretary of State is authorized to determine the treatment that should be accorded a foreign mission in the United States, based on due consideration of the benefits, privileges, and immunities provided to missions of the United States in the country or territory represented by that foreign mission. Foreign missions in the United States were notified by diplomatic note of the U.S. Government's implementation of a policy of reciprocity in determining what benefits, privileges, and immunities are to be accorded foreign diplomatic and consular personnel.

Pursuant to this policy of reciprocity, on May 17, 1985, the Internal Revenue Service announced the commencement of a pilot program in the Washington, D.C. area to provide foreign diplomatic and consular personnel reciprocal exemption privileges from federal gasoline excise taxes. *See* Announcement 85-50, 1985-23 I.R.B. 25. Under this program, the State Department's Office of Foreign Missions certifies exemptions of individuals and periodically issues a list of the exempt individuals to certain oil companies. The pilot program was phased in by geographic region and, since August 1, 1986, the gasoline tax reciprocal exemption program has been in effect nationwide.

SEC. 3. APPLICATIONS AND PROCEDURES

Effective August 1, 1986, where the Department of State's Office of Foreign Missions has certified to an oil company participating in the program that a certain individual is eligible for tax exemption such individual may make tax-exempt purchases of gasoline or diesel fuel throughout the United States by purchasing the fuel with a credit card issued by such company.

The amount of gasoline tax will be included in the price of the gasoline charged by the retail dealer to the eligible person. The tax will thereafter be deducted from the purchase price by the oil company's billing department. Neither cash transactions nor purchases made with credit cards issued by entities other than the oil companies who receive the Office of Foreign Missions list (e.g., bank credit cards) are exempt from the gasoline tax.

Similarly, in the case of the retailers excise tax on diesel fuel imposed by section 4041(a)(1) of the Code and the manufacturers excise tax on diesel fuel imposed by section 4091(a) of the Code, the exemption applies only if the diesel fuel is purchased with a credit card issued by such oil company. The tax on the diesel fuel will be included in the price charged to the eligible individual but will be deducted from the purchase price by the oil company's billing department.

Generally, in the case of transactions involving diplomatic and consular personnel, the oil company that issues the credit card will credit its purchaser's account for an amount that includes the federal excise tax. Pursuant to the authority of section 201(c) of the Foreign Missions Act, and under procedures similar to those described in section 6416 of the Code, such oil company may file for a credit or refund (without interest) of the gasoline or diesel fuel tax.

Under Rev. Rul. 65-100 diplomats were required to present special identification cards in order to obtain exemption from retailers excise taxes. Such cards are no longer issued for purposes of diplomatic federal excise tax exemptions and are no longer required to substantiate diplomatic status for purposes of exemption from the diesel fuel tax.

Any questions regarding an individual's eligibility for inclusion on the Department of State exemption list should be directed to the U.S. State Department, Office of Foreign Missions, Washington, D.C. 20520.

EFFECT ON OTHER REVENUE RULINGS

Effective August 1, 1986, Rev. Rul. 73-198 and Rev. Rul. 65-100 are modified insofar as they apply to sales of gasoline and diesel fuels to diplomatic and consular personnel of foreign governments.

Subpart B.—Diesel Fuel and Aviation Fuel

Section 4091.—Imposition of Tax

Under what circumstances may diplomatic and consular personnel purchase gasoline and diesel fuel free of federal excise taxes. See Rev. Rul. 89-8, page 294.

Subchapter F.—Special Provisions Applicable to Manufacturers Tax

Section 4216.—Definition of Price

26 CFR 48.4216(b)-2: Constructive sale price; basic rules.
(Also Section 7805; 301.7805-1.)

Intercompany sales; rebuttal of constructive sale price. The Service will follow the court decision in *Storm Plastics, Inc.* v. *United States*, 770 F. 2d 148 (10th Cir. 1985), and allow a manufacturer to rebut the constructive sale price of section 4216(b)(1) of the Code even if there are no sales by the manufacturer to unrelated wholesale distributors. Rev. Rul. 77-66 is revoked and Rev. Rul. 76-182's conclusion that the 95 percent rule of Rev. Rul. 71-240 is rebuttable even when the manufacturer makes no sales to unrelated third party distributors is reinstated.

Rev. Rul. 89-47

ISSUE

The Internal Revenue Service has reconsidered Rev. Rul. 77-66, 1977-1 C.B. 338, in light of the decision in *Storm Plastics, Inc. v. United States*, 770 F.2d 148 (10th Cir. 1985).

LAW AND ANALYSIS

Under the constructive sale price provisions of section 4216(b)(1)(C) of the Internal Revenue Code, when an article subject to a manufacturers excise tax imposed under Chapter 32 is sold otherwise than in an arm's length transaction and at less than fair market price, the Service may construct a sale price for purposes of computing excise tax liability.

Rev. Rul. 77-66 concludes that if there are no sales by the manufacturer/taxpayer or an affiliated distributor to unrelated wholesale distributors, then there is no clearly reliable or feasible means of determining fair market price other than the constructive sale price provided by section 4216(b) of the Code. Therefore, in such circumstances, the constructive sale price is the fair market price for purposes of computing excise tax liability. Absent sales in the ordinary course of trade to unrelated wholesale distributors, the manufacturer may not rebut this constructive sale price.

In *Storm Plastics*, the court held that, even if there are no sales to unrelated wholesale distributors, the manufacturer is entitled to rebut the constructive sale price provided by section 4216(b)(1)(C) of the Code with the use of industry data, expert testimony, etc. The court indicated that Congress intended that the constructive sale price be used as the fair market price or tax base for the manufacturer's sales in such circumstances unless the taxpayer could show that another price was clearly applicable. *See* S. Rep. No. 91-1444, 91st Cong., 2d Sess. 21 (1970), 1971-1 C.B. 574, 585. The court further held that the conclusion in Rev. Rul. 77-66 does not manifest the intent of Congress because taxpayers may be able to establish, in a variety of ways, that a price is a fair market price.

HOLDING

The Service will follow the *Storm Plastics* decision and allow the manufacturer to rebut the constructive sale price of section 4216(b)(1) even if there are no sales by the manufacturer to unrelated wholesale distributors.

If a manufacturer does not have sales to unrelated wholesale distributors in the ordinary course of trade, the constructive sale price of section 4216(b)(1) of the Code will apply unless the manufacturer carries its burden of establishing that its product was sold at a fair market price.

EFFECT ON OTHER REVENUE RULINGS

Rev. Rul. 71-240, 1971-1 C.B. 372, concludes that in computing the manufacturers excise tax on sales between related companies, any intercompany sale price that is less than 95 percent of the selling company's lowest established resale price to unrelated wholesale distributors is considered less than fair market price. Rev. Rul. 76-182, 1976-1 C.B. 343, modifies Rev. Rul. 71-240 by concluding that if a manufacturer sells taxable articles to an affiliated distributor, a fair market price will be determined pursuant to the constructive sale price provisions of section 4216(b) of the Code unless the manufacturer can show that a lower price is clearly applicable. Rev. Rul. 76-182 further concludes that the 95 percent rule of Rev. Rul. 71-240 creates a rebuttable presumption. Rev. Rul. 77-66 modified Rev. Rul. 76-182 by concluding that the 95 percent rule of Rev. Rul. 71-240 creates a rebuttable presumption only when the manufacturer makes sales to unrelated third party distributors.

Rev. Rul. 77-66 is revoked. Rev. Rul. 76-182's conclusion that the 95 percent rule of Rev. Rul. 71-240 is rebuttable even when the manufacturer makes no sales to unrelated third party distributors is reinstated.

PROSPECTIVE APPLICATION

Pursuant to the authority granted in section 7805(b) of the Code, the holding in this revenue ruling will not be applied retroactively to the extent that it has adverse tax consequences to a taxpayer.

Chapter 33.—Facilities and Services
Subchapter B.—Communications

Section 4251.—Imposition of Tax

26 CFR 49.4251-1: Imposition of tax.
(Also Sections 4252, 4291.)

Public announcement service; communications tax. Tax consequences under section 4251 of the Code are described for amounts paid for a public announcement service.

Rev. Rul. 89-84

ISSUE

Are amounts paid for, or in connection with, providing a public announcement service (PAS) subject to the tax imposed by section 4251 of the Internal Revenue Code, and, if so, who is liable for the tax under the circumstances described below?

FACTS

PAS is a service that enables a subscriber to a local telephone company to call one or more telephone numbers of an information provider (IP) and hear recorded information on stock prices, sports scores, soap opera summaries, or news and weather reports.

When a subscriber calls a PAS number, the telephone company bills the subscriber 50 cents a call, a price selected by the IP. Pursuant to the tariff filed with and approved by the state utility commission, the entire per call transmission charge by the telephone company is borne by the IP. Thus, when the telephone company bills a subscriber (the call initiator) 50 cents for a completed call to a PAS telephone number, the telephone company retains out of the 50 cents collected a 30 cent transmission charge to the IP for local telephone service, and remits the net amount of 20 cents to the IP. If the telephone company is unable to collect the 50 cents from the subscriber then the telephone company bills the IP for the 30 cent transmission charge.

IP's payments to the telephone company for PAS also include a one-time service establishment charge, a flat monthly charge for each telephone number assigned to it, and a change charge for each IP requested change in the IP selected price, telephone number, or program name.

LAW AND ANALYSIS

Section 4251(a)(1) of the Code imposes a tax on amounts paid for certain communications services, including local telephone service as provided in section 4251(b)(1)(A). Section 4251(a)(2) provides that the tax shall be paid by the person paying for the service, and section 4291 provides that the tax shall be collected by the person receiving payment for the service.

Section 4252(a) of the Code provides that the term "local telephone service" means (1) the access to a local telephone system and the privilege of telephonic quality communication with substantially all persons having telephone or radio telephone stations constituting a part of such local telephone system, and (2) any facility or service provided in connection with a service described in (1).

Section 4253(g) of the Code provides that no tax shall be imposed under section 4251 on so much of any amount paid for the installation of any instrument, wire, pole, switchboard, apparatus, or equipment as is properly attributable to such installation.

In Rev. Rul. 75-102, 1975-1 C.B. 351, a telephone company sold "time-of day" and "weather forecast" services to businesses that wished to advertise their products. When one of these services was purchased by an advertiser, the telephone company assigned a specific number for the service and the persons calling would hear the correct time or weather forecast as well as the advertising message prepared by the advertiser. The advertiser subscribing to such service was billed monthly by the telephone company on the basis of the number of incoming calls.

Rev. Rul. 75-102 holds that the time-of-day and weather forecast services furnished by the telephone company provide the advertiser with access to a local telephone system and the privilege of telephonic quality communication with all persons having telephones in the system. Thus, such services are "local telephone service" and amounts paid by the business advertisers for such services are subject to the tax imposed by section 4251(a) of the Code.

The IP in this case is no different from an advertiser or any other service provider that wishes to communicate a message or information using the local telephone system. Subject to the approval of the state utility commission, the telephone company can determine the charge (tariff) for accessing the local telephone system in order to communicate a message or information, and whether an IP will bear some, all, or none of this charge.

In this case, pursuant to the tariff filed with and approved by the state utility commission, the entire telephone access and transmission charge is borne by the IP, the call recipient. The telephone company bills the telephone subscriber for the IP, selected price of 50 cents for every completed call to a PAS telephone number, retains out of the 50 cents collected a 30 cent transmission charge to the IP for local telephone service, and remits the net amount of 20 cents to the IP. The IP's constructive payment of the 30 cent charge (per completed PAS call) to the telephone company provides the IP with local telephone service in the form of access to the local telephone system and the privilege of telephonic quality communication with all persons having telephones in the system.

However, the net amount (20 cents per completed PAS call) remitted to the IP by the telephone company is not an amount paid for local telephone service in the form of a "service provided in connection with a [local telephone] service", as provided in section 4252(a)(2) of the Code. This is because the providing of PAS does not implement, facilitate, or otherwise assist in accessing or transmitting local telephone service. *Compare* Rev. Rul. 73-171, 1973-1

C.B. 445, which holds that amounts paid for automatic call distributing equipment are amounts paid for taxable local telephone service because such equipment helps to implement that service, *with* Rev. Rul. 72-616, 1972-2 C.B. 575, which holds that amounts paid for yellow pages listings are not amounts paid for taxable local telephone service because such listings are a form of advertising.

Although the one-time service establishment charge paid by the IP is in the nature of an installation fee that is exempt from tax under section 4253(g) of the Code, the flat monthly charge and the change charges paid by the IP are taxable charges for local telephone service under section 4251.

HOLDING

The IP is liable for the tax imposed by section 4251 of the Code on the 30 cents per call amount it is deemed to have paid to the telephone company for its local telephone service in connection with providing PAS. Amounts paid by the call initiators for PAS, including the 20 cents per call remitted by the telephone company to the IP, are not subject to the section 4251 tax.

Section 4252.—Definitions

Tax consequences under section 4251 of the Code are described for amounts paid for a public announcement service. See Rev. Rul. 89-84, page 296.

Subchapter E.—Special Provisions Applicable to Services and Facilities Taxes

Section 4291.—Cases Where Persons Receiving Payment Must Collect Tax

Tax consequences under section 4251 of the Code are described for amounts paid for a public announcement service. See Rev. Rul. 89-84, page 296.

Subtitle F.—Procedure and Administration
Chapter 61.—Information and Returns
Subchapter A.—Returns and Records
Part VI.—Extension of Time for Filing Returns

Section 6081.—Extension of Time for Filing Returns

26 CFR 1.6081-4T: Extensions of time in the case of certain partnerships, corporations and U.S. citizens and residents (temporary).

T.D. 8241

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

Extension of Time to File for Taxpayers Outside the United States and Puerto Rico

AGENCY: Internal Revenue Service, Treasury.

ACTION: Temporary regulations.

SUMMARY: This document provides Temporary Income Tax Regulations relating to the extension of time to file federal income tax returns and pay any taxes owing for United States citizens and U.S. residents who are outside of the United States and Puerto Rico. These temporary regulations reflect changes to the current regulations provided by Notice 88-40 [1988-1 C.B. 526] (issued by IRS Public Affairs Office and not published in the Federal Register) and clarify existing rules.

EFFECTIVE DATE: These temporary regulations apply to federal income tax returns due on or after April 15, 1988.

SUPPLEMENTARY INFORMATION:

PAPERWORK REDUCTION ACT

The temporary regulations contain no new reporting or recordkeeping requirements but merely move existing requirement to the new temporary regulations section and, thus, are not subject to the Paperwork Reduction Act (44 U.S.C. 3501), as amended.

BACKGROUND

This document contains amendments to the Income Tax Regulations (26 CFR Part 1) under section 6081 of the Internal Revenue Code.

NEED FOR TEMPORARY REGULATIONS

Because of the need for immediate guidance regarding the circumstances under which the Internal Revenue Service will grant an extension of time to file federal income tax returns due after April 15, 1988, and pay any taxes owing thereon, under §1.6081-2 of the regulations, it is impractical to issue these temporary regulations either with notice and public comment procedure under section 553(b) of title 5 of the United States Code, or under the effective date limitation of section 553(d) of title 5.

EXPLANATION OF PROVISIONS

Section 6081(a) provides that the Secretary may grant a reasonable extension of time for filing any return required by this title or by regulations.

The regulations remove an obsolete reference to §.6073-4 of the regulations contained in §1.6081-1(a). They also remove obsolete §1.6081-2(b).

Section 1.6081-2(a) provides, in part, that United States citizens and residents traveling outside the United States and Puerto Rico are granted an extension of time to file federal income tax returns and pay any taxes owing. The temporary regulations remove this provision.

Section 1.6081-2(a) also provides an extension of time to file and pay for United States citizens residing outside the United States and Puerto Rico and for U.S. residents living outside the United States and Puerto Rico. The temporary regulations clarify what is meant by residing and living outside the United States and Puerto Rico.

SPECIAL ANALYSIS

These rules are not major rules as defined in Executive Order 12991. Therefore, a Regulatory Impact Analysis is not required. A general notice of proposed rulemaking is not required by 5 U.S.C. 553 for temporary regulations. Therefore, these rules do not constitute regulations subject to the Regulatory Flexibility Act (5 U.S.C. chapter 6) and a Regulatory Flexibility Analysis is not required.

* * * * * *

Adoption of amendments to the regulations

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

INCOME TAX REGULATIONS
(26 CFR Part 1)

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

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

Par. 2. Paragraph (a) of §1.6081-1 is amended by removing the fifth sentence.

Par. 3. Section 1.6081-2 is redesignated as §1.6081-4T and is revised to read as follows:

§1.6081-4T Extensions of time in the case of certain partnerships, corporations and U.S. citizens and residents (temporary).

(a) *In general.* The rules in this paragraph apply to returns of income due after April 15, 1988. An extension of time for filing returns of income and for paying any tax shown on that return is hereby granted to and including the fifteenth day of the sixth month following the close of the taxable year in the case of:

(1) Partnerships which are required under paragraph (e)(2) of §1.6031-1 to

file returns on the fifteenth day of the fourth month following the close of the taxable year of the partnership, and which keep their records and books of account outside the United States and Puerto Rico;

(2) Domestic corporations which transact their business and keep their records and books of account outside the United States and Puerto Rico;

(3) Foreign corporations which maintain an office or place of business within the United States;

(4) Domestic corporations whose principal income is from sources within the possessions of the United States;

(5) United States citizens or residents whose tax homes and abodes, in a real and substantial sense, are outside the United States and Puerto Rico; and

(6) United States citizens and residents in military or naval service on duty, including non-permanent or short term duty, outside the United States and Puerto Rico.

(b) In order to qualify for the extension under this section, a statement must be attached to the return showing that the person for whom the return is made is a person described in paragraph (a) of this section.

(c) For purposes of paragraph (a)(5) of this section, whether a person is a United States resident will be determined in accordance with section 7701(b) of the Code. The term "tax home," as used in paragraph (a)(5), will have the same meaning which it has for purposes of section 162 (a)(2) (relating to travel expenses away from home). If a person does not have a regular or principal place of business, that person's tax home will be considered to be his regular place of abode in a real and substantial sense.

(d) In order to qualify for the extension under paragraph (a)(6), the assigned tour of duty outside the United States and Puerto Rico must be for a period that includes the entire due date of the return.

(e) A person otherwise qualifying for the extension under paragraph (a)(5) or paragraph (a)(6) shall not be disqualified because he is physically present in the United States or Puerto Rico at any time, including the due date of the return.

(f)With respect to income tax returns due on April 15, 1988, an extension of time for filing a return of income and for paying any tax shown on that return is hereby granted to and including the fifteenth day of the sixth month following the close of the taxable year in the case of citizens or residents of the United States who are traveling outside the United States and Puerto Rico. A taxpayer will be considered to be traveling outside the United States and Puerto Rico only if the period of travel outside the United States and Puerto Rico is a period of at least fourteen days continuous travel that includes all of April 15, 1988. For returns due after April 15, 1988, no extension will be granted to taxpayers traveling outside the United States and Puerto Rico.

OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT (26 CFR Part 602)

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

Authority: 26 U.S.C. 7805.

Par. 5. Section 602.101(c) is amended by removing from the table "§1.6081-2 . 1545-0148".

Par. 6. Section 602.101(c) is amended by inserting in the appropriate place in the table "§1.6081-4T ... 1545-0148".

Lawrence B. Gibbs,
Commissioner of Internal Revenue.

Approved January 13, 1989.

O. Donaldson Chapoton,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on February 22, 1989, 8:45 a.m., and published in the issue of the Federal Register for February 22, 1989, 54 F.R. 7762)

Subchapter B.—Miscellaneous Provisions

Section 6109.—Identifying Numbers

26 CFR 301.6109-1: Identifying numbers

Procedures are established to permit certain fiduciaries or other persons who are authorized to represent ten or more estates or trusts in federal tax matters to file consolidated applications to obtain employer identification numbers. See Rev. Proc. 89-37, page 919.

Chapter 62.—Time and Place for Paying Tax
Subchapter B.—Extensions of Time for Payment

Section 6166.—Extension of Time for Payment of Estate Tax Where Estate Consists Largely of Interest in Closely Held Business

26 CFR 20.6166-1: Election of alternate extension of time for payment of estate tax where estate consists largely of interest in closely held business.

At what rate does interest accrue on unpaid interest that should have been paid on past annual interest payment dates if the time for payment of estate tax is extended under section 6166 of the Code and a deficiency is assessed after the estate has timely made one or more annual interest payments? See Rev. Rul. 89-32, page 307.

26 CFR 20.6166A-3. Acceleration of payment. (Also Section 2032A.)

Extension of time for payment; estate tax; closely held business. Sale of specially valued property to a person, not a qualified heir, where proceeds reduce debt on assets of the ongoing business, is not a disposition for purposes of section 6166(g)(1)(A) of the Code, but is a disposition for purposes of section 2032A.

Rev. Rul. 89-4

ISSUES

1. If there is a sale of a portion of the assets of a closely held business to allay impending foreclosure and all the proceeds are applied to reduce mortgage debt on encumbered assets of the ongoing business, has there been a disposition of an interest in the business or withdrawal of funds from the business within the meaning of section 6166(g)(1)(A) of the Internal Revenue Code?

2. If the sale was of qualified property specially valued under section 2032A of the Code, was there a disposition within the meaning of section 2032A(c) of the Code?

FACTS

D, the decedent, died in 1983. At the time of *D*'s death, *D* had owned and operated a farm as a sole proprietor for more than 10 years. The farm consists of 2 separate tracts of land, each encumbered by a mortgage. Tract *A* had a fair market value of $700,000 and was encumbered by mortgage and accrued interest of $400,000. Tract *B* had a fair market value of $500,000, and was encumbered by a mortgage and accrued interest of $300,000. The adjusted value of the farming business was $550,000. The adjusted gross estate was $700,000. The executor elected to specially value the farm real property under section 2032A of the Code. The executor also elected to defer the payment of a portion of the estate tax pursuant to section 6166 of the Code.

In 1988, the outstanding mortgages on Tract *A* and Tract *B* had matured and were in a delinquent status. Foreclosure was imminent. However, there were insufficient cash and liquid assets to satisfy the unpaid mortgages and accrued interest which totaled $700,000. To allay impending foreclosure, Tract *A* was sold for $700,000 to a person who was not a qualified heir, and the entire proceeds were used to retire the mortgages on both Tract *A* and Tract *B*.

As a result of this transaction the adjusted value of the farming business remained at $550,000, but now consisted of $500,000 in unencumbered real estate, and $50,000 representing the equity in the farm equipment and miscellaneous assets.

LAW AND ANALYSIS

Section 6166(a)(1) of the Code provides that, if the value of an interest in a closely held business that is included in determining the gross estate of a decedent exceeds 35 percent of the adjusted gross estate, the executor may elect to pay part or all of the estate tax in 2 or more (but not exceeding 10) equal installments. Under section 6166(a)(2), only the amount of estate tax attributable to the closely held business may be paid in installments.

Section 6166(g)(1)(A) of the Code provides that if any portion of an interest in a qualified closely held business is distributed, sold, exchanged, or otherwise disposed of, or money or property attributable to such an interest is withdrawn from the business, and if the aggregate of such distributions, sales, exchanges or other dispositions and withdrawal equals, or exceeds 50 percent of the value of such trade or business, then the extension of time for payment shall cease to apply, and any unpaid portion of the tax payable in installments shall be paid upon notice and demand.

Section 2032A of the Code provides that real property used for family purposes or in a closely held business may, if certain conditions are satisfied, be valued on the basis of its current use rather than on the basis of its highest and best use under conventional rules of valuation.

Section 2032A(c)(1) of the Code imposes an additional estate tax if, within 10 years after the decedent's death and before the death of the qualified heir -

(A) the qualified heir disposes of any interest in qualified real property (other than by a disposition to a member or his family), or

(B) the qualified heir ceases to use for the qualified use the qualified real property which was acquired (or passed) from a decedent.

Section 6166 of the Code was intended to relieve the executor and the heirs from the necessity of partially liquidating a closely held business in order to pay estate taxes. The purpose of the acceleration provisions in section 6166(g)(1)(A) is to withdraw the benefits of section 6166 if 50 percent of the business is sold, or if 50 percent of the net assets are withdrawn from the business.

In a case where the sale of encumbered assets of a business is necessary to preserve the ongoing business from creditors threatening foreclosure on those assets, treating such a sale as a disposition would not be consistent with the purpose of section 6166 of the Code. Further, such a sale does not decrease the value of the closely held business included in the estate.

Therefore, a sale of a portion of the business assets of a closely held business that is made to allay impending foreclosure on encumbered business assets does not constitute a disposition of an interest in the business nor a withdrawal of funds from the business within the meaning of section 6166(g)(1)(A) of the Code, if all the proceeds are applied to reduce mortgage debt on other assets of the ongoing business. However, in a case in which sales proceeds exceed the amount of the mortgage and accrued interest, removal from the business of any excess funds would be a withdrawal of funds from the business within the meaning of section 6166(g)(1)(A) of the Code. Such a disposition would have to be added to other dispositions to determine if the aggregate of such distributions, sales, exchanges, or other disposition and withdrawals equals or exceeds 50 percent of the value of the interest. If so, the extension of time provided by section 6166(a) would cease to apply.

Although the sale of Tract *A* does not constitute a disposition within the meaning of section 6166(g)(1)(A) of the Code, under section 2032A of the Code, any sale of specially valued property to a person who is not a qualified heir constitutes a disposition for purposes of section 2032A(c). Such a sale results in the imposition of the additional estate tax under that section. Unlike section 6166, section 2032A is focused on real property, and requires the continued dedication of the specially valued real property to a qualified use.

HOLDINGS

1. The sale of a portion of the assets of a closely held business to allay impending foreclosure does not constitute a disposition of an interest in the business within the meaning of section 6166(g)(1)(A) of the Code, if the proceeds are applied to reduce mortgage debt on encumbered assets of the ongoing business.

2. The sale of a portion of qualified property valued under section 2032A of the Code to a person who is not a qualified heir to pay the unpaid balance on the mortgage that encumbered the qualified property, existing at date of death, constitutes a disposition within the meaning of section 2032A of the Code, triggering the imposition on the recapture tax under section 2032A(c).

Chapter 64.—Collection
Subchapter B.—Receipt of Payment

Section 6323.—Validity and Priority Against Certain Persons

26 CFR 301.6323(f)-1: Place for filing notice; form.

T.D. 8234

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 301

Electronic Filing of Notice of Federal Tax Lien

AGENCY: Internal Revenue Service, Treasury.

ACTION: Final regulations.

SUMMARY: This document removes temporary regulations and adopts as final regulations proposed regulations published in the FEDERAL REGISTER on February 23, 1988, relating to a notice of Federal tax lien filed by the use of an electronic or magnetic medium. These regulations clarify existing regulations under section 6323(f) of the Internal Revenue Code (Code).

EFFECTIVE DATES: The regulations are effective for a notice of Federal tax lien filed on or after February 23, 1988.

SUPPLEMENTARY INFORMATION:

BACKGROUND

On February 23, 1988, the Federal Register published temporary regulations (52 F.R. 5269) (1988-1 C.B. 399) and proposed regulations (53 FR 5279) (1988-1 C.B. 927) under section 6323(f) of the Code relating to a notice of Federal tax lien filed by the use of an electronic or magnetic medium, clarifying existing regulations under section 6323(f) of the Code. No written comments were received. A public hearing was neither requested nor held. Accordingly, the temporary regulations are removed and the proposed regulations are adopted as final regulations by this Treasury decision.

IN GENERAL

This document amends the Administrative Regulations (26 CFR Part 301) under section 6323 of the Code. These regulations clarify that the term "Form 668" includes a notice of Federal tax lien filed by the use of an electronic or magnetic medium where the law of the state in which a notice of Federal tax lien is filed permits such method of filing.

Section 6321 of the Code imposes a lien in favor of the United States whenever a person liable for any tax neglects or refuses to pay the tax after demand. For such lien to be valid as against any purchaser, holder of a security interest, mechanic's lienor, or judgment lien creditor, a notice of the lien must be filed which meets the requirements of section 6323(f). Section 6323(f)(3) provides that the form and content of the notice referred to in section 6323(a) shall be prescribed by the Secretary, and that such notice is valid notwithstanding any other provision of law regarding the form or content of a notice of lien.

NOTICE OF LIEN MAY BE FILED BY THE USE OF AN ELECTRONIC OR MAGNETIC MEDIUM

Section 301.6323(f)-1(c) of the regulations provides that notice of a Federal tax lien "shall be filed on Form 668, 'Notice of Federal Tax Lien under Internal Revenue Laws'." These final regulations clarify that the term "Form 668" includes both a Form 668 printed on paper and a Form 668 filed by the use of an electronic or magnetic medium if the law of the state in which the notice is filed permits a notice of Federal tax lien to be filed by the use of such medium. The use of a non-paper form will not affect the decision to place a notice of lien on file and will not significantly affect the timing of issuance of a notice of lien. Rather, the use of a non-paper form merely simplifies the manner of transmitting information to a state after a lien is determined to be valid and any remaining issues are resolved. Paper forms will continue to be used in states that do not permit electronic or magnetic filing.

The use of electronic or magnetic media to file a notice of tax lien will enable the Internal Revenue Service to better serve the public by (a) reducing the time it takes to notify the public that a lien exists; (b) reducing the amount of paperwork necessary to file a notice; and (c) in certain cases, eliminating or reducing the cost of filing a notice of lien, which cost is generally billed to the taxpayer involved.

REFILING A NOTICE OF LIEN

Section 6323(g) of the Code and §301.6323(g)-1 of the regulations, which govern the refiling of a notice of Federal tax lien, do not require a particular form to be used in refiling a notice of Federal tax lien. Therefore, an amendment to the regulations is not necessary to allow a notice of Federal tax lien to be refiled by the use of any electronic or magnetic medium permitted by the state in which the notice is refiled.

SPECIAL ANALYSES

Although a notice of proposed rulemaking that solicited public comment was issued, the Internal Revenue Service concluded when the notice was issued that the regulations are interpretative and that the notice and public procedure requirements of 5 U.S.C. 553 did not apply. Accordingly, the final regulations do not constitute regulations subject to the Regulatory Flexibility Act (5 U.S.C. chapter 6).

The Commissioner of Internal Revenue has determined that this final rule is not a major rule as defined in Executive Order 12291 and that a regulatory impact analysis therefore is not required.

* * * * * *

Adoption of amendments to the regulations

Accordingly, Part 301 of Title 26 of the Code of Federal Regulations is amended as follows:

Paragraph 1. The authority for Part 301 is amended as follows:

(1) By removing the following citation:

Authority: 26 U.S.C. 7805 * * * Section 301.6323(f)-1T(c) is also issued under 26 U.S.C. 6323(f)(3); and

(2) By adding the following citation:

Authority: 26 U.S.C. 7805 * * * Section 301.6323(f)-1(c) is also issued under 26 U.S.C. 6323(f)(3).

Par. 2. 26 CFR Part 301 is amended as follows:

(1) By removing §301.6323(f)-1T; and

(2) By revising §301.6323(f)-1(c) to read as follows:

§301.6323(f)-1 *Place for filing notice; form.*

* * * * * *

(c) *Form*—(1) *In general.* The notice referred to in §301.6323(a)-1 shall be filed on Form 668, "Notice of Federal Tax Lien under Internal Revenue Laws." Such notice is valid notwithstanding any other provision of law regarding the form or content of a notice of lien. For example, omission from the notice of lien of a description of the property subject to the lien does not affect the validity thereof even though State law may require that the notice contain a description of the property subject to the lien.

(2) *Form 668 defined.* The term "Form 668" generally means a paper form. However, if a state in which a notice referred to in §301.6323(a)-1 is filed permits a notice of Federal tax lien to be filed by the use of an electronic or magnetic medium, the term "Form 668" includes a Form 668 filed by the use of any electronic or magnetic medium permitted by that state. A Form 668 must identify the taxpayer, the tax liability giving rise to the lien, and the date the assessment arose regardless of the method used to file the notice of Federal tax lien.

* * * * * *

Lawrence B. Gibbs,
Commissioner of Internal Revenue.

Approved November 2, 1988.

O. Donaldson Chapoton,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on November 23, 1988, 8:45 a.m., and published in the issue of the Federal Register for November 25, 1988, 53 F.R. 47675)

Section 6326.—Administrative Appeal of Liens

26 CFR 301.6326-1T: Administrative appeal of the erroneous filing of notice of federal tax lien (temporary).

T.D. 8250

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 301

Administrative Appeal of the Erroneous Filing of Notice of Federal Tax Lien

AGENCY: Internal Revenue Service, Treasury

ACTION: Temporary regulations

SUMMARY: This document contains temporary regulations that provide for the administrative appeal of the erroneous filing of a notice of federal tax lien. The right to an administrative appeal of the erroneous filing of a notice of federal tax lien was established by the Technical and Miscellaneous Revenue Act of 1988. The regulations set forth the situations in which persons may appeal the erroneous filing of a notice of federal tax lien, the office to which appeals may be made, and the information and documents that must be submitted with an appeal. The text of the regulations also cross-references the notice of proposed rulemaking in * * * [GL-161-89, page 1012, this Bulletin].

EFFECTIVE DATE: The regulations providing the right to an administrative appeal of the erroneous filing of a notice of federal tax lien are effective July 7, 1989.

SUPPLEMENTAL INFORMATION: This document contains temporary regulations amending the Procedure and Administration Regulations (26 CFR Part 301) under section 6326 of the Internal Revenue Code. The regulations reflect the amendment of section 6326 by section 6238 of the Technical and Miscellaneous Revenue Act of 1988 (Pub. L. No. 100-647).

Explanation of Provisions

Section 6238 of the Technical and Miscellaneous Revenue Act of 1988 (Pub. L. No. 100-647, 102 Stat. 3342) redesignated section 6326 of the Internal Revenue Code as section 6327 and added a new section 6326. Section 6326(a) provides that the Secretary shall prescribe regulations that provide for the administrative appeal of the erroneous filing of a notice of federal tax lien. Section 6326(b) provides that if the Secretary determines that the Internal Revenue Service has erroneously filed a notice of federal tax lien, the Secretary must expeditiously, and, to the extent practicable, within 14 days after such determination, issue a certificate of release of the lien. This certificate must include a statement that the filing was erroneous.

The regulations provide that a person may file an administrative appeal of the erroneous filing of a notice of federal tax lien in any of the following situations: 1) the tax liability that gave rise to the lien was satisfied in full prior to the filing of notice; 2) the underlying liability was assessed in violation of the deficiency procedures set forth in section 6213 of the Internal Revenue Code; 3) the underlying liability was assessed in violation of Title 11, *i.e.*, the Bankruptcy Code; or 4) the statute of limitations for collection expired prior to the filing of notice.

The legislative history of section 6326 indicates that the administrative appeal is intended to be used only for the purpose of correcting publicly the erroneous filing of a notice of federal tax lien, not to challenge the underlying deficiency that led to the filing of a lien. In addition to the three situations specifically enumerated in the legislative history, to which section 6326 is meant to apply, the Internal Revenue Service considers it in keeping with the spirit of the Taxpayer Bill of Rights also to allow an appeal when the statute of limitations on collection expired prior to the filing of notice of federal tax lien. This additional situation also involves an erroneous filing of a notice of federal tax lien.

The Internal Revenue Service welcomes comments from the public concerning other possible situations that may involve the erroneous filing of a notice of federal tax lien. Some situations that the public might think should be covered by section 6326 already are covered under other sections of the Internal Revenue Code. For example, it may appear that the filing of a federal tax lien against a person with the same name as the liable taxpayer is erroneous and should be covered by section 6326 and these regulations. This situation, however, is covered by section 6325(e) of the Internal Revenue Code, which gives the Secretary the authority to issue a certificate of nonattachment of lien if, because of confusion of names, any person (other than the person against whom the tax was assessed) is or may be injured by the appearance that a notice of lien filed under section 6323 of the Code refers to such person.

The regulations provide that appeals under section 6326 shall be made to the district director, attention Chief, Special Procedures Function, of the district in which the lien was filed.

The regulations provide that a request for appeal under section 6326 is to be submitted in writing, and is to include the identity of the appealing party, a copy of the notice of lien affecting the property, if available, and the ground upon which the release of lien is sought. If the ground for release is that the liability was paid prior to the filing, the written request must include proof of full payment. If the ground upon which the filing of notice is being appealed is that the tax liability that gave rise to the lien was assessed in violation of the deficiency procedures set forth in section 6213 of the Internal Revenue Code, the appealing party must explain how the assessment was erroneous. If the ground for appeal is that the tax liability that gave rise to the lien was assessed in violation of Title II, the appealing party must identify the court and the district in which the bankruptcy petition was filed and provide the docket number and the date of filing of the bankruptcy petition.

Finally, the regulations provide that the appeal provided by section 6326 and these regulations shall be a person's exclusive administrative remedy for the erroneous filing of a notice of federal tax lien.

Special Analysis

It has been determined that these temporary regulations are not major rules as defined in Executive Order 12291. Therefore, a Regulatory Impact Analysis is not required. It is certified that these rules will not have a significant economic impact on a substantial number of small entities because the regulations only provide procedures for any taxpayer to follow to administratively appeal the erroneous filing of a federal tax lien. Therefore, the analysis requirements of the Regulatory Flexibility Act (5 U.S.C. Chapter 6) do not apply.

* * * * * *

Adoption of Addition to the Regulations

Accordingly, Title 26, Part 301 of the Code of Federal Regulations is amended as follows.

Paragraph 1. The authority citation for Part 301 is amended by adding the following citation:

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

Par. 2. Section 301.6326-1T is added immediately following section 301.6325-1 to read as follows.

§301.6326-1T. *Administrative appeal of the erroneous filing of notice of federal tax lien (temporary).*

(a) In general. Any person may appeal to the district director of the district in which a notice of federal tax lien was filed on the property or rights to property of such person for a release of lien alleging an error in the filing of notice of lien. Such appeal may be used only for the purpose of correcting the erroneous filing of a notice of lien, not to challenge the underlying deficiency that led to the imposition of a lien. If the district director determines that the Internal Revenue Service has erroneously filed the notice of any federal tax lien, the district director shall expeditiously and, to the extent practicable within 14 days after such determination issue a certificate of release of lien. The certificate of release of such lien shall include a statement that the filing of notice of lien was erroneous.

(b) *Appeal alleging an error in the filing of notice of lien.* For purposes of paragraph (a) of this section, an appeal of the filing of notice of federal tax lien must be based on any one of the following allegations:

(1) The tax liability that gave rise to the lien, plus any interest and additions to tax associated with said liability was satisfied prior to the filing of notice of lien;

(2) The tax liability that gave rise to the lien was assessed in violation of the deficiency procedures set forth in section 6213 of the Internal Revenue Code;

(3) The tax liability that gave rise to the lien was assessed in violation of Title 11 of the United States Code (the Bankruptcy Code); or

(4) The statutory period for collection of the tax liability that gave rise to the lien expired prior to the filing of notice of federal tax lien.

(c) *Notice of federal tax lien that lists multiple liabilities.* When a notice of federal tax lien lists multiple liabilities, a person may appeal the filing of notice of lien with respect to one or more of the liabilities listed in the notice, if the notice was erroneously filed with respect to such liabilities. If a notice of federal tax lien was erroneously filed with respect to one or more liabilities listed in the notice, the district director shall issue a certificate of release with respect to such liabilities. For example, if a notice of federal tax lien lists tax liabilities for years 1980, 1981 and 1982, and the entire liabilities for 1981 and 1982 were paid prior to the filing of notice of lien, the taxpayer may appeal the filing of notice of lien with respect to the 1981 and 1982 liabilities and the district director must issue a certificate of release with respect to the 1981 and 1982 liabilities.

(d) *Procedures for appeal*—(1) *Manner.* An appeal of the filing of notice of federal tax lien shall be made in writing to the district director (marked for the attention of the Chief, Special Procedures Function) of the district in which the notice of federal tax lien was filed.

(2) *Form.* The appeal shall include the following information and documents:

(i) Name, current address, and taxpayer identification number of the person appealing the filing of notice of federal tax lien:

(ii) A copy of the notice of federal tax lien affecting the property, if available; and

(iii) The grounds upon which the filing of notice of federal tax lien is being appealed.

(A) If the ground upon which the filing of notice is being appealed is that the tax liability in question was satisfied prior to the filing, proof of full payment as defined in paragraph (e) of this section must be provided.

(B) If the ground upon which the filing of notice is being appealed is that the tax liability that gave rise to lien was assessed in violation of the deficiency procedures set forth in section 6213 of the Internal Revenue Code, the appealing party must explain how the assessment was erroneous.

(C) If the ground upon which the filing of notice is being appealed is that the tax liability that gave rise to the lien was assessed in violation of Title 11 of the United States Code (the Bankruptcy Code), the appealing party must provide the following:

(*1*) The identity of the court and the district in which the bankruptcy petition was filed: and

(*2*) The docket number and the date of filing of the bankruptcy petition.

(*3*) *Time.* An administrative appeal of the erroneous filing of notice of federal tax lien shall be made within 1 year after the taxpayer becomes aware of the erroneously filed tax lien.

(e) *Proof of full payment.* As used in paragraph (d)(2)(iii) of this section, the term "proof of full payment" means:

(1) An internal revenue cashier's receipt reflecting full payment of the tax liability in question prior to the date the federal tax lien at issue was filed:

(2) A canceled check to the Internal Revenue Service in an amount which was sufficient to satisfy the tax liability for which release is being sought: or

(3) Any other manner of proof acceptable to the district director.

(f) *Exclusive remedy.* The appeal established by section 6326 of the Internal Revenue Code and by this section shall be the exclusive administrative remedy with respect to the erroneous filing of a notice of federal tax lien.

(g) *Effective date.* The provisions of this section are effective July 7, 1989.

There is need for immediate guidance with respect to the provisions contained in this Treasury decision. For this reason, it is found impractical to issue this Treasury decision with notice and public procedure under subsection (b) of section 553 of title 5 of the United States Code or subject to the effective date limitation of subsection (d) of that section.

Michael J. Murphy,
Acting Commissioner of Internal Revenue.

Approved April 21 1989.

John G. Wilkins,
Acting Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on May 5, 1989, 8:45 a.m., and published in the issue of the Federal Register for May 8, 1989, 54 F.R. 19568)

Chapter 65.—Abatements, Credits, and Refunds
Subchapter A.—Procedure in General

Section 6402.—Authority to Make Credits or Refunds

26 CFR 301.6402-6T: Offset of past-due legally enforceable debt against overpayment (temporary).

T.D. 8239

TITLE 26—INTERNAL REVENUE.—CHAPTER 1, SUBCHAPTER F, PART 301—PROCEDURE AND ADMINISTRATION

Reduction of Tax Overpayments by Amount of Past-due Legally Enforceable Debt Owed to Federal Agency

AGENCY: Internal Revenue Service, Treasury.

ACTION: Temporary Regulations.

SUMMARY: This document contains temporary regulations which further amend temporary regulations that were published in the Federal Register on September 30, 1985 [T.D. 8053, 1985-2 C.B. 333 and LR-291-84, 1985-2 C.B. 839], and were amended on May 13, 1987 [T.D. 8139, 1987-2 C.B. 280 and LR-72-86, 1987-2 C.B. 1030], relating to the reduction of a taxpayer's overpayment (*i.e.*, tax refund) by the amount of any past-due legally enforceable debt owed to a Federal agency and referred by that agency to the Internal Revenue Service for offset. The text of the temporary regulations set forth in this document also serves as the text of the proposed regulations cross-referenced in the notice of proposed rulemaking in * * * [IA-41-88, page 1019, this Bulletin].

The regulations affect any taxpayer who owes a past-due legally enforceable debt to any Federal agency identified as eligible to participate in the tax refund offset program by the Commissioner of Internal Revenue and who has made an overpayment of taxes, and such Federal agency to which the past-due legally enforceable debt is owed.

EFFECTIVE DATES: The regulations apply to refunds payable under section 6402 of the Internal Revenue Code of 1986 after December 31, 1985 and on or before January 10, 1994. However, if legislation is enacted extending the tax refund offset program beyond January 10, 1994, the regulations apply to refunds payable through the date to which such legislation extends the program. In such a case the Service will publish a notice confirming the extension of these regulations.

SUPPLEMENTARY INFORMATION:

BACKGROUND

On September 30, 1985, temporary regulations under section 6402(d) and (e) of the Internal Revenue Code of 1954, and section 3720A of subchapter II of chapter 37 of Title 31, United States Code were published in the Federal Register (50 FR 39713, Sept. 30, 1985). Those regulations were amended on May 13, 1987 (52 FR 17949, May 13, 1987). The effective date of section 6402(d) was extended by section 9402 of the Omnibus Budget Reconciliation Act of 1987 (P.L. 100-203, 101 Stat. 1330-376) and further extended by section 701 of the Family Support Act of 1988 (P.L. 100-485, 102 Stat. 2425). This document amends those temporary regulations, which provided guidance concerning which debts qualify for referral to the Service for the Federal tax refund offset program and concerning procedures relating to operation of the program.

IN GENERAL

Section 6402(d) of the Internal Revenue Code requires the Internal Revenue Service (a) to reduce the amount of any overpayment (*i.e.*, tax refund) otherwise payable to a taxpayer by the amount of any past-due legally enforceable debt owed to a Federal agency of which the Service has been notified, (b) to pay the amount of the reduction to the agency to which the debt is owed, and (c) to notify the taxpayer that the overpayment has been reduced.

The temporary regulations require that a Federal agency submit a notification of a taxpayer's liability or past-due legally enforceable debt to the Service on magnetic tape by December 1 of each year. The regulations are amended to require the notification to be submitted to the Service by a date specified in a revenue procedure. Since the date by which notification must be submitted each year is subject to change, it was determined that providing the date by revenue procedure would allow greater flexibility in administering the program.

The regulations are amended to provide that the amount that is transmitted to each Federal agency is reduced by a fee for each offset.

The effective date of the regulations is amended to provide that the regulations are effective for refunds payable after December 31, 1985, and on or before January 10, 1994. However, if legislation extending the tax refund offset program beyond January 10, 1994, is enacted, the regulations are effective for refunds payable through the date to which such legislation extends the program.

SPECIAL ANALYSES

The Commissioner of Internal Revenue has determined that this temporary rule is not a major rule as defined in Executive Order 12291 and, therefore, a Regulatory Impact Analysis is not required. A general notice of proposed rulemaking is not required by 5 U.S.C. 553 for temporary regulations. Accordingly, these temporary regulations do not constitute regulations subject to the Regulatory Flexibility Act (5 U.S.C. chapter 6).

* * * * * *

Amendments to the regulations

The amendments to 26 CFR Part 301 are as follows:

Paragraph 1. The authority for Part 301 continues to read as follows:

Authority 26 U.S.C. 7805. * * * Section 301.6402-6T also issued under 31 U.S.C. 3720A.

Par. 2. Section 301.6402-6T is amended as follows:

1. In paragraph (b), the first sentence of the concluding language that follows paragraph (b)(8) is revised to read as set forth below:

2. In paragraph (c)(1), the introductory language that precedes paragraph (c)(1)(i) is revised to read as set forth below.

3. Paragraphs (i) and (k) are revised to read as set forth below.

§301.6402-6T Offset of past-due legally enforceable debt against overpayment. (Temporary)

* * * * * *

(b) * * *

For purposes of this paragraph, in order to make a reasonable attempt to notify the taxpayer the agency must use such address information as may be obtainable from the Service pursuant to section 6103(m)(2), (m)(4) or (m)(5) of the Code. * * *

(c) *Time and content of notification of liability for past-due legally enforceable debt.* (1) A Federal agency must submit a notification of a taxpayer's liability for past-due legally enforceable debt to the Service on magnetic tape by such date as shall be specified in a Revenue Procedure each year. Such notification must contain—

* * * * * *

(i) *Fees.* Refund offset fees in amounts determined to be sufficient to reimburse the Department of the Treasury for the full cost of the refund offset procedure prescribed by this section shall be deducted from amounts collected prior to disposition of such amounts as described in paragraph (h) of this section. The fees shall be deposited in the United States Treasury and credited to the appropriation accounts which bore all or part of the costs involved in administering the refund offset procedures.

* * * * * *

(k) *Effective date.* This section applies to refunds payable under section 6402 of the Internal Revenue Code after December 31, 1985, and on or before January 10, 1994. However, if legislation is enacted extending the tax refund offset program beyond January 10, 1994, this section applies to refunds payable through the date to which such legislation extends the program.

* * * * * *

There is need for immediate guidance with respect to the provisions contained in this Treasury decision. For this reason, it is found impractical to issue this Treasury decision with notice and public procedure under subsection (b) of section 553 of Title 5 of the United States Code or subject to the effective date limitation of subsection (d) of that section.

Lawrence B. Gibbs,
Commissioner of Internal Revenue.

Approved December 22, 1988.

Dennis E. Ross,
Acting Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on January 3, 1989, 2:39 p.m., and published in the issue of the Federal Register for January 6, 1989, 54 F.R. 400)

Section 6404.—Abatements

26 CFR 301.6404-0T: Table of contents (temporary).

T.D. 8254

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Parts 301 and 602

Abatement of Penalty or Addition to Tax Attributable to Erroneous Advice

AGENCY: Internal Revenue Service, Treasury.

ACTION: Temporary regulations.

SUMMARY: This document contains temporary regulations relating to the abatement of a portion of any penalty or addition to tax attributable to erroneous written advice furnished to a taxpayer by an officer or employee of the Internal Revenue Service, acting in such officer's or employee's official capacity. Changes to the applicable law were made by the Omnibus Taxpayer Bill of Rights provisions of the Technical and Miscellaneous Revenue Act of 1988. The regulations affect all taxpayers, and provide guidance regarding the definition of "advice" and the procedures that must be followed to obtain an abatement. The text of the temporary regulations set forth in this document also serves as the text of the proposed regulations cross-referenced in the Notice of Proposed Rulemaking in * * * [IA-24-89, page 1021, this Bulletin].

EFFECTIVE DATE: The temporary regulations are effective with respect to advice requested on or after January 1, 1989.

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

This regulation is 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 requirement contained in this regulation has been reviewed and, pending receipt and evaluation of public comments, approved by the Office of Management and Budget (OMB) under control number 1545-0024. The time estimates for the reporting and recordkeeping requirements contained in this regulation are included in the burden of Form 843.

For further information concerning the collection of information, where to submit comments on the collection of information, and suggestions for reducing the burden, please refer to the preamble to the cross-reference notice of proposed rulemaking published elsewhere in * * * [IA-24-89, page 1021, this Bulletin].

Background

This document contains temporary regulations amending the Procedure and Administration Regulations (26 CFR Part 301) under section 6404 of the Internal Revenue Code of 1986 (Code). The amendments would conform the regulations to section 6229 of the Technical and Miscellaneous Revenue Act of 1988 (Pub. L. 100-647, 102 Stat. 3342).

In general

Section 6404(f) provides that the Internal Revenue Service shall abate any portion of any penalty or addition to tax attributable to erroneous advice furnished to a taxpayer in writing by an officer or employee of the Service, acting in such officer's or employee's official capacity. The Service will abate a portion of any penalty or addition to tax under section 6404(f) only if (a) the written advice was reasonably relied upon by the taxpayer; (b) the written advice was in response to a specific written request of the taxpayer; and (c) the portion of the penalty or addition to tax did not result from a failure by the taxpayer to provide the Service with adequate or accurate information. Section 6404(f) is effective for advice requested on or after January 1, 1989.

Reliance on written advice

The written advice from the Service must have been reasonably relied upon by the taxpayer in order for any penalty to be abated under section 6404(f). Thus, in the case of written advice from the Service that relates to an item included on a federal tax return of a taxpayer, if such advice is received subsequent to the date on which the taxpayer filed such return, the taxpayer did not reasonably rely on the written advice in filing such return. However, if a taxpayer files an amended return that conforms with written advice received from the Service, the taxpayer will be considered to have reasonably relied on the advice for purposes of the position set forth in the amended return. In the case of written advice that does not relate to an item included on a federal tax return (for example, advice relating to the payment of estimated taxes), if such written advice is received by the taxpayer subsequent to the act or omission that is the basis of the penalty or addition to tax, then the taxpayer shall not be considered to have reasonably relied on such written advice.

If the written advice relates to a continuing action or series of actions, the taxpayer may rely on that advice until put on notice that the advice no longer represents Service position and, thus, is no longer valid. Correspondence from the Service to the taxpayer stating that the advice no longer represents Service position is sufficient to put the taxpayer on notice. Further, any of the following events, occurring subsequent to the issuance of advice, that set forth a position contrary to the position of the written advice will serve to put the taxpayer on notice that the advice is no is no longer valid: (a) legislation or a tax treaty; (b) a United States Supreme Court decision; (c) temporary or final regulations; and (d) a revenue ruling, a revenue procedure, or other statement published in the Internal Revenue Bulletin.

Definitions

For purposes of section 6404(f) and the temporary regulations thereunder, a written response issued to a taxpayer by an officer or employee of the Service shall constitute "advice" if, and only if, the response applies the tax laws to the specific written facts submitted by the taxpayer and provides a conclusion regarding the tax treatment to be accorded the taxpayer upon the application of the tax laws to those facts. The regulations define the terms "penalty" and "addition to tax" as any liability of a particular taxpayer imposed under Subtitle F, Chapter 68, Subchapter A and Subchapter B of the Internal Revenue Code, and the liabilities imposed by sections 6038(b), 6038(c), 6038A(d), 6038B(b), 6039E(c), and 6332(d)(2). In addition the terms "penalty" and "addition to tax" shall include any liability resulting from the application of other provisions of the Code where the Commissioner of Internal Revenue has designated by regulation, revenue ruling, or other guidance published in the Internal Revenue Bulletin that such provision shall be considered a penalty or addition to tax for purposes of section 6404(f). The terms "penalty" and "addition to tax" shall also include interest imposed with respect to any penalty or addition to tax. The Service welcomes any comments concerning which provisions, if any, not included in the definition of "penalty" and "addition to tax" should be considered a penalty or an addition to tax for purposes of section 6404(f) and the regulations thereunder.

Procedures for abatement

Section 301.6404-3T(d) provides that taxpayers entitled to an abatement of a penalty or addition to tax pursuant to section 6404(f) should complete and file Form 843. If the erroneous advice received relates to an item on a federal tax return, taxpayers should submit Form 843 to the Internal Revenue Service Center where the return was filed. If the erroneous advice does not relate to an item on a federal tax return, Form 843 should be submitted to the Service Center where the taxpayer's return was filed for the taxable year in which the taxpayer relied on the erroneous advice. Form 843 must be accompanied by copies of: (a) the taxpayer's written request for advice; (b) the erroneous written advice furnished by the Service to the taxpayer and relied on by the taxpayer; and (c) the report (if any) of tax adjustments that identifies the penalty or addition to tax and the item relating to the erroneous written advice.

Period for requesting abatement

An abatement of any penalty or addition to tax pursuant to section 6404(f) and §301.6404-3T shall be allowed only if the request for abatement is submitted within the period allowed for collection of such penalty or addition to tax, or, if the penalty or addition to tax has been paid, the period allowed for claiming a credit or refund of such penalty or addition to tax.

Regulatory Impact Analysis

These proposed rules are not major rules as defined in Executive Order 12291. Therefore, a Regulatory Impact Analysis is not required.

Issuance of Proposed Regulation and Submission to Small Business Administration

The rules contained in this document are also being issued as proposed regulations by the notice of proposed rulemaking on this subject in * * * [IA-24-89, page 1021, this Bulletin]. Pursuant to section 7805(f) of the Internal Revenue Code, a copy of the rules will be submitted to the Administrator of the Small Business Administration for comment on their impact on small businesses.

* * * * * *

Adoption of amendments to the regulations

Accordingly, 26 CFR Parts 301 and 602 are amended as follows:

Paragraph 1. The authority for Part 301 is amended by adding the following citation:

Authority: 26 U.S.C. 7805 * * * Section 301.6404-3T is also issued under 26 U.S.C. 6404(f)(3).

Par. 2. The following new section is added immediately following §301.6403-1 to read as follows:

§301.6404-0T Table of contents (temporary).

This section lists the paragraphs contained in sections 301.6404-1T - 301.6404-3T.

§301.6404-1 Abatements.

§301.6404-2T Definition of ministerial act (temporary).

(a) In general.

(b) Ministerial act.

(1) Definition.

(2) Examples.

(c) Effective date.

§301.6404-3T Abatement of penalty or addition to tax attributable to erroneous written advice of the Internal Revenue Service (temporary).

(a) General rule.

(b) Requirements.

(1) In general.

(2) Advice was reasonably relied upon.

(i) In general.

(ii) Advice relating to a tax return.

(iii) Amended returns.

(iv) Advice not related to a tax return.

(v) Period of reliance.

(3) Advice was in response to written request.

(4) Taxpayer's information must be adequate and accurate.

(c) Definitions.

(1) Advice.

(2) Penalty and addition to tax.

(d) Procedures for abatement.

(e) Period for requesting abatement.

(f) Examples.

(g) Effective date.

Par. 3. The following new section is added immediately following §301.6404-2T to read as follows:

§301.6404-3T Abatement of penalty or addition to tax attributable to erroneous written advice of the Internal Revenue Service (temporary).

(a) *General rule.* Any portion of any penalty or addition to tax that is attributable to erroneous advice furnished to the taxpayer in writing by an officer or employee of the Internal Revenue Service (Service), acting in his or her official capacity, shall be abated, provided the requirements of paragraph (b) of this section are met.

(b) *Requirements*—(1) *In general.* Paragraph (a) of this section shall apply only if—

(i) The written advice was reasonably relied upon by the taxpayer;

(ii) The advice was issued in response to a specific written request for advice by the taxpayer; and

(iii) The taxpayer requesting advice provided adequate and accurate information.

(2) *Advice was reasonably relied upon*—(i) *In general.* The written advice from the Service must have been reasonably relied upon by the taxpayer in order

for any penalty to be abated under Paragraph (a) of this section.

(ii) *Advice relating to a tax return.* In the case of written advice from the Service that relates to an item included on a federal tax return of a taxpayer, if such advice is deceived by the taxpayer subsequent to the date on which the taxpayer filed such return, the taxpayer shall not be considered to have reasonably relied upon such written advice for purposes of this section, except as provided in paragraph (b)(2)(iii) of this section.

(iii) *Amended returns.* If a taxpayer files an amended federal tax return that conforms with written advice received by the taxpayer from the Service, the taxpayer will be considered to have reasonably relied upon the advice for purposes of the position set forth in the amended return.

(iv) *Advice not related to a tax return.* In the case of written advice that does not relate to an item included on a federal tax return (for example, the payment of estimated taxes), if such written advice is received by the taxpayer subsequent to the act or omission of the taxpayer that is the basis for the penalty or addition of tax, then the taxpayer shall not be considered to have reasonably relied upon such written advice for purposes of this section.

(v) *Period of reliance.* If the written advice received by the taxpayer relates to a continuing action or series of actions, the taxpayer may rely on that advice until the taxpayer is put on notice that the advice is no longer consistent with Service position and, thus, no longer valid. For purposes of this section, the taxpayer will be put on notice that written advice is no longer valid if the taxpayer receives correspondence from the Service stating that the advice no longer represents Service position. Further, any of the following events, occurring subsequent to the issuance of the advice, that set forth a position that is inconsistent with the written advice received from the Service shall be deemed to put the taxpayer on notice that the advice is no longer valid—

(A) Enactment of legislation or ratification of a tax treaty;

(B) A decision of the United States Supreme Court;

(C) The issuance of temporary or final regulations; or

(D) The issuance of a revenue ruling, a revenue procedure, or other statement published in the Internal Revenue Bulletin.

(3) *Advice was in response to written request.* No abatement under paragraph (a) of this section shall be allowed unless the penalty or addition to tax is attributable to advice issued in response to a specific written request for advice by the taxpayer. For purposes of the preceding sentence, a written request from a representative of the taxpayer shall be considered a written request by the taxpayer only if—

(i) The taxpayer's representative is an attorney, a certified public accountant, an enrolled agent, an enrolled actuary, or any other person permitted to represent the taxpayer before the Service and who is not disbarred or suspended from practice before the Service; and

(ii) The written request for advice either is accompanied by a power of attorney that is signed by the taxpayer and that authorizes the representative to represent the taxpayer for purposes of the request, or such a power of attorney is currently on file with the Service.

(4) *Taxpayer's information must be adequate and accurate.* No abatement under paragraph (a) of this section shall be allowed with respect to any portion of any penalty or addition to tax that resulted because the taxpayer requesting the advice did not provide the Service with adequate and accurate information. The Service has no obligation to verify or correct the taxpayer's submitted information.

(c) *Definitions*—(1) *Advice.* For purposes of section 6404(f) and the regulations thereunder, a written response issued to a taxpayer by an officer or employee of the Service shall constitute "advice" if, and only if, the response applies the tax laws to the specific facts submitted in writing by the taxpayer and provides a conclusion regarding the tax treatment to be accorded the taxpayer upon the application of the tax law to those facts.

(2) *Penalty and addition to tax.* For purposes of section 6404(f) and the regulations thereunder, the terms "penalty" and "addition to tax" refer to any liability of a particular taxpayer imposed under Subtitle F, Chapter 68, Subchapter A and Subchapter B of the Internal Revenue Code, and the liabilities imposed by sections 6038(b), 6038(c), 6038A(d), 6038B(b), 6039E(c), and 6332(d)(2). In addition, the terms "penalty" and "addition to tax" shall include any liability resulting from the application of other provisions of the Code where the Commissioner of Internal Revenue has designated by regulation, revenue ruling, or other guidance published in the Internal Revenue Bulletin that such provision shall be considered a penalty or addition to tax for purposes of section 6404(f). The terms "penalty" and "addition to tax" shall also include interest imposed with respect to any penalty or addition to tax.

(d) *Procedures for abatement.* Taxpayers entitled to an abatement of a penalty or addition to tax pursuant to section 6404(f) and this section should complete and file Form 843. If the erroneous advice received relates to an item on a federal tax return, taxpayers should submit Form 843 to the Internal Revenue Service Center where the return was filed. If the advice does not relate to an item on a federal tax return, the taxpayer should submit Form 843 to the Service Center where the taxpayer's return was filed for the taxable year in which the taxpayer relied on the erroneous advice. At the top of Form 843 taxpayers should write, "Abatement of penalty or addition to tax pursuant to section 6404(f)." Further, taxpayers must state on Form 843 whether the penalty or addition to tax has been paid. Taxpayers must submit, with Form 843, copies of the following—

(1) The taxpayer's written request for advice;

(2) The erroneous written advice furnished by the Service to the taxpayer and relied on by the taxpayer; and

(3) The report (if any) of tax adjustments that identifies the penalty or addition to tax and the item relating to the erroneous written advice.

(e) *Period for requesting abatement.* An abatement of any penalty or addition to tax pursuant to section 6404(f) and this section shall be allowed only if the request for abatement described in paragraph (d) of this section is submitted within the period allowed for collection of such penalty or addition to tax, or, if the penalty or addition to tax has been paid, the period allowed for claiming a credit or refund of such penalty or addition to tax.

(f) *Examples.* The following examples illustrate the application of section 6404(f) of the Code and the regulations thereunder:

Example 1. In February 1989, an individual submitted a written request for advice to an Internal Revenue Service Center and included adequate and accurate information to consider the request. The question posed by the taxpayer concerned whether a certain amount was includible in income on the taxpayer's 1989 federal income tax return. An employee of the Service Center issued the taxpayer a written response that concluded that based on the specific facts submitted by the taxpayer, the amount was not includible in income on the taxpayer's 1989 return. Since the response provided a conclusion regarding the tax treatment accorded the taxpayer on the basis of the facts submitted, the response constitutes "advice" for purposes of section 6404(f). The taxpayer filed his 1989 return and, relying on the Service's advice, did not include the item in income. Upon examination, it was determined that the item should have been included in income on the taxpayer's 1989 return. Because the taxpayer reasonably relied upon erroneous written advice from the Service, any penalty or addition to tax attributable to the erroneous advice will be abated by the Service. However, the erroneous advice will not affect the amount of any taxes and interest owed by the taxpayer (except to the extent interest relates to a penalty or addition to tax attributable to the erroneous advice) due to the fact that the item was not included in income

Example 2. In March 1989, an individual submitted a written request to the National Office of the Internal Revenue Service regarding whether a certain activity constitutes a passive activity within the meaning of section 469 of the Code. The request did not meet the procedural requirements set forth by the National Office for consideration of the submission as a private letter ruling request and, thus, was not treated as such by the Service. The Service furnished the taxpayer with a written response that transmitted various published provisions of section 469 and the regulations thereunder relevant to the determination of whether an activity is passive within the meaning of those provisions. The Service also included a Publication regarding the tax treatment of passive activities. However, the Service's response contained no opinion or determination regarding whether the taxpayer's described activity was or was not passive under section 469. The Service's response is not advice within the meaning of section 6404(f), and cannot be relied upon for purposes of an abatement of a portion of a penalty or addition to tax under that section.

Example 3. On April 1, 1989, an individual submitted a written request for advice to an Internal Revenue Service Center. The advice related to an item included on a federal tax return. The individual filed a federal income tax return with the appropriate Service Center on April 15, 1989. Subsequently, on May 1, 1989, the individual received advice from the Service Center concerning the written request made on April 1. Because the individual filed his tax return prior to the date on which written advice from the Service was received, the individual did not rely on the Service's written advice for purposes of section 6404(f). If, however, the individual amends his tax return to conform with the written advice received from the Service, the individual will be considered to have reasonably relied upon the Service's advice.

Example 4. Individual A, on May 1, 1989, received advice from the Service that concluded that interest paid by the taxpayer with respect to a specific loan was interest paid or accrued in connection with a trade or business, within the meaning of section 163(h)(2)(A) of the Code. The advice relates to a continuing action. Therefore, provided the facts submitted by the taxpayer to obtain the advice remain adequate and accurate (that is, the circumstances relating to the indebtedness do not change), Individual A may rely on the Service's advice for subsequent taxable years until the individual is put on notice that the advice no longer represents Service position and, thus, is no longer valid.

Example 5. An individual, on June 1, 1989, received advice from the Service that concluded that no gain or loss would be recognized with respect to a transfer of property to his spouse under section 1041. The advice does not relate to a continuing action. Therefore, the taxpayer may not rely on the advice of the Service for transfers other than the transfer discussed in the taxpayer's written request for advice.

(g) *Effective date*. Section 6404(f) shall apply with respect to advice requested on or after January 1, 1989.

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

Authority: 26 U.S.C. 7805

Par. 5. Section 602.101(c) is amended by inserting in the appropriate place in the table:

"§301.6404-3T(d) ....1545-0024."

The provisions contained in this Treasury decision are needed to provide immediate guidance. For this reason, it is found impracticable and contrary to public interest to issue this Treasury decision with notice and public procedure under subsection (b) of section 553 of Title 5 of the United States Code or subject to the effective date limitation of subsection (d) of that section.

Michael J. Murphy,
Acting Commissioner of Internal Revenue.

Approved May 8, 1989.

John G. Wilkins,
Acting Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on May 15, 1989, 8:45 a.m., and published in the issue of the Federal Register for May 16, 1989, 54 F.R. 21055)

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. (Also Sections 6166, 6621; 20.6166-1, 301.6621-1.)

Interest rate; estate tax; closely held business. If the time for payment of estate tax is extended under section 6166 of the Code and a deficiency is assessed after the estate has timely made one or more interest payments, the 4-percent rate prescribed by section 6601(j) is applied to determine the amount of interest that should have been paid in each annual payment. Interest on any underpayment of interest thus determined accrues at the prevailing rate under section 6601(a) from the date the interest should have been paid under section 6166(f)(1) had the return shown the correct tax liability. Rev. Rul. 67-161 clarified and amplified.

Rev. Rul. 89-32

ISSUE

If the time for payment of estate tax is extended under section 6166 of the Internal Revenue Code and a deficiency is assessed after the estate has timely made one or more annual interest payments, at what rate does interest accrue on unpaid interest that should have been paid on each past annual interest payment date?

LAW AND ANALYSIS

Section 6166(a)(1) of the Code provides generally that if the value of an interest in a closely held business is included in determining the gross estate of a decedent and exceeds 35 percent of the adjusted gross estate, the executor may elect to pay all or part of the estate tax in up to 10 equal installments.

Section 6166(a)(3) of the Code provides generally that if the time for payment of estate tax is extended under section 6166, the first annual installment of tax must be paid on or before the date selected by the executor, which cannot be more than 5 years after the date prescribed by section 6151(a) for payment of estate tax.

Under section 6166(e) of the Code, if an election under section 6166(a) has been made and if a deficiency has been assessed, the deficiency shall (subject to the limitation provided by section 6166(a)(2)) be prorated to the installments payable under section 6166(a). Section 6166(e) does not apply if the deficiency is due to negligence, to intentional disregard of rules and regulations, or to fraud with intent to evade tax.

Section 6166(f) of the Code prescribes the time for payment of interest when the time for payment of tax has been extended pursuant to a section 6166(a) election. Under section 6166(f)(1), interest payable under section 6601 must be paid annually on any unpaid portion of the tax attributable to the first 5 years after the date prescribed by section 6151(a) for payment of the tax.

Section 6166(g)(3) of the Code provides generally that if any payment of principal or interest is not paid within 6 months of the date fixed for its payment under section 6166, the unpaid portion of the tax payable in installments must be paid upon notice and demand from the Secretary.

Section 6601(a) of the Code provides generally that if any amount of tax is not paid on or before the last date prescribed for payment, interest on the unpaid amount must be paid at an annual rate established under section 6621 for the period from such last date to the date paid.

Under section 6601(e)(1) of the Code, any reference in the Code (except subchapter B of chapter 63, relating to deficiency procedures) to any tax imposed by the Code shall be deemed also to refer to interest imposed by section 6601 on such tax.

Section 6601(j)(1) of the Code provides generally that if the time for payment of an amount of estate tax, including any deficiency, is extended as provided in section 6166, interest on the 4-percent portion of the amount shall (in lieu of the annual rate provided by section 6601(a)) be paid at the rate of 4 percent.

Section 6601(j)(2) of the Code provides that the "4-percent portion" means the lesser of —

(A) $345,800 reduced by the amount of the credit allowable under section 2010(a); or

(B) the amount of the tax imposed by chapter 11 that is extended as provided in section 6166.

Through the statutory provisions described above, Congress has provided liquidity relief to an estate in which the decedent's interest in a closely held business is a significant part of the gross estate. If an election is made under section 6166 of the Code, the estate makes only annual interest payments during the initial five-year period on the tax attributable to the closely held business during which time payment of the tax is deferred. Moreover, within the limits of section 6601(j)(2), interest accrues during the period of deferral under section 6601(j)(1) at the rate of 4 percent rather than under section 6601(a) at the prevailing rate.

If a deficiency is assessed during the five-year deferral period, and the deficiency is attributable to the decedent's interest in a closely held business and is within the limits of section 6601(j)(2) of the Code, the deficiency is prorated to the scheduled installments of tax, and interest is imposed at the rate of 4 percent. Sections 6166(e) and 6601(j).

The question presented is how interest is calculated if the deficiency is assessed after one or more annual interest payments have been made. In such case, the interest payments that were made before assessment of the deficiency will have been less than the payments that would have been made had the correct liability been shown on the return. If the 4-percent rate of interest were applied to the interest that should have been paid in past annual interest payments from the date such interest was due until the date of notice and demand for such interest, the estate would be in a better position than if the tax liability had been reported correctly on the return.

Under section 6166(f)(1) of the Code, interest on any unpaid deferred tax attributable to the first 5 years after the date prescribed by section 6151(a) for payment of tax must be paid annually. Because a deficiency represents a portion of the unpaid tax, interest attributable to a deficiency that qualifies for deferral must also be paid annually under section 6166(f)(1). When a deficiency is assessed after an annual interest payment date, the fact that the correct amount of interest was not paid within 6 months of the past annual interest payment date does not cause acceleration of the unpaid tax under section 6166(g)(3) if the additional interest is paid within 6 months of notice and demand. This does not mean, however, that the 4-percent rate of interest applies to the underpayment of interest until there is notice and demand.

The operation of what is now designated as section 6601(j) of the Code was explained by Congress in H.R. Rep. No. 2198, 85th Cong., 1st Sess. 20-21 (1958), 1959-2 C.B. 709, 723:

> *Rate of Interest.*—... [T]he bill amends subsection (b) of section 6601 [presently subsection (j)] of the 1954 Code, relating to interest on extension of time to pay estate tax, to provide that interest shall be payable on any amount of estate tax, including a deficiency, which comes within the scope of section 6166, at the rate of 4 percent per annum instead of the normal rate .... which is provided by subsection (a) of section 6601. However, if any amount of such tax is not paid on or before the expiration of the period of extension applicable thereto, the [normal] rate will apply from the date of such expiration to the date the tax is paid.

Under section 6166(f)(1) of the Code, an estate is obligated to pay the interest on the full amount of its unpaid tax annually, and the 4-percent rate of interest prescribed by section 6601(j) extends only to the date on which the interest should have been paid. Congress did not intend that an estate with a deficiency be entitled to the 4-percent rate of interest for any period beyond the date on which the annual interest payment on the full amount of unpaid tax was due. Because interest is considered part of the tax under section 6601(a), interest on any underpayment of interest accrues at the prevailing rate under section 6601(e) from the date the interest should have been paid under section 6166(f)(1) had the return shown the correct tax liability.

The above principles are illustrated with the following example:

D died on March 31, 1982. *E*, the executor, timely filed *D*'s estate tax return on December 31, 1982. The estate elected to pay $200,000 of the estate tax attributable to an interest in a closely held business in 10 equal installments under section 6166(a) of the Code. The first installment of tax is due December 31, 1987. The first interest payment of $8,161.66 as determined under Rev. Proc. 83-7, 1983-1 C.B. 583, which provides tables and procedures for computing interest using the daily compounding rules, was due December 31, 1983, and *E* made the payment timely.

$200,000 × .040808298 (Table 10) for the period: (1-1-83 to 12-31-83) 365 days at 4 percent	=	$8,161.66

Subsequently, the Internal Revenue Service asserted a deficiency of $40,000 against the estate, all of which qualified under section 6166(a). Notice and demand was sent to *E* on August 31, 1984.

The entire deferred deficiency accrues interest at 4 percent because the limits imposed under section 6601(j)(2) of the Code have not been reached, and the date has not passed for payment of any portion of the deficiency. However, the date for payment of the first annual interest payment was December 31, 1983, and interest attributable to the deficiency was not paid. This unpaid interest accrues interest under section 6601(a) at the prevailing rate from the date it was due (December 31, 1983) until paid. The total additional interest payable as of August 31, 1984, as reflected in the notice and demand, is:

Interest on $40,000 for the period: (1-1-83 to 12-31-83) 365 days at 4 percent $40,000 × 040808298 (Table 10)	$1,632.33
(1-1-84 to 6-30-84) 182 days at 11 percent/leap years $1,632.33 × .056214263 (Table 41) =	$ 91.76
(7-1-84 to 8-31-84) 62 days at 11 percent/leap years $1 724.09 × .018805661 (Table 41)	$ 32.42
Total	$1,756.51

This amount must be paid within 6 months of notice and demand in order to avoid the acceleration provisions of section 6166(g)(3)(A).

Interest for 1984 on the principal amount of the deficiency will be paid on December 31, 1984, as part of the annual interest payment due under section 6166(f).

HOLDING

If the time for payment of estate tax is extended under section 6166 of the Code and a deficiency is assessed after the estate has timely made one or more interest payments, the 4-percent rate prescribed by section 6601(j) is applied to determine the amount of interest that should have been paid in each annual payment. Interest on any underpayment of interest thus determined accrues at the prevailing rate under section 6601(a) from the date the interest should have been paid under section 6166(f)(1) had the return shown the correct tax liability.

EFFECT ON OTHER REVENUE RULINGS

Rev. Rul. 67-161, 1967-1 C.B. 342, concludes that the 4-percent rate provided in former section 6601(b) of the Code, now section 6601(j)(1), applies to a deficiency prorated under section 6166 to tax installments, both past and future. However, Rev. Rul. 67-161 does not address the period of time during which the 4-percent rate applies. The portion of a deficiency prorated to an installment accrues interest at 4 percent (if within the 4-percent limitations) from the date prescribed by section 6151(a) for payment of the tax until the date prescribed by section 6166(a)(3) for payment of the installment to which the portion of the deficiency is prorated. Thereafter, the portion of the deficiency accrues interest under section 6601(a). Rev. Rul. 67-161 is clarified and amplified.

Subchapter C.—Determination of Interest Rate; Compounding of Interest

Section 6621.—Determination of Rate of Interest

26 CFR. 301.6621-1: Interest rate.

Interest rates; underpayments and overpayments. The rate of interest determined under section 6621 of the Code for the calendar quarter beginning April 1, 1989, will increase to 11 percent for overpayments and 12 percent for underpayments.

Rev. Rul. 89-36

Section 6621 of the Internal Revenue Code establishes differential rates for allowance of interest on tax overpayments and assessment of interest on tax underpayments. Under section 6621(a)(1), the overpayment rate is the sum of the federal short-term rate plus 2 percentage points. Under section 6621(a)(2), the underpayment rate is the sum of the federal short-term rate plus 3 percentage points.

Section 6621(b)(1) of the Code provides that the Secretary shall determine the federal short-term rate for the first month in each calendar quarter.

Section 6621(b)(2)(A) of the Code provides that the federal short-term rate determined under section 6621(b)(1) for any month shall apply during the first calendar quarter beginning after such month.

Section 6621(b)(2)(B) of the Code provides that in determining the addition to tax under section 6654 for failure to pay estimated tax for any taxable year, the federal short-term rate which applies during the third month following such taxable year shall also apply during the first 15 days of the fourth month following such taxable year.

Section 6621(b)(3) of the Code provides that the federal short-term rate for any month shall be the federal short-term rate determined during such month by the Secretary in accordance with section 1274(d), rounded to the nearest full percent (or, if a multiple of ½ of 1 percent, the rate shall be increased to the next highest full percent).

Notice 88-59, 1988-1 C.B. 546, announced that in determining the quarterly interest rates to be used for overpayments and underpayments of tax under section 6621 of the Code, the Internal Revenue Service will use the federal short-term rate based on daily compounding because that rate is most consistent with section 6621 which, pursuant to section 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 January 1989 is 9 percent. Accordingly, an overpayment rate of 11 percent and an underpayment rate of 12 percent are established for the calendar quarter beginning April 1, 1989. These rates apply to amounts bearing interest during that calendar quarter except that, pursuant to section 6621(b)(2)(B) of the Code, the 11 percent rate applicable to underpayments for the calendar quarter beginning January 1, 1989, continues to be applicable to individual estimated tax underpayments from April 1, 1989, through April 15, 1989. For April 16, 1989, through June 30, 1989, the 12 percent underpayment rate applies to such individual estimated tax underpayments.

Interest factors for daily compound interest for annual rates of 11 percent and 12 percent were published in Tables 17 and 18 of Rev. Proc. 83-7, 1983-1 C.B. 583, 600, 601.

Annual interest rates to be compounded daily pursuant to section 6622 of the Code that apply for prior periods are set forth in the accompanying tables.

TABLE OF INTEREST RATES
PERIODS BEFORE JUL. 1, 1975 - DEC. 31, 1986
OVERPAYMENTS AND UNDERPAYMENTS

PERIOD	RATE	DAILY RATE TABLE IN 1983-1 C.B.
Before Jul. 1, 1975	6%	Table 2, pg. 586
Jul. 1, 1975—Jan. 31, 1976	9%	Table 4, pg. 588
Feb. 1, 1976—Jan. 31, 1978	7%	Table 3, pg. 587
Feb. 1, 1978—Jan 31, 1980	6%	Table 2, pg. 586
Feb. 1, 1980—Jan. 31, 1982	12%	Table 5, pg. 588
Feb. 1, 1982—Dec. 31, 1982	20%	Table 6, pg. 588
Jan. 1, 1983—Jun. 30, 1983	16%	Table 22, pg. 605
Jul. 1, 1983—Dec. 31, 1983	11%	Table 17, pg. 600
Jan. 1, 1984—Jun. 30, 1984	11%	Table 41, pg. 625
Jul. 1, 1984—Dec. 31, 1984	11%	Table 41, pg. 625
Jan. 1, 1985—Jun. 30, 1985	13%	Table 19, pg. 602
Jul. 1, 1985—Dec. 31, 1985	11%	Table 17, pg. 600
Jan. 1, 1986—Jun. 30, 1986	10%	Table 16, pg. 599
Jul. 1, 1986—Dec. 31, 1986	9%	Table 15, pg. 598

TABLE OF INTEREST RATES
FROM JAN. 1, 1987 PRESENT

	OVERPAYMENTS			UNDERPAYMENTS		
	RATE	TABLE	PG	RATE	TABLE	PG.
Jan. 1, 1987—Mar. 31, 1987	8%	14	597	9%	15	598
Apr. 1, 1987—Jun. 30, 1987	8%	14	597	9%	15	598
Jul. 1, 1987—Sep. 30, 1987	8%	14	597	9%	15	598
Oct. 1, 1987—Dec. 31, 1987	9%	15	598	10%	16	599
Jan. 1, 1988—Mar. 31, 1988	10%	40	624	11%	41	625
Apr. 1, 1988—Jun. 30, 1988	9%	39	623	10%	40	624
Jul. 1, 1988—Sep. 30, 1988	9%	39	623	10%	40	624
Oct. 1, 1988—Dec. 31, 1988	10%	40	624	11%	41	625
Jan. 1, 1989—Mar. 31, 1989	10%	16	599	11%	17	600
Apr. 1, 1989—Jun. 30, 1989	11%	17	600	12%	18	601

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 July 1, 1989, will increase to 11 percent for overpayments and 12 percent for underpayments.

Rev. Rul. 89-69

Section 6621 of the Internal Revenue Code establishes differential rates for allowance of interest on tax overpayments and assessment of interest on tax underpayments. Under section 6621(a)(1), the overpayment rate is the sum of the federal short-term rate plus 2 percentage points. Under section 6621(a)(2), the underpayment rate is the sum of the federal short-term rate plus 3 percentage points.

Section 6621(b)(1) of the Code provides that the Secretary shall determine the federal short-term rate for the first month in each calendar quarter.

Section 6621(b)(2)(A) of the Code provides that the federal short-term rate determined under section 6621(b)(1) for any month shall apply during the first calendar quarter beginning after such month.

Section 6621(b)(2)(B) of the Code provides that in determining the addition to tax under section 6654 for failure to pay estimated tax for any taxable year, the federal short-term rate which applies during the third month following such taxable year shall also apply during the first 15 days of the fourth month following such taxable year.

Section 6621(b)(3) of the Code provides that the federal short-term rate for any month shall be the federal short-term rate determined during such month by the Secretary in accordance with section 1274(d), rounded to the nearest full percent (or, if a multiple of ½ of 1 percent, the rate shall be increased to the next highest full percent).

Notice 88-59, 1988-1 C.B. 546, announced that in determining the quarterly interest rates to be used for overpayments and underpayments of tax under section 6621 of the Code, the Internal Revenue Service will use the federal short-term rate based on daily compounding because that rate is most consistent with section 6621 which, pursuant to section 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 April 1989 is 9 percent. Accordingly, an overpayment rate of 11 percent and an underpayment rate of 12 percent are established for the calendar quarter beginning July 1, 1989.

Interest factors for daily compound interest for annual rates of 11 percent and 12 percent were published in Tables 17 and 18 of Rev. Proc. 83-7, 1983-1 C.B. 583, 600, 601.

Annual interest rates to be compounded daily pursuant to section 6622 of the Code that apply for prior periods are set forth in the accompanying tables.

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TABLE OF INTEREST RATES
FROM JAN. 1, 1987 - PRESENT

	OVERPAYMENTS			UNDERPAYMENTS		
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Jan. 1, 1987—Mar. 31, 1987	8%	14	597	9%	15	598
Apr. 1, 1987—Jun. 30, 1987	8%	14	597	9%	15	598
Jul. 1, 1987—Sep. 30, 1987	8%	14	597	9%	15	598
Oct. 1, 1987—Dec. 31, 1987	9%	15	598	10%	16	599
Jan. 1, 1988—Mar. 31, 1988	10%	40	624	11%	41	625
Apr. 1, 1988—Jun. 30, 1988	9%	39	623	10%	40	624
Jul. 1, 1988—Sep. 30, 1988	9%	39	623	10%	40	624
Oct. 1, 1988—Dec. 31, 1988	10%	40	624	11%	41	625
Jan. 1, 1989—Mar. 31, 1989	10%	16	599	11%	17	600
Apr. 1, 1989—Jun. 30, 1989	11%	17	600	12%	18	601

26 CFR 301.6621-1: Interest rate.

At what rate does interest accrue on unpaid interest that should have been paid on past annual interest payment dates if the time for payment of estate tax is extended under section 6166 of the Code and a deficiency is assessed after the estate has timely made one or more annual interest payments? See Rev. Rul. 89-32, page 307.

Chapter 68.—Additions to the Tax, Additional Amounts, and Assessable Penalties
Subchapter A.—Additions to the Tax and Additional Amounts

Section 6652.-Failure to File Certain Information Returns, Registration Statements, Etc.

Guidance is provided for computing the income limits applicable to exempt facility bonds issued to provide for qualified residential rental projects under section 142 of the Code and to low-income housing credits under section 42. See Rev. Rul. 89-24, page 24.

Section 6661.—Substantial Understatement of Liability

26 CFR 1.6661-4: Disclosure of certain information.

Guidance is provided as to when information provided on a return in accordance with the applicable forms and instructions will be adequate disclosure for purposes of reducing an understatement of income tax under section 6661 of the Code. See Rev. Proc. 89-11, page 797.

26 CFR 1.6661-5: Items relating to tax shelters. (Also Sections 170, 262, 501; 1.170A-1, 1.262-1, 1.501(c)(3)-1.)

Substantial understatement penalty; "mail order" churches. ''Churches'' such as those described in Rev. Ruls. 78-232 and 81-94 are ''tax shelters'' for purposes of the substantial understatement penalty imposed by section 6661 of the Code. Rev. Ruls. 78-232 and 81-94 amplified.

Rev. Rul. 89-74

ISSUE

Are ''churches'' such as those described in Rev. Rul. 78-232, 1978-1 C.B. 69, and Rev. Rul. 81-94, 1981-1 C.B. 330, ''tax shelters'' within the meaning of section 6661 of the Internal Revenue Code?

FACTS

In Rev. Rul. 78-232, the taxpayer, claiming to be a duly ordained minister, formed a ''church.'' The original members of the church consisted of the taxpayer, the taxpayer's spouse and two minor children, and a few family friends. The taxpayer was employed full-time by a state government, and continued in this employment after the church was formed. The taxpayer's salary checks were received by the taxpayer and deposited into the church's bank account. The funds from the church bank account, however, were primarily used to furnish the taxpayer with lodging, food, clothing, and other living expenses in a manner comparable to that which the taxpayer previously enjoyed.

In Rev. Rul. 81-94, a professional nurse formed a ''church'' and became its minister by purchasing a ''certificate of ordination'' and a church charter from an organization selling such certificates and charters. Pursuant to a vow of poverty, all the nurse's assets, including a house and an automobile, were transferred to the church. In addition, the nurse's wage income was deposited into the church bank account. In return, the church assumed all the nurse's existing liabilities, such as the home mortgage and all outstanding credit card balances. The church also provided the nurse with a full living allowance sufficient to maintain or improve the nurse's standard of living and permitted the nurse to use the house and automobile for personal purposes.

LAW AND ANALYSIS

Section 501(c)(3) of the Code provides for the exemption from federal income tax of organizations organized and operated exclusively for religious or charitable purposes, no part of the net earnings of which inures to the benefit of any private shareholder or individual. Section 1.501(c)(3)-1(d)(1)(ii) of the Income Tax Regulations provides that an organization described in section 501(c)-(3) must serve a public rather than a private interest. For example, such an organization cannot be organized or operated for the purpose of benefiting certain designated individuals or the creator or the creator's family.

Sections 170(a)(1) and 170(c) of the Code provide a deduction for any ''charitable contribution.'' A ''charitable contribution'' is defined to include a contribution or a gift to or for the use of an organization organized and operated exclusively for religious or charitable purposes, no part of the net earnings of which inures to the benefit of any private shareholder or individual.

Section 262 of the Code provides, in general, that no deduction shall be allowed for personal, living, or family expenses.

Section 6661(a) of the Code imposes a penalty if there is a substantial understatement of income tax. The penalty is equal to 25 percent of the underpayment attributable to such understatement.

Section 6661(b)(1) of the Code provides that a substantial understatement exists if the understatement exceeds the greater of 10 percent of the tax required to be shown on the return or $5,000 ($10,000 in the case of certain corporations).

Section 6661(b)(2)(B) of the Code provides that the amount of the understatement shall be reduced by the portion of the understatement which is attributable to (i) the tax treatment of any item by the taxpayer if there is or was substantial authority for such treatment, or (ii) any item with respect to which the relevant facts affecting the item's tax treatment are adequately disclosed in the return or in a statement attached to the return.

In the case of any understatement attributable to a tax shelter, section 6661(b)(2)(C)(i) of the Code provides that the taxpayer must be able to show that there is or was substantial authority for the tax treatment taken *and* that the taxpayer reasonably believed that the tax treatment was more likely than not the proper tax treatment. That section further provides that the adequate disclosure exception in section 6661(b)(2)(B)(ii) does not apply to any item attributable to a tax shelter.

Section 6661(b)(2)(C)(ii) of the Code and the underlying regulations define the term "tax shelter," for purposes of section 6661, to mean a partnership or other entity (such as a corporation or trust), any investment plan or arrangement, or any other plan or arrangement, if the principal purpose of such partnership, entity, plan, or arrangement is the avoidance or evasion of federal income tax.

Section 1.6661-5(c) of the regulations provides that an item of income, gain, loss, deduction or credit will be considered a "tax shelter item" if the item is directly or indirectly attributable to the principal purpose of a tax shelter to avoid or evade federal income tax.

Rev. Proc. 89-11, page 797, this Bulletin, provides, in section 4(a)(4), that merely disclosing "the name of an organization to which the taxpayer makes a donation and the amount of the donation (for which a charitable contribution deduction is claimed) will not constitute adequate disclosure for purposes of section 6661 of the Code if the taxpayer receives a substantial benefit from the donation shown." This revenue procedure has no applicability, however, if the organization to which the donation is being made is a "tax shelter" under section 6661(b)(2)(C)(ii), since the adequate disclosure exception does not apply in such cases.

In *Tweeddale v. Commissioner*, 92 T.C. No. 31 (March 22, 1989), the petitioner claimed on his individual income tax return that his income was exempt from tax because he was a "minister" in the Basic Bible Church of America. For the purchase price of $1200, the petitioner received a letter certifying him to be a minister of the Basic Bible Church, a certificate of ordination, a certificate of Doctor of Divinity, a letter from the "Archbishop" of the Church outlining the minister's obligations and duties, and a vow of poverty. Petitioner attached the documents to his individual income tax return for 1983. The court concluded that the principal purpose for establishing the ministry was tax avoidance and that the ministry was a tax shelter for purposes of section 6661 of the Code. Accordingly, the adequate disclosure exception to the penalty did not apply.

Rev. Rul. 78-232 holds that the amount of the salary checks deposited by the taxpayer in the church bank account is not deductible as a charitable contribution under section 170 of the Code on two alternative grounds. First, the contribution is not a "charitable contribution" within the meaning of section 170 because the transfer was made with the expectation of procuring a benefit in return. Second, the church is not an organization described in section 170(c) because it was operated for the private purposes of the taxpayer and not exclusively for religious or other charitable purposes.

Rev. Rul. 81-94 holds that the church is not an exempt organization under section 501(c)(3) of the Code because it was operated to serve the private interests of the taxpayer rather than a public interest and therefore was not operated exclusively for religious or charitable purposes. The church was merely a vehicle for handling the taxpayer's personal financial transactions.

The churches in Rev. Rul. 78-232 and Rev. Rul. 81-94 were formed for the principal purpose of avoiding federal income taxes. These churches thus come within the definition of "tax shelter" under section 6661 of the Code.

HOLDING

"Churches" such as those described in Rev. Rul. 78-232 and Rev. Rul. 81-94 are "tax shelters" within the meaning of section 6661 of the Code. Therefore, in the case of any understatement of income tax attributable to such a church, the adequate disclosure exception in section 6661(b)(2)(B)(ii) is not available to reduce such a taxpayer's understatement of income tax for purposes of applying the substantial understatement penalty.

EFFECT ON OTHER REVENUE RULINGS

Rev. Rul. 78-232 and Rev.Rul. 81-94 are amplified.

Chapter 78.—Discovery of Liability and Enforcement of Title
Subchapter A.—Examination and Inspection

Section 7602.—Examination of Books and Witnesses

CT. D. 2043

SUPREME COURT OF THE UNITED STATES
No. 87-1064

United States, Petitioner v. Philip George Stuart, Sr. et al.

[—U.S.—]

On Writ of Certiorari to The United States Court of Appeals for The Ninth Circuit

February 28, 1989

Syllabus

Articles XIX and XXI of the 1942 Convention Respecting Double Taxation (1942 Convention) between the United States and Canada require the United States, upon request and consistent with United States revenue laws, to obtain and convey information to Canadian authorities to assist them in determining a Canadian taxpayer's income tax liability. Respondent Canadian citizens and residents maintained accounts in a bank in the United States. In attempting to ascertain their Canadian income tax liability for certain years, the Canadian Department of National Revenue (Revenue Canada), pursuant to Articles XIX and XXI, requested the Internal Revenue Service (IRS) to provide pertinent bank records. After the IRS Director of Foreign Operations concluded that the requests fell within the 1942 Convention's scope and that it would be appropriate for the United States to honor them, the IRS served on the bank administrative summonses for the requested information, but, at respondents' request, the bank refused to comply. Respondents then petitioned the Federal District Court to quash the summonses, contending that because under 26 U.S.C. §7602(c) the IRS may not issue a summons to further its investigation of a United States taxpayer when a Justice Department referral for possible criminal prosecution is in effect and because Revenue Canada's investigation of respondents was "a criminal investigation, preliminary stage," United States law proscribed the use of a summons to obtain information for Canadian authorities regarding respondents' American bank accounts. This argument was rejected, and the District Court ordered the bank to comply with the summonses. The Court of Appeals reversed, holding that before the IRS may honor a request for information under the 1942 Convention it must determine that Revenue Canada's investigation has not reached a stage analogous to a Justice Department referral by the IRS and that here the affidavit submitted by the IRS failed to state that such a determination had been made with respect to Revenue Canada's investigation of respondents.

Held: Neither the 1942 Convention nor domestic legislation requires the IRS to attest that a Canadian tax investigation has not reached a stage analogous to a Justice Department referral by the IRS in order to obtain enforcement of a summons issued pursuant to a request by Canadian authorities under the 1942 Convention. So long as the IRS satisfies the requirements of good faith set forth in *United States* v. *Powell,* 379 U.S. 48, 57-58—that the investigation be conducted for and relevant to a legitimate purpose, that the information sought not be already in the IRS's possession, and that the statutorily required administrative steps have been followed—and complies with applicable statutes, it is entitled to enforcement of its summons, whether or not the Canadian tax investigation is directed towards criminal prosecution under Canadian law.

(a) Aside from whether the 1942 Convention, in conjunction with 26 U.S.C. §7602(c), narrows the class of legitimate purposes for which the IRS may issue an administrative summons, the IRS's affidavits plainly satisfied the requirements of good faith set forth in *United States* v. *Powell, supra.*

(b) Section 7602(c) does not, by its terms, apply to the summonses challenged in this case, for its speaks only to investigation into possible violations of United States revenue laws, forbidding the issuance of a summons "if a Justice Department referral is in effect." Therefore, §7602(c) does not itself appear to bar enforcement of the summonses in question. This conclusion is supported by §7602(c)'s legislative history indicating that Congress did not intend to make enforcement of a treaty summons contingent upon the foreign tax investigation's not having reached a stage analogous to a Justice Department referral. The concerns that prompted Congress to enact §7602(c)—particularly that of preventing the IRS from encroaching upon the rights of potential criminal defendants—are not present when the IRS issues summonses at the request of most foreign governments conducting investigations into possible violations of their own tax laws. This is especially so where none of the countries, including Canada, with whom the United States has tax treaties providing for exchanges of information employ grand juries and criminal discovery procedures differ considerably among those countries.

(c) Articles XIX and XXI of the 1942 Convention on their face do not support respondents' argument that because the IRS would not be able, under American law, to issue an administrative summons to gather information for use by the Government once a Justice Department referral was in effect, the IRS is not in a position to obtain such information once Canadian authorities have reached a corresponding stage in their investigation. Those Articles both refer to information that the IRS may obtain under American law, but that law does not contain the restriction respondents claim. Section 7602(c) only limits the issuance of a summons when a Justice Department referral is in effect and says nothing about foreign officials' decisions to investigate possible violations of their countries' laws with a view to criminal prosecution outside the United States. The elements of good faith outlined in *United States* v. *Powell, supra,* do not constitute such a restriction, nor does the reasoning in *United States* v. *LaSalle National Bank,* 437 U.S. 298, whose principal holding was codified in §7602(c), favor respondents' position, since the provision of information to Canadian authorities could not curtail the rights of potential criminal defendants in this country by undermining American discovery rules or diminishing the grand jury's role. Moreover, the purpose behind Articles XIX and XXI—the reduction of tax evasion by allowing signatories to demand information from each other—counsels against interpreting those provisions to limit inquiry in the manner respondents desire; the Government's regular compliance with Canadian authorities' requests for information without inquiring whether they intend to use the information for criminal prosecution weighs in favor of its reading of Articles XIX and XXI; and the result urged by respondents would contravene Congress' main reason for laying down as easily administrable test in §7602(c).

813 F.2d 243, reversed and remanded.

BRENNAN, J., delivered the opinion of the Court, in which REHNQUIST, C.J., AND WHITE, MARSHALL, BLACKMUN, and STEVENS, J.J., joined, and in all but Part II-C of which O'CONNOR and KENNEDY, J.J., joined. KENNEDY, J., filed an opinion concurring in part and concurring in the judgment, in which O'CONNOR, J., joined. SCALIA, J., filed an opinion concurring in the judgment.

JUSTICE BRENNAN delivered the opinion of the Court.

Articles XIX and XXI of the Convention Respecting Double Taxation, Mar. 4, 1942, United States-Canada, 56 Stat. 1405-1406, T.S. No. 983, oblige the United States, upon request and consistent with United States revenue laws, to obtain and convey information to Canadian authorities to assist them in determining a Canadian taxpayer's income tax liability. The question presented is whether the United States Internal Revenue Service may issue an administrative summons pursuant to a request by Canadian authorities only if it first determines that the Canadian tax investigation has not reached a stage analogous to a domestic tax investigation's referral to the Justice Department for criminal prosecution. We hold that neither the 1942 Convention nor domestic legislation imposes this precondition to issuance of an administrative summons. So long as the summons meets statutory requirements and is issued in good faith, as we defined that term in *United States* v. *Powell,* 379 U.S. 48, 57-58 (1964) [Ct.D. 1891, 1965-1 C.B. 336], compliance is required, whether or not the Canadian tax investigation is directed toward criminal prosecution under Canadian law.

I

Respondents are Canadian citizens and residents who maintained bank accounts with the Northwestern Commercial Bank in Bellingham, Washington. In attempting to ascertain their Canadian income tax liability for 1980, 1981, and 1982, the Canadian Department of National Revenue (Revenue Canada) asked the Internal Revenue Service (IRS) in January 1984 to secure and provide pertinent bank records. Revenue Canada made its requests pursuant to Articles XIX and XXI of the 1942 Convention.[1] The IRS Director of Foreign Operations—the "competent authority" under Article XIX—concluded that Revenue Canada's requests fell within the scope of the Convention and that it would be appropriate for the United States to honor them. App. 27-28. Specially, he found that "the requested information is not within the possession of the Internal Revenue Service or the Canadian tax authorities; that the requested information may be relevant to a determination of the correct tax liability of [respondents] under Canadian law; and that the same type of information can be obtained by tax authorities under Canadian law." *Id.*, at 28. Thus, on April 2, 1984, the IRS served on Northwestern Commercial Bank administrative summonses for the requested information.

At respondents' behest, the bank refused to comply. In accordance with 26 U.S.C. §7609(b)(2), respondents petitioned the United States District Court for the Western District of Washington to quash the summonses. Only one of their claims is before us. Respondents contended that because the IRS may not issue a summons to further its investigation of a United States taxpayer when a Justice Department referral is in effect, 26 U.S.C. §7602(c), and because Revenue Canada's investigation of each of them was, in the words of the IRS Director of Foreign Operations, "a criminal investigation, preliminary stage," App. 28, United States law proscribed the use of a summons to obtain information for Canadian authorities regarding respondents' American bank accounts. The Magistrate who held a consolidated hearing on respondents' claims rejected this argument. Without addressing their contention that the IRS may not issue a summons pursuant to a request by Revenue Canada once a Canadian tax investigation has reached a stage equivalent to a Justice Department referral for criminal prosecution, the Magistrate found that, even if respondents' legal claims were assumed to have merit, they had failed to carry their burden of showing that the Canadian authorities' investigation had advanced that far. App. to Pet. for Cert. 31a. Upon considering the Magistrate's report and respondents' objections to it, the District Court ordered the bank to comply with the summonses. *Id.*, at 25a-26a, 34a-35a.

After the Court of Appeals for the Ninth Circuit stayed the enforcement orders pending appeal, a divided panel of the court reversed. 813 F. 2d 243 (1987). The Ninth Circuit held that a summons issued pursuant to a request under the 1942 Convention, like one issued as part of a domestic tax investigation, will be enforced only if it was issued in good faith. The Court of Appeals further stated that the elements of good faith we described in *United States* v.*Powell,* 379 U.S., at 57-58, are not exhaustive; rather, in light of our subsequent decision in *United States* v. *LaSalle National Bank,* 437 U.S. 298 (1978) [Ct.D. 1994, 1978-2 C.B. 336], and Congress' enactment of what is now 26 U.S.C. §7602(c) good faith in domestic tax investigations also requires that the IRS not have referred the case to the Justice Department for possible criminal prosecution. Finally, and most significantly for purposes of this litigation, the Ninth Circuit ruled that the IRS acts in good faith in complying with a request for information under the 1942 Convention only when Canadian authorities act in good faith in seeking IRS assistance, and that the good faith of Canadian authorities should be judged by the same standard applicable to the IRS when it conducts a domestic investigation. Hence, the Court of Appeals concluded, before the IRS may honor a request for information it must determine that Revenue Canada's investigation has not reached a stage analogous to a Justice Department referral by the IRS. In addition, the Court of Appeals said, "in order to establish its prima facie case by affidavit, the IRS must make an affirmative statement" that Canadian authorities are acting in good faith and that their investigation has not yet reached that stage; the burden of proof on this point rests initially with the IRS rather than the taxpayer attempting to quash a summons, the court held, because the IRS "can consult with Canada's competent authority and can be expected to have greater familiarity with Canadian administrative procedures." 813 F. 2d, at 250. The Court of Appeals reversed the District Court's decisions because the affidavits submitted by the IRS failed to state that Revenue Canada's investigation of respondents had not yet reached a point analogous to an IRS referral to the Justice Department.

We granted certiorari, 485 U.S. ______ (1988), to resolve a conflict between the Ninth Circuit's decision in this case and the Second Circuit's holding in *United States* v. *Manufacturers & Traders Trust Co.*, 703 F. 2d 47 (1983). We now reverse.

II

A

In *United States* v. *Powell, supra,* we rejected the claim that the IRS must show probable cause to obtain enforcement of an administrative summons issued in connection with a domestic tax investigation. See 379 U.S., at 52-57. We held instead that the IRS need only demonstrate good faith in issuing the summons, which we defined as follows:

> "[The IRS Commissioner] must show that the investigation will be conducted pursuant to a legitimate purpose, that the inquiry may be relevant to the purpose, that the information sought is not already within the Commissioner's possession, and that the administrative steps required by the Code have been followed—in particular, that the 'Secretary of his delegate," after investigation, has determined the further examination to be necessary and has notified the taxpayer in writing to the effect." *Id.*, at 57-58.

Once the IRS has made such a showing, we stated, it is entitled to an enforcement order unless the taxpayer can show that the IRS is attempting to abuse the court's process. "Such an abuse would take place," we said, "if the summons had been issued for an improper purpose, such as to harass the taxpayer or to put pressure on him to settle a collateral dispute, or for any other purpose reflecting on the good faith of the particular investigation." *Id.*, at 58. See also *United States* v. *Bisceglia,* 420 U.S. 141, 146 (1975) [Ct.D. 1970, 1975-1 C.B. 379]. The taxpayer carries the burden of proving an abuse of the court's process. 379 U.S., at 58.

Leaving aside the question whether the 1942 Convention, in conjunction with 26 U.S.C. §7602(c), narrows the class of legitimate purposes for which the IRS may issue an administrative summons, the affidavits the IRS submitted in respondents' cases plainly satisfied the requirements of good faith we set forth in *Powell* and have repeatedly reaffirmed. See, *e.g., Tiffany Fine Arts, Inc.* v. *United States,* 469 U.S. 310, 321 (1985) [Ct.D. 2029, 1985-1 C.B. 386]; *United States* v. *Arthur Young & Co.*, 465 U.S. 805, 813, n. 10 (1984) [Ct.D. 2026, 1984-1 C.B. 270]. The IRS Director of Foreign Operations stated under oath that the information sought was not within the possession of American or Canadian tax authorities, that it might be relevant to the computation of respondents' Canadian tax liabilities, and that the same type of information could be obtained by Canadian authorities under Canadian law. App. 28. He further noted that the "[e]xchanged information may only be disclosed as required in the normal administrative or judicial process operative in the administration of the tax system of the requesting country," and that improper use of exchanged information would be protested. *Ibid.* In addition, the IRS issued its summonses in conformity with applicable statutes and duly informed respondents of their issuance. In their petitions to quash, respondents nowhere alleged that the IRS was trying to use the District Court's process for some improper purpose, such as harassment or the acquisition of bargaining power in connection with some collateral dispute. See *id.*, at 18-20. Nor does it appear that they later sought to prove abuse of process. Unless 26 U.S.C. §7602(c) or the 1942 Convention imposes more stringent requirements on the enforcement of the administrative summonses issued in this case, the IRS was entitled to enforcement orders under the rule laid down in *Powell.*

B

Section 7602(c) does impose an additional constraint on the issuance of summonses to further domestic tax investigations.[2] By its terms, however, it does not apply to the summonses challenged by respondents, for it speaks only to investigations into possible violations of

United States revenue laws. Section 7602(c) forbids the issuance of a summons "if a Justice Department referral is in effect" with respect to a person about whom information is sought by means of the summons. At the time of the District Court's decision, no Justice Department referral was in effect with regard to respondents; indeed, the IRS agent seeking the bank records to fulfill Revenue Canada's request said in her affidavit that no domestic tax investigation of any kind was pending. See App. 30. Section 7602(c) therefore does not itself appear to bar enforcement of the summonses at issue here.[3]

The legislative history of §7602(c) supports this conclusion. Prior to its enactment, we held in *United Stats* v. *LaSalle National Bank*, 437 U.S. 298 (1978), that the IRS may not issue a summons once it has recommended prosecution to the Justice Department, nor may it circumvent this requirement by delaying such a recommendation in order to gather additional information. We based our holding in large part on our finding that "[n]othing in §7602 or its legislative history suggests that Congress intended the summons authority to broaden the Justice Department's right of criminal litigation discovery or to infringe on the role of the grand jury as a principal tool of criminal accusation." *Id.*, at 312 (citations omitted). When Congress codified the essence of our holding in §7602(c), it apparently shared our concern about permitting the IRS to encroach upon the rights of potential criminal defendants. The Report of the Senate Finance Committee noted that "the provision is in no way intended to broaden the Justice Department's right of criminal discovery or to infringe on the role of the grand jury as a principal tool of criminal prosecution." S. Rep. No. 97-494, vol. 1, p. 286 (1982).

This explanation for the restriction embodied in §7602(c) suggests that Congress did not intend to make the enforcement of a treaty summons contingent upon the foreign tax investigation's not having reached a stage analogous to a Justice Department referral. None of the civil-law countries with whom the United States has tax treaties providing for exchanges of information employ grand juries, and Canada has ceased to use them.[4] Moreover, criminal discovery procedures differ considerably among countries with whom we have such treaties.[5] The concerns that prompted Congress to pass §7602(c) are therefore not present when the IRS issues summonses at the request of most foreign governments conducting investigations into possible violations of their own tax laws. If Congress had intended §7602(c) to impose a restriction on the issuance of summonses pursuant to treaty requests parallel to the restriction it expressly imposes on summonses issued by the IRS in connection with domestic tax investigations, it would presumably have offered some reason for extending the sweep of the section beyond its plain language. In addition, Congress would likely have discussed the appropriateness of extending the protections afforded by United States law to citizens of other countries who are not subject to criminal prosecution here, and would doubtless have considered the problems posed by the application of §7602(c) to requests by treaty partners, in particular the difficulty of determining when a foreign investigation has progressed to a point analogous to a Justice Department referral.[6] Respondents have not directed us, however, to anything in the legislative history of §7602(c) suggesting that Congress intended it to apply to summonses issued pursuant to treaty requests, or to any reference to the problems its application would have occasioned. We therefore see no reason to think that §7602(c) means more than it says.

C

The only conceivable foundation for the Ninth Circuit's rule that an IRS summons issued at the request of Canadian authorities may not be enforced unless the IRS provides assurance that the Canadian investigation has not proceeded to a stage analogous to a Justice Department referral is therefore the language of the 1942 Convention itself. Article XIX obliges the competent authority for the United States to furnish, upon request, relevant information that it is "in a position to obtain under its revenue laws." Article XXI repeats this clause almost verbatim, permitting the IRS Commissioner to supply Canadian authorities with relevant information he "is entitled to obtain under the revenue laws of the United States of America." Respondents contend that because the IRS would not be able, under American law, to issue an administrative summons to gather information for use by the Government once a Justice Department referral was in effect, the IRS is not in a position to obtain such information once Canadian authorities have reached a corresponding stage in their investigation.

(1)

We are not persuaded by this argument. "The clear import of treaty language controls unless 'application of the words of the treaty according to their obvious meaning effects a result inconsistent with the intent or expectations of its signatories.'" *Sumitomo Shoji America, Inc.* v. *Avagliano*, 457 U.S. 176, 180 (1982), quoting *Maximov* v. *United States*, 373 U.S. 49, 54 (1964) [Ct.D. 1880, 1963-2 C.B. 689]. Articles XIX and XXI both refer to information that the IRS may obtain under American law. American law, however, does not contain the restriction respondents claim to find there. Section 7602(c) only limits the issuance of summonses when a Justice Department referral is in effect; it says nothing about decisions by foreign tax officials to investigate possible violations of their countries' tax laws with a view to criminal prosecution outside the United States. The elements of good faith we outlined in *United States* v. *Powell*, 379 U.S. 48 (1964), do not contain such a restriction. Nor does our reasoning in *United States* v. *LaSalle National Bank*, 437 U.S. 298 (1978), favor the result respondents urge, because the provision of information to Canadian authorities could not curtail the rights of potential criminal defendants in this country by undermining American discovery rules or diminishing the role of the grand jury. And respondents have not suggested that some other segment of American law, such as the law of privilege, prevents the IRS from issuing an administrative summons pursuant to a treaty request once a treaty partner has embarked on a tax investigation leading to a foreign criminal prosecution. Articles XIX and XXI of the 1942 Convention on their face therefore lend no support to respondents' position.

(2)

Nontextual sources that often assist us in "giving effect to the intent of the Treaty parties," *Sumitomo, supra*, at 185, such as a treaty's ratification history and its subsequent operation, further fail to sustain respondents' claim. The Senate Committee on Foreign Relations did not hold hearings on the Convention prior to its ratification in 1942, and the Committee Report did not even mention the provisions for exchange of information. See S. Exec. Rep. No. 3, 77th Cong., 2d Sess. (1942), 1 Legislative History of United States Tax Conventions (Committee Print compiled by the

Staff of the Joint Committee on Internal Revenue Taxation) (Leg. Hist.), 455 (1962). The sole reference to these provisions during the brief floor debate in the Senate contained no hint that the 1942 Convention was intended to incorporate domestic restrictions on the issuance of summonses by the IRS in connection with American tax investigations, such as the limitation later codified in §7602(c).[7] The President's message accompanying transmittal of the proposed treaty to the Senate, see S. Exec. Doc. B, 77th Cong., 2d Sess. (1942), reprinted in Leg. Hist. 445, and the President's proclamation at the time the Convention was signed, see Leg. Hist. 475, similarly contain no language supporting respondents' argument. Indeed, given that a treaty should generally be "construe[d] ... liberally to give effect to the purpose which animates it" and that "[e]ven where a provision of a treaty fairly admits of two constructions, one restricting, the other enlarging, rights which may be claimed under it, the more liberal interpretation is to be preferred," *Bacardi Corp. of America* v. *Domenech*, 311 U.S. 150, 163 (1940) (citations omitted), the evident purpose behind Articles XIX and XXI—the reduction of tax evasion by allowing signatories to demand information from each other—counsels against interpreting those provisions to limit inquiry in the manner respondents desire. In any event, nothing in the history of the Convention's ratification buttresses respondents' claim.[8]

(3)

Nor do other aids to interpretation strengthen their case. The practice of treaty signatories counts as evidence of the treaty's proper interpretation, since their conduct generally evinces their understanding of the agreement they signed. See *Trans World Airlines, Inc.* v. *Franklin Mint Corp.*, 466 U.S. 243, 259 (1984); *Factor* v. *Laubenheimer*, 290 U.S. 276, 294-295 (1933). The Government's regular compliance with requests for information by Canadian authorities without inquiring whether they intend to use the information for criminal prosecution therefore weighs in favor of its reading of Articles XIX and XXI. Similarly, "[a]lthough not conclusive, the meaning attributed to treaty provisions by the Government agencies charged with their negotiation and enforcement is entitled to great weight." *Sumitomo*, 457 U.S., at 184-185. See also *Kolovrat* v. *Oregon*, 366 U.S. 187, 194 (1961). The IRS's construction of the 1942 Convention repudiates rather than confirms the interpretation respondents ask us to adopt. Finally, the result urged by respondents would contravene Congress' main reason for laying down an easily administrable test in §7602(c): "summons enforcement proceedings should be summary in nature and discovery should be limited." S. Rep. No. 97-494, vol. 1, p. 285 (1982). If respondents had their way, disputes would inevitably arise over whether a Canadian tax investigation had progressed to a point analogous to a Justice Department referral when Revenue Canada made its request for information, thereby "spawn[ing] protracted litigation without any meaningful results for the taxpayer." *Ibid.* It seems unlikely that Congress would have welcomed this result when it ratified the 1942 Convention, or that Congress intended it when it approved the bill containing what is presently §7602(c).

III

We conclude that the IRS need not attest that a Canadian tax investigation has not yet reached a stage analogous to a Justice Department referral by the IRS in order to obtain enforcement of a summons issued pursuant to a request by Canadian authorities under the 1942 Convention. So long as the IRS itself acts in good faith, as that term was explicated in *United States* v. *Powell*, 379 U.S., at 57-58, and complies with applicable statutes, it is entitled to enforcement of its summons. Accordingly, the judgment of the Court of Appeals is reversed, and the case is remanded for further proceedings consistent with this opinion.

It is so ordered.

Notes

[1]Articles XIX and XXI of the Convention Respecting Double Taxation, Mar. 4, 1942, United States-Canada, 56 Stat. 1405-1406, T.S. No. 983, provide in part:

"ARTICLE XIX

"With a view to the prevention of fiscal evasion, each of the contracting States undertakes to furnish to the other contracting State, as provided in the succeeding Articles of the Convention, the information which its competent authorities have at their disposal or are in a position to obtain under its revenue laws in so far as such information may be of use to the authorities of the other contracting State in the assessment of the taxes to which this Convention relates.

"The information to be furnished under the first paragraph of this Article, whether in the ordinary course or on request, may be exchanged directly between the competent authorities of the two contracting States."

"ARTICLE XXI

"1. If the Minister in the determination of the income tax liability of any person under any of the revenue laws of Canada deems it necessary to secure the cooperation of the Commissioner, the Commissioner may, upon request, furnish the Minister such information bearing upon the matter as the Commissioner is entitled to obtain under the revenue laws of the United States of America."

[2]Section 7602(c) of Title 26 reads:

"(c) No administrative summons when there is Justice Department referral

"(1) Limitation of authority

"No summons may be issued under this title, and the Secretary may not begin any action under section 7604 to enforce any summons, with respect to any person if a Justice Department referral is in effect with respect to such person.

"(2) Justice Department referral in effect

"For purposes of this subsection—

"(A) In general

"A Justice Department referral is in effect with respect to any person if—

"(i) the Secretary has recommended to the Attorney General a grand jury investigation of, or the criminal prosecution of, such person for any offense connected with the administration or enforcement of the internal revenue laws, or

"(ii) any request is made under section 6103(h)(3)(B) for the disclosure of any return or return information (within the meaning of section 6103(b)) relating to such person.

"(B) Termination

"A Justice Department referral shall cease to be in effect with respect to a person when—

"(i) the Attorney General notifies the Secretary, in writing, that—

"(i) the Attorney General notifies the Secretary, in writing, that—

"(I) he will not prosecute such person for any offense connected with the administration or enforcement of the internal revenue laws,

"(II) he will not authorize a grand jury investigation of such person with respect to such an offense, or

"(III) he will discontinue such a grand jury investigation.

"(ii) a final disposition has been made of any criminal proceeding pertaining to the enforcement of the internal revenue laws which was instituted by the Attorney General against such person, or

"(iii) the Attorney General notifies the Secretary, in writing, that he will not prosecute such person for any offense connected with the administration or enforcement of the internal revenue laws relating to the request described in subparagraph (A)(ii).

"(3) Taxable years, etc., treated separately

"For purposes of this subsection, each taxable period (or, if there is no taxable period, each taxable event) and each tax imposed by a separate chapter of this title should be treated separately."

[3]We need and do not decide whether the IRS could issue a summons to honor a treaty request if the individual under investigation by the requesting foreign government were also under investigation by American authorities and a Justice Department referral were in effect with respect to him. Nor do

we address the question whether the IRS could use in a criminal prosecution evidence it obtained from Canadian authorities pursuant to a treaty request made while a Justice Department referral was in effect.

[4]See the Criminal Law Amendment Act, 1985, ch. 19, §§113-115, reprinted in Revised Statutes of Canada, ch. 27, §§113-115 (Supp. I 1985). See also *Re McKibbon and the Queen,* 6 D.L.R. (4th) 1, 20-35 (1984) (recounting the history of grand juries in Canada). Other common-law countries have eliminated the grand jury as well. See, *e.g., Saywell* v. *Attorney-General,* [1982] 2 N.Z.L.R. 97, 100-105 (discussing consequences for presentation of indictment of abolition of grand juries in New Zealand, England, and Australia).

[5]As of September 30, 1988, the United States had in force income tax conventions containing exchange of information provisions with over 30 countries, ranging from France to Poland to Japan. Fogarasi, Gordon, Venuti, & Renfroe, Current Status of U.S. Tax Treaties, 17 Tax Mgmt. Int'l J. 507, 509 (1988). Not all of those countries distinguish between civil and criminal prosecutions for tax offenses as does the United States. In some Swiss Cantons, for example, tax fraud—the most severe offense—is prosecuted in the administrative rather than in the criminal courts, and a single administrative agency investigates and prosecutes all tax offenses. See Meier, Banking Secrecy in Swiss and International Taxation, 7 Int'l Law. 16, 26 (1973).

[6]The difficulty of finding the equivalent of a Justice Department referral is particularly acute in Canadian tax investigations. Although criminal prosecution is centered in Canadian attorneys-general, just as criminal prosecution in the United States falls within the province of the Justice Department, "[t]he similarity appears to stop there." Scheim & Cantillon, Stuart v. United States: Standards for Section 7602 Summons in Treaty Matters, 17 Tax Mgmt. Int'l J. 479, 482 (1988). Revenue Canada routinely gathers virtually all of the information necessary for criminal prosecution before turning a case over to the Canadian Justice Department, see *id.,* at 482-484, and available Canadian agency manuals suggest "that a case is referred to Justice only when it is already in a stage amenable to Court presentation, and that some degree of cooperation continues after that point." *Id.,* at 482. Scheim and Cantillon conclude: "It appears therefore that [Revenue Canada] adopts an institutional posture tilted towards prosecution well before referral." *Ibid.* If this conclusion is correct, then it might be difficult in at least some cases to determine whether a Canadian tax investigation has reached a point analogous to a Justice Department referral by the IRS.

[7]Contrary to JUSTICE SCALIA'S suggestion, see *post,* at 8, the Solicitor General relied on the preratification Senate debate in his brief, see Brief for United States 29, and n. 11, pointing out that the only reference to intergovernmental exchanges of information came in the following colloquy:

"Mr. Taft ...

"In other words, if an American citizen were using a Canadian bank deposit to evade income taxation, I think the convention would permit the United States Government to ask the Canadian Government to obtain information from its own bank and furnish it to this Government in connection with the enforcement of our internal-revenue laws.

"Mr. George. It does provide for exchange of information, as the Senator from Ohio points out." 88 Cong. Rec. 4714 (1942).

Nor is reliance on the Senate's preratification debates and reports improper. As JUSTICE SCALIA acknowledges, the American Law Institute's most recent Restatement counsels consideration of such materials. See Restatement (Third) of the Foreign Relations Law of the United States §314, Comment *d* (1987) ("indication that ... the Senate ascribed a particular meaning to the treaty is relevant"); *id.,* §325, Reporter's Note 5 ("A court ... is required to take into account ... (i) Committee reports, debates, and other indications of meaning that the legislative branch has attached to an agreement ..."). Consultation of these materials is eminently reasonable. *Pace* JUSTICE SCALIA, reviewing preratification Senate debates and reports is not akin to "determining the meaning of a bilateral contract between two corporations on the basis of what the Board of Directors of one of them thought it meant when authorizing the Chief Executive Officer to conclude it." *Post,* at 4. Senate debates do not occur behind closed doors, out of earshot of proposed treaty partners, nor are preratification Senate reports kept under seal. Both are public statements. They therefore bear no resemblance to the private deliberations of a Board of Directors prior to the Board's decision whether to authorize the Chief Executive Officer to sign an agreement. Insofar as the contract analogy is apt, the better comparison is to a meeting of the Board whose minutes and position papers the other corporation's Board and Chief Executive Officer are invited to peruse. It is hornbook contract law that the proper construction of an agreement is that given by one of the parties when "that party had no reason to know of any different meaning attached by the other, and the other had reason to know the meaning attached by the first party." Restatement (Second) of Contracts §201(2)(b) (1981). See also E. Farnsworth, Contracts 487-488 (1982). A treaty's negotiating history, which JUSTICE SCALIA suggests would be a better interpretive guide than preratification Senate materials, see *post,* at 4, would in fact be a worse indicator of a treaty's meaning, for that history is rarely a matter of public record available to the Senate when it decides to grant or withhold its consent.

[8]A new United States-Canada Income Tax Convention became effective August 16, 1984, after the summonses involved in this case were issued. 1986-2 Cum. Bull. 258. Article XXVII of the new Convention closely resembles Articles XIX and XXI of the 1942 Convention. Yet neither the new Convention nor its supplementary protocols suggest any limitation on United States compliance with a treat request dependent upon the status of a Canadian tax investigation. The hearing before the Senate Foreign Relations Committee, see Hearing on Tax Treaties before the Senate Committee on Foreign Relations, 97th Cong., 1st Sess., 1-115 (1981), the technical explanation of the new Convention, see 1986-2 Cum. Bull. 275, 294, and the perfunctory ratification debate in the Senate, see 130 Cong. Rec. S8563-S8567, S8571-S8573 (June 28, 1984), are similarly silent on this point. Thus, the Senate apparently did not believe that in ratifying the new Convention it was giving respondents' claim the force of law, just as it did not appear to think, from the legislative history it left behind, that section 7602(c) accomplished that end on its own.

Section 7701.—Definitions

(Also Section 593; 1.593-11.)

Domestic building and loan association; loan secured by cooperative housing corporation stock. A loan made for the purchase of stock in a cooperative housing corporation, and secured by such stock, qualifies as a loan described in section 7701(a)(19)(C)(v) of the Code if the house or apartment that the stock entitles the stockholder to occupy is to be used as a residence.

Rev. Rul. 89-59

ISSUES

(1) Does a loan that is made for the purchase of stock in a cooperative housing corporation described in section 216(b) of the Internal Revenue Code, and is secured by such stock, qualify as a loan described in section 7701(a)(19)(C)-(v) of the Code?

(2) Does such a loan constitute a qualifying real property loan within the meaning of section 593(d)(1) of the Code?

FACTS

S is a savings and loan association. Some of the loans made or acquired by *S* are loans made for the purchase of stock in a cooperative housing corporation described in section 216(b) of the Code. Each of these loans is secured by the stock purchased with the loan proceeds. The house or apartment that ownership of this stock entitles the stockholder to occupy is to be used as a residence.

LAW

Section 216(b)(1) of the Code defines a cooperative housing corporation, in part, as a corporation each of the stockholders of which is entitled, solely by reason of ownership of stock in the corporation, to occupy for dwelling purposes a house, or an apartment in a building, owned or leased by the corporation.

Section 1.216-1(d)(2) of the Income Tax Regulations describes this right of occupancy as follows:

> Each stockholder of the corporation ... must be entitled to occupy for dwelling purposes an apartment in a building or a unit in a housing development owned or leased by such corporation.... [The right to occupy the

premises] must be conferred on each stockholder solely by reason of his ownership of stock in the corporation, that is, the stock must entitle the owner thereof either to occupy the premises or to a lease of the premises.

Section 7701(a)(19) of the Code requires that, in order for an entity to qualify as a domestic building and loan association, at least 60 percent of the entity's total assets must consist of assets of a type listed in section 7701(a)(19)-(C). One such type of asset, described in section 7701(a)(19)(C)(v), is a loan secured by an interest in residential real property. Section 7701(a)(19)(C)(v) provides that, for this purpose, residential real property includes single or multifamily dwellings.

Section 301.7701-13A(d) of the Regulations on Procedure and Administration provides that, for purposes of the 60-percent asset test, it is immaterial whether the taxpayer originated the loans or purchased or otherwise acquired them from another.

Section 593(a)(2) of the Code provides that, in order to deduct an addition to a reserve for bad debts under section 593, an otherwise eligible entity must meet the requirements of section 7701(a)(19)(C).

Section 593(b)(1) of the Code provides that the reasonable addition to a reserve for bad debts is an amount equal to the sum of a reasonable addition to the reserve for losses on nonqualifying loans plus a reasonable addition to the reserve for losses on qualifying real property loans.

Section 593(d)(1) of the Code defines the term "qualifying real property loan," with certain exceptions, as a loan secured by an interest in improved real property.

Section 1.593-11(b)(3) of the Income Tax Regulations provides that, for purposes of section 593(d)(1) of the Code, the word "interest" means an interest in real property which, under the law of the jurisdiction in which the property is situated, constitutes any one of several types of interest. For example, the interest may be an interest in fee in the property; or, in the case of a mobile unit, an ownership interest; or a long-term leasehold interest in the property, as described in the regulations.

Section 1.593-11(b)(4) of the regulations provides that, for purposes of section 593(d)(1) of the Code, the term "improved real property" includes land on which any building of a permanent nature is located, provided that the value of the building is substantial in relation to the value of the land.

ANALYSIS

In the present case, the loans held by *S* are loans made for the purchase of stock in a cooperative housing corporation described in section 216(b) of the Code. Each loan is secured by the stock purchased with the loan proceeds, and the house or apartment that this stock entitles the stockholder to occupy is to be used as a residence.

Each stockholder of a cooperative housing corporation described in section 216(b) is entitled, solely by reason of ownership of stock in the corporation, to occupy for dwelling purposes a house, or an apartment in a building, owned or leased by the corporation. That is, ownership of stock in the corporation entitles the stockholder either to occupy the house or apartment or to a lease of the house or apartment. In other words, the stockholder is entitled to dwell in the house or apartment as long as the stockholder owns the stock.

Assets described in section 7701(a)-(19)(C)(v) of the Code include loans secured by an interest in residential real property, and section 7701(a)(19)(C)(v) specifically provides that, for this purpose, residential real property includes single or multifamily dwellings. Since ownership of stock in a cooperative housing corporation described in section 216(b) entitles the stockholder to dwell in a house or apartment, and since the house or apartment underlying each loan in the present case is to be used as a residence, the loans in this case are loans described in section 7701(a)(19)(C)(v).

A qualifying real property loan, as defined in section 593(d)(1) of the Code, is a loan secured by an interest in improved real property. Section 1.593-11(b)(3) of the regulations provides that the word "interest" for this purpose includes an interest in fee, an ownership interest, or a long-term leasehold interest. Section 1.593-11(b)(4) provides that the term "improved real property" includes land which is the site of any building of a permanent nature, if the value of the building is substantial in relation to the value of the land. Since ownership of stock in the cooperative housing corporation entitles the stockholder to dwell in a house or apartment, such stock constitutes an interest in improved real property within the meaning of section 593(d)(1). Accordingly, loans made for the purchase of, and secured by, such stock are qualifying real property loans for purposes of section 593.

The treatment of loans secured by cooperative housing corporation stock under other sections of the Code supports these conclusions. For example, a loan secured by stock in a cooperative housing corporation described in section 216(b) is treated as a loan secured by an interest in real property for purposes of section 856(c). In Rev. Rul. 76-101, 1976-1 C.B. 186, an unincorporated trust, otherwise qualifying as a real estate investment trust under section 856, invested in notes that were secured by stock in a cooperative housing corporation. In order to qualify as a real estate investment trust, the trust was required by section 856(c) to derive at least 75 percent of its gross income from, among other items, interest on obligations secured by mortgages on interests in real property. The ruling concludes that since the owner of the stock in the cooperative housing corporation was entitled, solely by reason of the stock ownership, to occupy a specified unit for dwelling purposes pursuant to a proprietary lease, the stock qualified as an interest in real property within the meaning of section 856(c)(6)(C). Accordingly, the ruling holds that interest on the notes secured by the stock qualified as interest on obligations secured by mortgages on interests in real property for purposes of section 856(c)(3).

HOLDINGS

(1) A loan that is made for the purchase of stock in a cooperative housing corporation described in section 216(b) of the Code, and is secured by such stock, qualifies as a loan described in section 7701(a)(19)(C)(v) if the house or apartment that the stock entitles the stockholder to occupy is to be used as a residence.

(2) A loan that is made for the purchase of stock in a cooperative housing corporation described in section 216(b) of the Code, and is secured by such stock, is a qualifying real property loan within the meaning of section 593(d)(1).

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26 CFR 301.7701-2: Associations.

Limited partnerships. The state of Virginia is added to the list of states that have enacted legislation that corresponds to the Uniform Limited Partnership Act for purposes of section 301.7701-2 of the regulations. Rev. Rul. 84-80 amplified.

Rev. Rul. 89-38

In Rev. Rul. 84-80, 1984-1 C.B. 275, as amplified by Rev. Rul. 84-180, 1984-2 C.B. 314, Rev. Rul. 85-178, 1985-2 C.B. 338, Rev. Rul. 86-30, 1986-1 C.B. 370, Rev. Rul. 86-112, 1986-2 C.B. 214, Rev. Rul. 88-23, 1988-1 C.B. 404, and Rev. Rul. 88-43, 1988-1 C.B. 404, the Internal Revenue Service listed several states that revised their limited partnership statutes following the promulgation of the Revised Uniform Limited Partnership Act. The Service determined that the legislation enacted by those states corresponds to the Uniform Limited Partnership Act (ULPA) for purposes of section 301.7701-2 of the Procedure and Administration Regulations.

The Service has determined that Virginia has enacted legislation that, as of its effective date, corresponds to the ULPA for purposes of section 301.7701-2 of the regulations:

Virginia:

VA. Code Ann.

Sections 50-73.1 through 50-73.77. (Supp.1987) effective January 1, 1987.

EFFECT ON OTHER RULINGS

Rev. Rul. 84-80 is amplified.

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26 CFR 301.7701-2: Associations.

An organization seeking a ruling that it is properly classified as a partnership must satisfy specified information requirements and applicable conditions. See Rev. Proc. 89-12, page 798.

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26 CFR 301.7701-3: Partnerships.

An organization seeking a ruling that it is properly classified as a partnership must satisfy specified information requirements and applicable conditions. See Rev. Proc. 89-12, page 798.

Section 7702.—Life Insurance Contract Defined

Whether the Service will rule as to whether proceeds of 'self-insured'' life and survivor benefit plans established through a trust qualified under section 501(c)(9) of the Code are excludable from the beneficiary's gross income as amounts received under a life insurance contract that are paid by reason of the death of the insured under section 101(a). See Rev. Proc. 89-36, page 919.

Subchapter 80.—General Rules
Subchapter A.—Applications of Internal Revenue Laws

Section 7805.—Rules and Regulations

26 CFR 301.7805-1: Rules and regulations.

Shareholder's pro rata share of a controlled foreign corporation's increase in earnings invested in U.S. property. Rev. Rul. 71-373 that provides that a debt incurred by a wholly owned foreign corporation to a foreign bank reduces the amount of investment in U.S. property where the domestic parent issues a promissory note to guarantee the debt, is obsolete for investments in U.S. property made on or after June 14, 1988.

Rev. Rul. 89-12

T.D. 8209, 1988-2 C.B. 174, published in the Federal Register on June 14, 1988, provides temporary and proposed regulations that amend the specific charge rule under section 1.956-1(e) of the Income Tax Regulations with respect to investments in U.S. property made on or after June 14, 1988. Section 1.956-1T(e)(5) of the regulations, provides that, in the case of an investment in U.S. property that is an obligation of a related person, a liability will not be recognized as a specific charge reducing the investment in U.S. property if the liability representing the charge is with recourse with respect to the general credit or other assets of the investing controlled foreign corporation.

In Rev. Rul. 71-373, 1971-2 C.B. 275, a domestic corporation desired to obtain funds from a bank in country *W*. Such funds were available to the domestic corporation's country *W* subsidiary at an interest rate below that prevailing in the United States, a rate not available to the domestic parent. Consequently, the parent delivered its own promissory note to its country *W* subsidiary in the desired amount. Under the banking practices in country *W*, the bank required parent's note as collateral for the loan to the subsidiary. Upon delivery of the parent's note to the country *W* bank, the funds were delivered to the subsidiary, which in turn forwarded them to its parent.

The United States property involved in Rev. Rul. 71-373 is the promissory note given by the domestic parent to provide collateral for the subsidiary's loan from the country *W* bank. The revenue ruling held that, because the subsidiary had a liability to the country *W* bank identical to its United States property (the parent's note) that was contemporaneously incurred with the acquisition of such property, and because the subsidiary was required to discharge the obligation to the bank at the same time as the parent paid its note to the subsidiary, there was a specific charge against the property that was a liability within the meaning of section 1.956-1(e)(1) of the regulations. Therefore, in determining the amount of the subsidiary's investment in United States property for purposes of sections 951(a)(1)(B) and 956 of the Internal Revenue Code, the revenue ruling held that the debt incurred by the subsidiary to the country *W* bank reduced the amount of the subsidiary's investment in United States property in accordance with section 1.956-1(e)(1).

Rev. Rul. 71-373 is silent about whether the subsidiary's debt to the country *W* bank was with or without recourse. Accordingly, pursuant to the authority contained in section 7805 of the Internal Revenue Code of 1986, Rev. Rul. 71-373 is declared obsolete for investments made on or after June 14, 1988.

EFFECT ON OTHER DOCUMENTS

Rev. Rul. 71-373 is obsolete for investments in United States property made on or after June 14, 1988.

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26 CFR 301.7805-1: Rules and regulations.

Rulings; obsolete. For taxable years ending after October 4, 1976, expenses incurred in the sale of property by an estate, not as a dealer, may not be used to offset the amount of the sales price of the property in determining gain or loss for federal income tax purposes if the expenses are allowed as a deduction for federal estate tax purposes. Rev. Rul. 71-173 obsoleted.

Rev. Rul. 89-75

ISSUE

Periodically, the Internal Revenue Service has obsoleted revenue rulings which, although not specifically revoked or superseded, are not considered determinative with respect to future transactions because (1) the applicable statutory provisions have been changed or repealed; (2) the ruling position is specifically covered by statute, regulations, or a subsequent published position; or (3) the facts set forth no longer exist or are not sufficient to permit application of the current statute.

The revenue ruling listed below is hereby declared to be obsolete:

Rev. Rul.	*No.*
71-173	1971-1 C.B. 204

The purpose of this declaration of obsoleteness is to make clear to all concerned that the above listed revenue ruling is not determinative with respect to taxable years ending after October 4, 1976.

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26 CFR 301.7805-1: Rules and regulations.

Should the modification of Rev. Rul. 74-598, 1974-2 C.B. 287, *amplified by* Rev. Rul. 75-383, 1975-2 C.B. 127, be applied retroactively. See Rev. Rul. 89-46, page 272.

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26 CFR 301.7805-1: Rules and regulations.

Will the Service follow the court decision in *Storm Plastics, Inc.* v. *United States*, 770 F.2d 148 (10th Cir. 1985), and allow a manufacturer to rebut the constructive sale price of section 4216(b)(1) of the Code even if there are no sales by the manufacturer to unrelated wholesale distributors. See Rev. Rul. 89-47, page 295.

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26 CFR 301.7805-1: Rules and regulations

Lines of business are set out for purposes of applying section 1.469-4T of the Temporary Income Tax Regulations. See Rev. Proc. 89-38, page 920.

Section 7811.—Taxpayer Assistance Orders

26 CFR 301.7811-1T: Authority to issue taxpayer assistance orders (temporary).

T.D. 8246

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 301

Taxpayer Assistance Orders

AGENCY: Internal Revenue Service, Treasury

ACTION: Temporary regulations

SUMMARY: This document contains temporary regulations relating to the issuance of taxpayer assistance orders. The Technical and Miscellaneous Revenue Act of 1988 added new section 7811 to the Internal Revenue Code of 1986. The regulations provide the public with guidance concerning the procedures for filing an application for a taxpayer assistance order, the terms of such order, and the effect of such an order on applicable statutes of limitations. The text of the temporary regulations set forth in this document also serves as the text of the proposed regulations cross-referenced in the notice of proposed rulemaking in * * * [GL-75-89, page 1012, this Bulletin].

EFFECTIVE DATE: The regulations take effect as of February 8, 1989.

SUPPLEMENTARY INFORMATION: This document contains temporary regulations for the Procedure and Administration Regulations (26 CFR Part 301) under section 7811 of the Internal Revenue Code. The regulations reflect the addition of section 7811 by section 6230 of the Technical and Miscellaneous Revenue Act of 1988 (Pub. L. 100-647).

Explanation of Provisions

As added by section 6230 of the Technical and Miscellaneous Revenue Act of 1988, section 7811 provides that upon application filed by a taxpayer or the taxpayer's duly authorized representative, the Ombudsman's office may issue a taxpayer assistance order if it determines that the taxpayer is suffering or is about to suffer a "significant hardship" as a result of the manner in which the Service is administering the internal revenue laws. To the extent authorized by Internal Revenue Service delegation orders, the authority exercisable by the Ombudsman under section 7811 may be exercised by Problem Resolution Officers in regional and district offices and at service and compliance centers. The terms of the taxpayer assistance order may require the Service to release levied property, or to stop any action or refrain from taking any action with respect to the taxpayer regarding collection, the immediate assessment of deficiencies in bankruptcies and receiverships, the issuance of administrative summonses and the discovery of liability, or any other similar provision in the Internal Revenue Code that is specifically described by the Ombudsman in the order. The taxpayer assistance order may be modified or rescinded only by the Ombudsman, a district director, a service center director, a compliance center director, a regional director of appeals, or the superior of those officials. All applicable statutes of limitations with respect to an action that is subject to a taxpayer assistance order are suspended from the date the taxpayer's written application is received by the Ombudsman until the later of the date of the Ombudsman's decision regarding the application or the date on which review of the Ombudsman's decision to issue a taxpayer assistance order is completed by an official authorized by section 7811(c) to modify or rescind the order. The statute of limitations will also be suspended for any additional period specified by the Ombudsman in the taxpayer assistance order. The Ombudsman may issue a taxpayer assistance order without an application by the taxpayer. However, the statute of limitations is not suspended if the Ombudsman issues a taxpayer assistance order in the absence of a written application by the taxpayer.

The regulations specify the time, form and manner of an application seeking a taxpayer assistance order. The application must be made on a signed Internal Revenue Service Form 911 or in a signed written statement which identifies the taxpayer and, where possible, the Service personnel and office involved, and which describes the Service's action and the significant hardship which has occurred or will occur as a result of the manner in which the internal revenue laws are being administered.

The regulations define "significant hardship" by reference to the effect that the manner in which the internal revenue laws are being administered has or will have on the taxpayer as well as the resultant perception of the Service's action or proposed action by taxpayers in general. The term is defined as more than an inconvenience to the taxpayer or a financial hardship, as such, but rather as a hardship from which the resultant disruption caused or to be caused to the taxpayer by the Internal Revenue Service's action or proposed action is such that it would offend the sense of fairness of taxpayers in general were they aware of all of the surrounding facts and circumstances.

The regulations specify that upon a determination of significant hardship, the Ombudsman may issue a taxpayer assistance order which requires the Service to release levied property to the extent that the Internal Revenue Service may release such property. In the absence of an overpayment there is, for example, no authority under which the Internal Revenue Service may release sums which have been credited against the taxpayer's liability and deposited into the Treasury of the United States. On the other hand, since bank levies issued after July 1, 1989 are subject to a 21-day freeze before they are honored under section 6332(c), and in most cases more than 21 days will expire before seized tangible property is sold, the taxpayer should have sufficient time after notice of the levy and before funds are credited against an account to apply for a taxpayer assistance order where a significant hardship arises as a result of such levy. The Service solicits comments as to whether there are instances where the inability to release funds that are not an overpayment will create significant hardship, and if so, whether the statute or regulations require amendment.

The regulations also specify that upon a determination of significant hardship, the Ombudsman may issue a taxpayer assistance order which requires the Service to stop or refrain from taking further action against a taxpayer under specific chapters of the Internal Revenue Code, or under other sections of the Internal Revenue Code under which the Service is taking or is about to take administrative action against the taxpayer that causes or would cause a significant hardship.

Under the regulations, a taxpayer assistance order may not require an affirmative action on the part of the Service with the exception of a release of levy. A taxpayer assistance order generally may not be issued to enjoin a criminal tax investigation because it is not the type of Service activity described in section 7811 nor one to which that section was meant to apply. Further, the regulations provide that the activities of the Office of Chief Counsel (with the exception of Appeals) generally may not be the subject of a taxpayer assistance order since neither the statute nor the legislative history appear to cover cases referred to Counsel (for example, no official of the Office of Chief Counsel, other than a regional director of appeals, is listed as one who may modify or rescind a Taxpayer Assistance Order), and taxpayers are otherwise protected by judicial remedies, including the possible award of attorney's fees. On the other hand, because the legislative history of section 7811 does not indicate that application of the section to Chief Counsel activities was specifically addressed by Congress, the Service welcomes comments on whether and to what extent acts of the Office of Chief Counsel should be subject to a taxpayer assistance order. The regulations further provide that a taxpayer assistance order may not be issued to contest the merits of any tax liability, and is not to be used as a substitute for or in addition to established administrative or judicial review procedures.

Finally, the regulations specify that all applicable statutes of limitations which are affected by any action which is the subject of a taxpayer assistance order are suspended from the date the Ombudsman receives the application until the later of the date on which the Ombudsman makes a determination with respect to the application or the date on which review of the Ombudsman's decision to issue a taxpayer assistance order is completed by an official authorized by section 7811(c) to modify or rescind the order. The statute of limitations will also be suspended for any additional period specified by the Ombudsman in the taxpayer assistance order. However, if the Ombudsman issues a taxpayer assistance order in the absence of a written application by the taxpayer, the statute of limitations is not suspended. Unless modified or rescinded, the taxpayer assistance order is binding on the Service.

Nothing in section 7811 or these regulations is to be construed as restricting or otherwise limiting taxpayer assistance practices of Problem Resolution Offices pursuant to existing delegation orders and Internal Revenue Manual provisions.

Special Analyses

These rules are not major rules as defined in Executive Order 12291. Therefore, a Regulatory Impact Analysis is not required. It is hereby certified that these regulations will not have a significant economic impact on a substantial number of small entities. Therefore, a Regulatory Flexibility Analysis is not required.

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Adoption of Addition to the Regulations

Accordingly, Title 26, Part 301 of the Code of Federal Regulations is amended as follows:

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

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

Par. 2. Section 301.7811-1T is added to read as follows:

§301.7811-1T. Authority to issue taxpayer assistance orders (temporary).

(a) *Authority to issue*—(1) *In general.* When an application is filed by the taxpayer or the taxpayer's duly authorized representative, in the form, manner and time specified in paragraph (b) of this section, the Ombudsman may issue a taxpayer assistance order if, in the determination of the Ombudsman, the taxpayer is suffering or is about to suffer a significant hardship as a result of the manner in which the internal revenue laws are being administered by the Internal Revenue Service.

(2) *Issuance without an application.* The Ombudsman may issue a taxpayer assistance order in the absence of an application under section 7811(a).

(3) *Duly authorized taxpayer's representative.* A "duly authorized taxpayer's representative" is any attorney, certified public accountant, enrolled actuary, or any other person permitted to represent the taxpayer before the Internal Revenue Service who is not disbarred or suspended from practice before the Internal Revenue Service and who has a written power of attorney executed by the taxpayer.

(4) *Significant hardship*—(i) *Determination required.* A determination of significant hardship is required to be made by the Ombudsman prior to the issuance of a taxpayer assistance order.

(ii) *Term defined.* The term "significant hardship" means a serious privation caused or about to be caused to the taxpayer as the result of the particular manner in which the internal revenue laws are being administered by the Internal Revenue Service. The term means more than an inconvenience to the taxpayer. Further, the term means more than financial hardship alone. Instead, even where financial hardship is involved, a finding of "significant hardship" will depend on an examination of the action taken, or to be taken, by the Internal Revenue Service which produces or would produce the financial hardship. The action or proposed action must be such that it would offend the sense of fairness of taxpayers in general were they aware of all the surrounding facts and circumstances.

(b) *Application for taxpayer assistance order.*—(1) *Form.* The application for a taxpayer assistance order shall be made on a Form 911 (Application for Taxpayer Assistance Order to Relieve Hardship) available from any local office of the Internal Revenue Service or in a written statement which shall contain the following information:

(i) Name, social security number (or the employer identification number), and current mailing address of the taxpayer submitting the application.

(ii) Kind of tax (individual, corporate, etc.) and tax period or periods involved.

(iii) Description of the Internal Revenue Service action or proposed action which is causing or is about to cause a significant hardship to the taxpayer and, if known, the Internal Revenue Service office and personnel involved.

(iv) Description of the specific hardship caused or about to be caused and the kind of relief requested.

(v) Signature of the taxpayer/applicant or duly authorized representative.

(2) *Manner*. An application for a taxpayer assistance order shall be filed with the Internal Revenue Service Problem Resolution Office in the district where the taxpayer resides. Overseas applicants having an A.P.O. or F.P.O. address shall file applications with the Internal Revenue Service, Problem Resolution Office where the return was filed. All other overseas applicants shall file applications with the Internal Revenue Service, Problem Resolution Office, Assistant Commissioner (International), Washington, D.C. Where appropriate, these Problem Resolution offices may refer an application for a taxpayer assistance order to another office of the Internal Revenue Service.

(3) *Time*. An application for a taxpayer assistance order shall be submitted within a reasonable time after the taxpayer becomes aware of the significant hardship or the potential significant hardship.

(c) *Contents of Taxpayer Assistance Orders*—(1) *Terms of order*. Upon determination that a taxpayer is suffering or about to suffer a significant hardship as a result of the manner in which the internal revenue laws are being administered, the Ombudsman may issue a taxpayer assistance order requiring the Internal Revenue Service to—

(i) Release levied property (to the extent that the Internal Revenue Service may by law release such property), or

(ii) Stop any action or refrain from taking further action against a taxpayer pursuant to:

(A) Chapter 64 (relating to collection),

(B) Chapter 70, subchapter B (relating to bankruptcy and receiverships),

(C) Chapter 78 (relating to discovery of liability and enforcement of title), or

(D) Any other section of the Internal Revenue Code under which the Internal Revenue Service is taking or is about to take administrative action against the taxpayer that causes or will cause a significant hardship.

(2) *Binding effect*. A taxpayer assistance order is binding on the Internal Revenue Service unless reversed by an official authorized to modify or rescind such an order as provided in paragraph (d) of this section.

(3) *Scope*. The terms of a taxpayer assistance order may require the release from levy of property of the taxpayer to the extent that the Internal Revenue Service may by law release such property. In the absence of an overpayment there is, for example, no authority under which the Internal Revenue Service may release sums which have been credited against the taxpayer's liability and deposited into the Treasury of the United States. A taxpayer assistance order may generally not be issued with respect to the investigation of any criminal tax violation and generally may not be issued to enjoin an act of the Office of Chief Counsel (with the exception of Appeals). A taxpayer assistance order may not be issued to contest the merits of any tax liability nor is a taxpayer assistance order intended to be a substitute for or an addition to any established administrative or judicial review procedure.

(d) *Authority to modify or rescind*. A taxpayer assistance order may be modified or rescinded only by the Ombudsman, a district director, a service center director, a compliance center director, a regional director of appeals, or the superiors of such officials. A modification or rescission by one of these designated officials may be elevated by the Ombudsman to the superior of such official.

(e) *Suspension of statutes of limitations*. (1) *In general*. The running of the applicable period of limitations for any action which is the subject of a taxpayer assistance order shall be suspended for the period beginning on the date the Ombudsman receives an application for a taxpayer assistance order in the form, manner, and time specified in paragraph (b) of this section and ending on the date on which the Ombudsman makes a determination with respect to the application, and for any additional period specified by the Ombudsman in an order issued pursuant to a taxpayer's application. For the purpose of computing the period suspended, all calendar days except the date of receipt of the application shall be included.

(2) *Date of determination*. The "date on which the Ombudsman makes a determination with respect to the application" is the date on which the taxpayer's request for a taxpayer assistance order is denied, or agreement is reached with the involved function of the Service, or a taxpayer assistance order is issued (except that when the taxpayer assistance order is reviewed by an official who may modify or rescind the taxpayer assistance order as provided in paragraph (d) of this section, the determination date is the date on which such review is completed).

(3) *Periods suspended*. The periods of limitations which are suspended under section 7811(d) are those which apply to the taxable periods to which the application for a taxpayer assistance order relate or the taxable periods specifically indicated in the terms of a taxpayer assistance order.

Example (1). On August 31, 1989, the Internal Revenue Service levies on funds in the taxpayer's checking account. On September 1, 1989, (at which time 7 months remain before the period of limitations on collection after assessment will expire on April 1, 1990) the Ombudsman receives the taxpayer's written application for a taxpayer assistance order. Subsequently, on September 6, 1989, the Ombudsman determines that the levy has caused a significant hardship and the Internal Revenue Service function which served the levy agrees to release the levy. The levy is released. As a result of the application and the decision by the Ombudsman and the involved function of the Service resolving the hardship, the statute of limitations on collection after assessment is suspended from the date the Ombudsman received the application, September 1, 1989, until the date on which the decision was made to release the levy, September 6, 1989. Therefore, the statute on limitations on collection after assessment will not expire until after April 6, 1990, which is 7 months plus 5 days after the date on which the application for a taxpayer assistance order was received by the Ombudsman.

Example (2). The facts are the same as in example (1) except that the Internal Revenue Service function which served the levy does not agree to release the levy, and the Ombudsman, having made a determination that the levy is causing a significant hardship, issues a taxpayer assistance order on September 6, 1989, in which the levy is ordered to be released and specifies that the statute of limitations on collection after assessment is suspended for an additional 15 days. The period of limitations on collection after assessment will therefore not expire until after April 21, 1990, which is 7 months and 20 days (5 days plus 15 days) after the application for the taxpayer assistance order was received by the Ombudsman.

Example (3). The facts are the same as in example (2) except that the Ombudsman does not specifically suspend the statute of limitations on collection after assessment for an additional number of days in the taxpayer assistance order, but rather the function seeks modification or rescission of the taxpayer assistance order and the appropriate official charged with that responsibility completes his consideration of the assistance order on September 8, 1989. The period of limitations on collection after assessment will therefore not expire until after April 8, 1990, which is 7 months and 7 days after the application for the taxpayer assistance order was received by the Ombudsman.

(4) *Absence of a written application*. The statute of limitations is not suspended in cases where the Ombudsman issues an order in the absence of a written application for relief by the taxpayer or the taxpayer's duly authorized representative.

(f) *Independent action of Ombudsman*. The Ombudsman may take any of the actions described in section 7811(b) in the absence of an application by the taxpayer.

(g) *Ombudsman*. The term "Ombudsman" includes any designee of the Ombudsman, such as Problem Resolution Officers in Internal Revenue Service regional and district offices and at Internal Revenue Service compliance and service centers.

(h) *Effective date*. These regulations are effective as of February 8, 1989.

Lawrence B. Gibbs,
Commissioner of Internal Revenue.

Approved February 24, 1989.

Dennis E. Ross,
Acting Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on March 21, 1989, 8:45 a.m., and published in the issue of the Federal Register for March 22, 1989, 54 F.R. 11699)

Subchapter C.—Provisions Affecting More Than One Subtitle

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

Loans; loan limit adjusted for inflation. The loan limit specified by section 7872(g)(2) of the Code is adjusted for inflation for the years 1987, 1988, and 1989.

Rev. Rul. 89-48

This revenue ruling contains the amount, increased by the inflation adjustments for 1987, 1988, and 1989, that section 7872(g) of the Internal Revenue Code permits a taxpayer to lend to a qualifying continuing care facility without incurring imputed interest.

Section 7872 of the Code generally treats loans bearing a below-market interest rate as if they bear interest at the market rate.

Section 7872(g)(1) of the Code provides that section 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 section 7872(g)(1) shall apply only to the extent that the aggregate outstanding amount of any loan to which section 7872(g) applies (determined without regard to section 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 section 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 section 7872(g)(1) applies, the $90,000 limit specified in section 7872(g)(2) shall be 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 such calendar year.

Table 1 sets forth the amount specified in section 7872(g)(2) of the Code, increased by the inflation adjustment for the years 1987, 1988, and 1989.

Table 1
Limit under 7872(g)(2)
Adjusted for inflation

Year	*Adjusted Amount*
1987	$92,200
1988	$94,800
1989	$98,800

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of January 1989. See Rev. Rul. 89-1, page 260.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of February 1989. See Rev. Rul. 89-15, page 262.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of March 1989. See Rev. Rul. 89-34, page 263.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of April 1989. See Rev. Rul. 89-39, page 264.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of May 1989. See Rev. Rul. 89-65, page 265.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of June 1989. See Rev. Rul. 89-77, page 266.

Part II. Treaties and Tax Legislation

CONTENTS

Subpart A.—Tax Conventions

Subpart B.—Legislation and Related Committee Reports

Subpart A.—Tax Conventions

UNITED STATES-BERMUDA CONVENTION RELATING TO INSURANCE ENTERPRISES AND MUTUAL ASSISTANCE[1]

Convention signed at Washington, D.C., July 11, 1986;

Diplomatic Notes to the Convention;

Ratified by the Senate of the United States of America October 1988;

Proclaimed by the President of the United States of America November 28, 1988;

Protocol of Exchange of Instruments of Ratification December 2, 1988;

CONVENTION BETWEEN THE GOVERNMENT OF THE UNITED STATES OF AMERICA AND THE GOVERNMENT OF THE UNITED KINGDOM OF GREAT BRITAIN AND NORTHERN IRELAND (ON BEHALF OF THE GOVERNMENT OF BERMUDA) RELATING TO THE TAXATION OF INSURANCE ENTERPRISES AND MUTUAL ASSISTANCE IN TAX MATTERS

The Government of the United States of America and the Government of the United Kingdom of Great Britain and Northern Ireland (on behalf of the Government of Bermuda), desiring to conclude a convention with respect to the taxation of insurance enterprises and mutual assistance in tax matters, have agreed as follows:

Article 1
General Definitions

1. In this Convention, unless the context otherwise requires:

(a) (i) the term "United States" means the United States of America, but does not include Puerto Rico, the Virgin Islands, Guam, or any other United States possession or territory; and

(ii) the term "Bermuda" means the islands in the Atlantic Ocean known as Bermuda;

(b) the term "person" includes an individual, an estate, a trust, a company, a partnership, and any other body of persons;

(c) the term "company" means any body corporate or any entity which is treated as a body corporate for tax purposes;

(d) the term "enterprise of insurance" means an enterprise of which the predominant business activity during the taxable year is the issuing of insurance or annuity contracts or acting as the reinsurer of risks underwritten by insurance companies, together with the investing or reinvesting of assets held in respect of insurance reserves, capital, and surplus incident to the carrying on of the insurance business;

(e) the terms "enterprise of a Covered Jurisdiction" and "enterprise of the other Covered Jurisdiction" mean respectively an enterprise carried on by a resident of a Covered Jurisdiction and an enterprise carried on by a resident of the other Covered Jurisdiction;

(f) the term "competent authority" means:

(i) in the case of the United States, the Secretary of the Treasury or his delegate; and

(ii) in the case of Bermuda, the Minister of Finance or his delegate;

(g) the term "insurance obligation" means any obligation which, in accordance with normal industry practice, an insurer undertakes under the terms of a contract of insurance, to make payments or incur expenses in connection with the insurance protection offered under the contract, including any such obligation to pay claims to or for the benefit of the insured resulting from damages connected with the covered risk, to pay interest on such claims, and to pay the costs of defending an insured against such damages, but in no event including any obligation to pay premiums or other costs of reinsuring the covered risk; and

(h) the term "Covered Jurisdiction" means the United States or Bermuda, as the context requires.

2. As regards the application of the Convention by a Covered Jurisdiction, any term not defined therein shall, unless the context otherwise requires or the competent authorities agree to a common meaning, have the meaning which it has under the laws of that Jurisdiction. For purposes of the United States, the preceding sentence shall refer to laws concerning taxes. The competent authorities may agree to a common meaning of a term for purposes of this Convention.

Article 2
Residence

For purposes of this Convention, the term "resident" of a Covered Jurisdiction means:

(a) in the case of the United States:

(i) any person, other than a company, resident in the United States for the purpose of United States tax; but in the case of a partnership, estate or trust, only to the extent that the income derived by such partnership, estate or trust is subject to United States tax as the income of a resident, either in its hands or in the hands of its partners or beneficiaries; and

(ii) a company created under the laws of the United States or a political subdivision thereof; and

(b) in the case of Bermuda:

(i) an individual who has the status of a legal resident of Bermuda; and

(ii) a company, partnership, trust, or association created under the laws of Bermuda.

Article 3
Permanent Establishment

1. For the purposes of Article 4, except as otherwise specified in this Article, the term "permanent establishment" means a regular place of business through which the business of an enterprise of insurance is wholly or partly carried on.

2. The term "permanent establishment" shall include especially a place of management, a branch, an office, and premises used as a sales outlet.

3. The term "permanent establishment" shall also include the furnishing of services, including consultancy, management, technical and supervisory services, within a Covered Jurisdiction by an enterprise of insurance through employees or other persons but only if:

(a) activities of that nature continue within the Jurisdiction for a period or periods aggregating more than 90 days in a twelve-month period, provided that a permanent establishment shall not exist in any taxable year in which such services are rendered in that Jurisdiction for a period or periods aggregating less than 30 days in the taxable year; or

[1] Treasury Department Technical Explanation, page 334.

(b) the services are performed within the Jurisdiction for an associated enterprise.

For purposes of this paragraph, two enterprises shall be "associated" if either participates directly or indirectly in the management, control, or capital of the other, or if the same persons participate directly or indirectly in the management, control, or capital of both.

4. Notwithstanding the preceding provisions of this Article, the term "permanent establishment" shall be deemed not to include any one or more of the following:

(a) the maintenance of a regular place of business solely for the purpose of purchasing goods or merchandise, or of collecting information, for the enterprise of insurance; or

(b) the maintenance of a regular place of business solely for the purpose of advertising, for the supply of information, for scientific research or for similar activities which have a preparatory or auxiliary character, for the enterprise.

5. Notwithstanding the provisions of paragraphs 1, 2, and 3, a person (other than an agent of independent status to whom paragraph 6 applies) acting in a Covered Jurisdiction on behalf of an enterprise of insurance of the other Covered Jurisdiction shall be deemed to be a permanent establishment of that enterprise in the first-mentioned Jurisdiction if he has and habitually exercises in the first-mentioned Jurisdiction an authority to conclude contracts on behalf of the enterprise, unless his activities are limited to those mentioned in paragraph 4 which, if exercised through a regular place of business, would not make that regular place of business a permanent establishment under the provisions of that paragraph.

6. An enterprise of insurance shall not be deemed to have a permanent establishment in a Covered Jurisdiction merely because it carries on business in that Jurisdiction through a broker, general commission agent, or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business. However, when the activities of such person are devoted substantially on behalf of that enterprise, he shall not be considered an agent of independent status within the meaning of this paragraph if the transactions between the agent and the enterprise were not made under arm's length conditions.

7. The fact that a company which is a resident of a Covered Jurisdiction controls or is controlled by a company which is a resident of the other Covered Jurisdiction, or which carries on business in that other Jurisdiction (whether through a permanent establishment or otherwise), shall not of itself constitute either company a permanent establishment of the other.

Article 4
Taxation of Insurance Enterprises

1. The business profits of an enterprise of insurance of a Covered Jurisdiction derived from carrying on the business of insurance (including insubstantial amounts of income incidental to such business) shall not be taxable in the other Covered Jurisdiction unless the enterprise carries on or has carried on business in the other Jurisdiction through a permanent establishment situated therein. If the enterprise carries on or has carried on business as aforesaid, the business profits of the enterprise may be taxed in the other Jurisdiction but only so much of them as is attributable to that permanent establishment. Nothing in this Convention shall prevent the United States from taxing its residents (as determined under Article 2(a)) and its citizens as if this Convention had not entered into force.

2. Where an enterprise of insurance of one of the Covered Jurisdictions carries on or has carried on business through a permanent establishment in the other Jurisdiction, there shall in each Covered Jurisdiction be attributed to the permanent establishment business profits which would reasonably be expected to have been derived by it, if it were a distinct and independent enterprise engaged in the same or similar activities under the same or similar conditions. In determining the business profits of a permanent establishment in a Covered Jurisdiction through which an enterprise of insurance of the other Jurisdiction carries on or has carried on business, there shall be allowed as deductions, for purpose of tax imposed by the first-mentioned Jurisdiction other than excise taxes on premiums paid to foreign insurers, expenses which are incurred for the purposes of the permanent establishment, including a reasonable allocation of executive and general administrative expenses, research and development expense, interest, and other expenses incurred for the enterprise of insurance as a whole (or the part thereof which includes the permanent establishment), whether incurred in the Jurisdiction in which the permanent establishment is situated or elsewhere. For the purposes of this paragraph, the business profits to be attributed to a permanent establishment shall be determined by the same method year by year unless there is good and sufficient reason to the contrary. Nothing in this Article shall affect taxation by a Covered Jurisdiction of dividends, interest, royalties, gains or compensation for services beneficially owned by a resident of the other Covered Jurisdiction if such items of income are not attributable to a permanent establishment of the beneficial owner of such income in the first-mentioned Jurisdiction.

3. A person which is a resident of a Covered Jurisdiction and which derives income from sources within the other Covered Jurisdiction shall not be entitled, in the other Covered Jurisdiction, to relief from taxation under this Article if:

(a) 50 percent or less of the beneficial ownership of such person is owned, directly or indirectly, by any combination of one or more individual residents of a Covered Jurisdiction or citizens of the United States; or

(b) the income of such person is used in substantial part, directly or indirectly, to make distributions (where such distributions are made with respect to beneficial ownership interests and are substantially disproportionate to such interests) to, or to meet liabilities (including liabilities for interest, royalties, or other expenses, but not including liabilities, whether or not for interest or other expenses, which constitute insurance obligations) to, persons who are neither residents of either of the Covered Jurisdictions nor citizens of the United States.

If one of the Covered Jurisdictions proposes to deny benefits to a resident of the other Covered Jurisdiction by reason of this paragraph, the competent authorities of the Covered Jurisdictions shall, upon request of the competent authority of the other Covered Jurisdiction, consult each other.

4. The provisions of paragraph 3 shall not apply if the person deriving the income is a company which is a resident of a Covered Jurisdiction in whose principal class of shares there is substantial and regular trading on a recognized stock exchange. For purposes of the preceding sentence, the term "recognized stock exchange" means:

(a) the NASDAQ System owned by the National Association of Securities

Dealers, Inc. and any other stock exchange registered with the Securities and Exchange Commission as a national securities exchange for purposes of the Securities Exchange Act of 1934; and

(b) any other stock exchange agreed upon by the competent authorities of the Covered Jurisdictions.

5. Nothing in this Convention shall limit any provisions of the law of either Covered Jurisdiction which permit the distribution, apportionment, or allocation of income, deductions, credits, or allowances between persons, whether or not residents of a Covered Jurisdiction, owned or controlled directly or indirectly by the same interests when necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such persons.

6. The existing taxes to which this Article shall apply in the United States are the Federal income taxes imposed by the Internal Revenue Code (but excluding the accumulated earnings tax and the personal holding company tax), and the excise taxes imposed on insurance premiums paid to foreign insurers. This Article shall, however, apply to the excise taxes imposed on insurance premiums paid to foreign insurers only to the extent that the risks covered by such premiums are not reinsured with a person not entitled to the benefits of this or any other convention which applies to these taxes. This Article shall also apply to any identical or substantially similar taxes which are imposed by the United States after the date of signature of the Convention in addition to, or in place of, the existing taxes, and shall also apply to any tax imposed by Bermuda after the date of signature of the Convention which is identical or substantially similar to the existing United States taxes to which this Article applies, to the same extent as it applies to those existing taxes. The competent authorities of the Covered Jurisdictions shall notify each other of any significant changes which have been made in their respective taxation laws and of any official published material concerning the application of the Convention, including explanations, regulations, rulings, or judicial decisions.

7. The taxation on a permanent establishment which an enterprise of insurance of a Covered Jurisdiction has in the other Covered Jurisdiction shall not be less favorably levied in that other Jurisdiction than the taxation levied on enterprises of insurance of that other Jurisdiction carrying on the same activities. This provision shall not be construed as obliging a Covered Jurisdiction to grant to residents of the other Covered Jurisdiction any personal allowances, reliefs, and reductions for taxation purposes on account of civil status or family responsibilities which it grants to its own residents. The provisions of this paragraph shall not be construed to prevent the United States from imposing an additional tax on the income of a permanent establishment maintained by a resident of Bermuda in the United States. Except where the provisions of paragraph 5 apply, interest, royalties, and other disbursements paid by a resident of a Covered Jurisdiction to an enterprise of insurance of the other Covered Jurisdiction shall, for purposes of determining the taxable profits of such resident, be deductible under the same conditions as if they had been paid to an enterprise of insurance of the first-mentioned Jurisdiction. For purposes of this paragraph, the term ''taxation'' means taxes which are the subject of this Convention.

Article 5
Mutual Assistance in Tax Matters

The competent authorities of the Covered Jurisdictions shall provide assistance as appropriate in carrying out the laws of the respective Covered Jurisdictions relating to the prevention of tax fraud and the evasion of taxes. In addition, the competent authorities shall, through consultations, develop appropriate conditions, methods, and techniques for providing, and shall thereafter provide, assistance as appropriate in carrying out the fiscal laws of the respective Covered Jurisdictions other than those relating to tax fraud and the evasion of taxes.

Article 6
Confidentiality

Any matters subject to assistance under Article 5 shall be treated as confidential in the same manner as such matters or items would be under the domestic laws of the Covered Jurisdiction requesting the assistance and, in any event, shall be disclosed only:

(a) in the case of the United States, to persons or authorities (including courts and administrative bodies) involved in the assessment, collection, or administration of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, taxes, and

(b) in the case of Bermuda, to the competent authority of Bermuda.

Such persons or authorities shall use such matters or items only for purposes of the assessment, collection, or administration of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, taxes. Such matters or items may be disclosed in public court proceedings or public decisions, but shall not be disclosed to any country other than one of the Covered Jurisdictions for any purpose.

Article 7
Entry into Force and Termination

1. This Convention shall be subject to ratification in accordance with the applicable procedures of each party and instruments of ratification shall be exchanged as soon as possible.

2. The Convention shall enter into force upon the exchange of instruments of ratification and its provisions shall have effect:

(a) in respect of excise taxes on insurance premiums paid to foreign insurers, for premiums paid or credited on or after January 1, 1986;

(b) in respect of income taxes imposed on the business profits derived by an enterprise of insurance, for such profits derived in taxable years beginning on or after the first day of the calendar year in which this Convention enters into force;

(c) in respect of mutual assistance covered by the first sentence of Article 5, for taxable years not barred by the statute of limitations of the Covered Jurisdiction requesting such assistance; provided, however, that neither Covered Jurisdiction shall be required by Article 5 to provide such assistance with respect to taxable years beginning prior to January 1, 1977; and

(d) in respect of mutual assistance covered by the second sentence (and not also described in the first sentence) of Article 5, for taxable years not barred by the statute of limitations of the Covered Jurisdiction requesting such assistance; provided, however, that neither Covered Jurisdiction shall be required by Article 5 to provide such assistance with respect to:

(i) taxable years beginning prior to January 1, 1977; or

(ii) taxable years beginning prior to the entry into force of the Convention if the provisions of such assistance would cause or result in the breach of an obligation to maintain confidentiality of information under the laws of such Jurisdiction in effect on the date of signature of the Convention.

2. The Convention shall continue in force indefinitely, but either party may give notice of termination to the other party on or after June 30 of the year following the calendar year in which this Convention enters into force and in such event the Convention shall terminate on the first day of the seventh full calendar month following that in which the notice is given.

Done at Washington, in duplicate, this Eleventh day of July, 1986.

FOR THE GOVERNMENT OF THE UNITED STATES OF AMERICA:

(John L. Whitehead)

FOR THE GOVERNMENT OF THE UNITED KINGDOM OF GREAT BRITAIN AND NORTHERN IRELAND (ON BEHALF OF THE GOVERNMENT OF BERMUDA):

(John Swan)

Department of State
Washington, July 11, 1986

The Department of State refers the British Embassy to the Convention between the Government of the United States of America and the Government of the United Kingdom of Great Britain and Northern Ireland (on behalf of the, Government of Bermuda) relating to the Taxation of Insurance Enterprises and Mutual Assistance in Tax Matters (the "Convention"), signed today. In the course of discussions involving the Convention, the following understandings were reached between representatives of the United States and Bermuda (each referred to herein as a "Covered Jurisdiction"):

(1) The United States Government noted that in order to implement the relief from excise taxes pursuant to paragraph 1 of Article 4 of the Convention it would be necessary to establish procedures which would, *inter alia,* ensure that companies claiming the benefits of that paragraph are entitled to such benefits and, in the case of refunds, that the amount and recipient of such refunds are properly determined. Representatives of Bermuda assured the representatives of the United States Government of Bermuda's willingness to establish such procedures as may be mutually agreed to ensure that relief from the excise tax is obtained by appropriate persons.

(2) The United States Government noted that paragraph 3 of Article 4 of the Convention limits the availability of the exemption granted to insurance enterprises by either Covered Jurisdiction under the Convention to persons resident in the other Covered Jurisdiction which (i) are more than 50 percent owned, directly or indirectly, by individual residents of the Covered Jurisdictions or U.S citizens; and (ii) do not use their income in substantial part, directly or indirectly, to make certain payments to persons who are neither residents of a Covered Jurisdiction nor U.S. citizens. The United States Government indicated that, for purposes of the ownership test in that provision, it would not treat any individual as owning "indirectly" through an intermediary entity any beneficial interest in an entity resident in one of the Covered Jurisdictions if the evidence of and rights to the ownership of any interest in such intermediary entity are in bearer form. For purposes of the second test, the term "liabilities" refers to payments which reduce gross premiums or are deductible against gross income, and includes interest, royalties, and premiums paid in connection with reinsuring risks. Also, if the sum of (i) the ratio which reinsurance premium payments bears to gross premiums less return premiums and (ii) the ratio which payments of other liabilities bears to (a) gross premiums less return premiums and less reinsurance premium payments plus (b) gross income from all other activities, is no more than 50 percent, such payments will not generally be considered "substantial," provided that in appropriate circumstances a lower aggregate percentage will be considered "substantial."

(3) The United States Government expressed its concern that the obligations of a Covered Jurisdiction not be construed to establish an obligation to provide assistance with respect to matters other than those relating to the domestic laws of a Covered Jurisdiction respecting taxes. The representatives of the United States and Bermuda agreed that the intended scope of Article 5 of the Convention is limited to assistance relating to the domestic laws of the Covered Jurisdictions concerning taxes.

(4) Representatives of Bermuda expressed concerns as to the policies of the United States Government regarding assistance that might relate to persons not resident in one of the two Covered Jurisdictions and matters that do not constitute a criminal investigation. The representatives of the United States Government discussed with the representatives of Bermuda the United States' policies relating to information exchange. The representatives of the United States and Bermuda agreed that, where the United States requests assistance with respect to a matter which (i) relates to a person not resident in one of the two Covered Jurisdictions or (ii) does not constitute a United States criminal or tax fraud investigation, a senior official designated by the Secretary of the Treasury shall certify such request as being relevant to and necessary for the determination of the tax liability of a United States taxpayer, or the criminal tax liability of a person under the laws of the United States. The representatives of the United States and Bermuda further agreed that, in connection with any assistance relating to persons not resident in one of the two Covered Jurisdictions, it shall be established to the satisfaction of the competent authority of the requested Jurisdiction that such assistance is necessary for the proper administration and enforcement of the fiscal laws of the requesting Jurisdiction. Where such necessity has been duly established, the competent authorities shall consult as to the appropriate form of such assistance.

(5) The representatives of the United States and Bermuda agreed that, subject to the limitations described in and agreement to procedures referred to in paragraph (4) above, it is intended that the

mutual assistance to be provided under Article 5 of the Convention come into effect under the limitations of Article 7 as follows:

(i) Subject to paragraph (iv), Bermuda's obligation under the Convention to provide assistance with respect to civil and criminal tax matters relating to taxable years of a taxpayer beginning after the entry into force of the Convention will not be limited by any confidentiality restrictions of Bermudian law, other than those relating to solicitor-client privilege.

(ii) With respect to matters relating to taxable years of a taxpayer beginning before the entry into force of the Convention (but beginning on or after January 1, 1977 and not barred by the statute of limitations), paragraph 2 (d)(ii) of Article 7 limits Bermuda's obligation to provide assistance with respect to civil tax matters (other than civil fraud) if the provision of such assistance would entail breach of an obligation to maintain confidentiality of information under the laws of Bermuda in effect on the date of signature of the Convention. Under this standard, confidential information would only include information protected by Bermudian statutory and common law. It is understood that under Bermudian common law confidential information would include information protected by the common law solicitor-client privIlege and banker-client privilege. It was agreed that if a taxpayer claims that other categories of information are protected under Bermudian common law, and if the United States so requests, the Government of Bermuda will have such a claim determined in the courts of Bermuda.

(iii) Bermuda's obligation under subparagraph 2 (c) of article 7 to provide assistance with respect to criminal tax matters (and tax matters involving civil fraud) relating to taxable years of a taxpayer beginning before the entry into force of the Convention (but on or after January 1, 1977 and not barred by the statute of limitations) would only be limited by the confidentiality obligations of the solicitor-client privilege.

(iv) Bermuda's obligation under the Convention to provide assistance with respect to civil tax matters (other than civil fraud) relating to a taxpayer's taxable years beginning after the entry into force of the Convention will not require it to cause any person to breach a legal obligation to maintain confidentiality of documents or information, properly asserted by such person under the laws of Bermuda as in effect on the date of signature of the Convention, where such documents or information were created in or derived from periods prior to the date of entry into force of the Convention. However, the limitation on Bermuda's obligation described in the preceding sentence will not apply to documents or information created in or derived from a date preceding the entry into force of the Convention that are relevant to a request relating to taxable years after the entry into force of the Convention and are of a kind that have a continuing operational effect. For example, if assistance is requested with respect to a taxpayer's bank transactions occurring after the entry into force of the Convention and the signature card for the account in question was executed prior to the entry into force of the Convention, Bermuda's obligation to provide assistance with respect to such a signature card would not be affected by confidentiality restrictions. Similarly, if a taxpayer's depreciation deduction for a year after entry into force of the Convention is under examination, Bermuda's obligation to provide assistance with respect to information about the purchase price of the property in question, if such property was acquired before the entry into force of the Convention, would not be affected by any confidentiality restrictions of Bermudian law.

(6) The representatives of the United States Government expressed concerns regarding whether assistance would be provided in a form which would permit its use in judicial or administrative proceedings. The representatives of the United States and Bermuda agreed that under Article 5 of the Convention, it was intended that, if specifically requested by a competent authority of a Covered Jurisdiction, the competent authority of the other Covered Jurisdiction shall provide information in the form of depositions of witnesses and authenticated copies of original documents (including books, papers, statements, records, accounts and writings) to the same extent such depositions and documents can be obtained under the laws and administrative practices of that other Jurisdiction.

(7) Representatives of Bermuda also expressed concerns as to the scope for use of unilateral compulsory measures by one Covered Jurisdiction to obtain documents, records, or other materials located in the territory of the other Covered Jurisdiction, and within the scope of assistance under the Convention, after entry into force of the Convention. In this context the representatives of the United States Government confirmed that, with respect to documents, records, or other materials in the custody of a resident of a Covered Jurisdiction and located in the territory of that Jurisdiction, it shall be the policy of the United States, where practicable, to request assistance pursuant to the provisions of the Convention before using unilateral measures.

(8) The representatives of the United States Government inquired whether shares of a company organized under the laws of Bermuda could be issued in bearer form. The representatives of Bermuda informed the United States representatives that the laws of Bermuda did not permit the issuance of company shares to an unnamed person.

(9) The United States representatives sought clarification that matters that were the subject of assistance under the Convention but that are made public in accordance with Article 6 of the Convention would not be further subject to Article 6. The representatives of the United States and Bermuda agreed that matters that are the subject of assistance under the Convention but that are made public in accordance with the Convention would not be further subject to Article 6.

(10) The representatives of the Government of the United States observed that, under the legal system applicable in Bermuda, the Convention is not self-executing and that legislation would be required in order to implement the provisions of the Convention. The representatives of Bermuda understood that instruments of ratification would not be exchanged until such legislation as may be required to implement the provisions of the Convention has been enacted. It was further understood that the Convention would be ratified and other necessary steps, such as the adoption of implementing legislation necessary to meet the obligations of the Convention, would be taken so as to permit the exchange of instruments of ratification at the earliest possible date.

(11) The representatives of Bermuda inquired whether, following the entry into force of the Convention, the Secretary of the Treasury of the United States would be prepared to certify that assistance under the Convention, and subject to the understandings of this Note, would

be satisfactory for purposes of section 927(e)(3) of the Internal Revenue Code of 1954, as amended (the "Code"), relating to countries qualifying as a jurisdiction in which a Foreign Sales Corporation (FSC) may be organized. The representatives of Bermuda also inquired whether the assistance provided for in the Convention, subject to the understandings of this Note, would be satisfactory for purposes of eligibility for convention tax benefits under section 274(h)(6) of the Code.

The representatives of the United States stated that upon entry into force of the Convention, and subject to the understandings contained in this Note, the Secretary of the Treasury, or his delegate, will be prepared to certify Bermuda for purposes of section 927(e)(3) of the Code such that a company organized under the laws of Bermuda may qualify as a FSC. Such certification would be published in the Federal Register and may be terminated effective six months after the date of publication of a notice of termination in the Federal Register. The United States Government also stated that, upon entry into force of the Convention, the Secretary of the Treasury, or his delegate, will be prepared to execute on behalf of the United States Government an executive agreement satisfying the requirements of section 274(h)(6) of the Code, which would incorporate by cross-reference the provisions of Articles 5 and 6 of the Convention and this Note, and would allow persons incurring expenses for attending business conventions in Bermuda to claim deductions for such expenses as though Bermuda were included as part of the "North American area."

(12) The representatives of Bermuda emphasized the necessity of including in the Convention additional provisions intended to prevent changes in U.S. income tax treaty policy from adversely affecting the economic position of Bermuda's insurance and tourism industries relative to those of U.S. treaty partners in similar circumstances under current U.S. tax treaty policy. The United States representatives were not able to accept such provisions. However, the United States Government recognizes that insurance and tourism currently play a vital role in the Bermudian economy. If, in the future, the income tax treaty policies of the United States change in a manner which would have a material, adverse effect on such Bermudian business activities, compared with existing circumstances, the United States Government would be prepared to reopen the discussions in order to take account of such change in policies.

The Department of State confirms that the foregoing understandings are in accord with the view of the Government of the United States and are approved by it. The Department of State would appreciate confirmation that such understandings are acceptable to the Government of the United Kingdom on behalf of Bermuda.

Embassy of the United Kingdom
and Northern Ireland
July 11, 1986

Her Britannic Majesty's Embassy present their compliments to the Department of State and have the honour to refer to the Department's Note of 11 July regarding the Convention between the Government of the United States of America and the Government of the United Kingdom of Great Britain and Northern Ireland (on behalf of the Government of Bermuda) relating to the Taxation of Insurance Enterprises and Mutual Assistance in Tax Matters (the "Convention"), signed today. The Department's Note states that in the course of discussions involving the Convention, the following understandings were reached between representatives of the United States and Bermuda (each referred to herein as a "Covered Jurisdiction"):

(1) The United States Government noted that in order to implement the relief from excise taxes pursuant to paragraph 1 of Article 4 of the Convention it would be necessary to establish procedures which would, *inter alia,* ensure that companies claiming the benefits of that paragraph are entitled to such benefits and, in the case of refunds, that the amount and recipient of such refunds are properly determined. Representatives of Bermuda assured the representatives of the United States Government of Bermuda's willingness to establish such procedures as may be mutually agreed to ensure that relief from the excise tax is obtained by appropriate persons.

(2) The United States Government noted that paragraph 3 of Article 4 of the Convention limits the availability of the exemption granted to insurance enterprises by either Covered Jurisdiction under the Convention to persons resident in the other Covered Jurisdiction which (i) are more than 50 percent owned, directly or indirectly, by individual residents of the Covered Jurisdictions or US citizens; and (ii) do not use their income in substantial part, directly or indirectly, to make certain payments to persons who are neither residents of a Covered Jurisdiction nor US citizens. The United States Government indicated that, for purposes of the ownership test in that provision, it would not treat any individual as owning "indirectly" through an intermediary entity any beneficial interest in an entity resident in one of the Covered Jurisdictions if the evidence of and rights to the ownership of any interest in such intermediary entity are in bearer form. For purposes of the second test, the term "liabilities" refers to payments which reduce gross premiums or are deductible against gross income, and includes interest, royalties, and premiums paid in connection with reinsuring risks. Also, if the sum of (i) the ratio which reinsurance premium payments bears to gross premiums less return premiums and (ii) the ratio which payments of other liabilities bears to (a) gross premiums less return premiums and less reinsurance premium payments plus (b) gross income from all other activities, is no more than 50 percent, such payments will not generally be considered "substantial," provided that in appropriate circumstances a lower aggregate percentage will be considered "substantial."

(3) The United States Government expressed its concern that the obligations of a Covered Jurisdiction not be construed to establish an obligation to provide assistance with respect to matters other than those relating to the domestic laws of a Covered Jurisdiction respecting taxes. The representatives of the United States and Bermuda agreed that the intended scope of Article 5 of the Convention is limited to assistance relating to the domestic laws of the Covered Jurisdictions concerning taxes.

(4) Representatives of Bermuda expressed concerns as to the policies of the United States Government regarding assistance that might relate to persons not resident in one of the two Covered Jurisdictions and matters that do not constitute a criminal investigation. The representatives of the United States Government discussed with the representatives of Bermuda the United States' policies relating to information exchange. The representatives of the United States and Bermuda agreed that, where the United States requests assistance with respect to a matter which (i) relates to a

person not resident in one of the two Covered Jurisdictions or (ii) does not constitute a United States criminal or tax fraud investigation, a senior official designated by the Secretary of the Treasury shall certify such request as being relevant to and necessary for the determination of the tax liability of a United States taxpayer, or the criminal tax liability of a person under the laws of the United States. The representatives of the United States and Bermuda further agreed that, in connection with any assistance relating to persons not resident in one of the two Covered Jurisdictions, it shall be established to the satisfaction of the competent authority of the requested Jurisdiction that such assistance is necessary for the proper administration and enforcement of the fiscal laws of the requesting Jurisdiction. Where such necessity has been duly established, the competent authorities shall consult as to the appropriate form of such assistance.

(5) The representatives of the United States and Bermuda agreed that, subject to the limitations described in and agreement to procedures referred to in paragraph (4) above, it is intended that the mutual assistance to be provided under Article 5 of the Convention come into effect under the limitations of Article 7 as follows:

(i) Subject to paragraph (iv), Bermuda's obligation under the Convention to provide assistance with respect to civil and criminal tax matters relating to taxable years of a taxpayer beginning after the entry into force of the Convention will not be limited by any confidentiality restrictions of Bermudian law, other than those relating to solicitor-client privilege.

(ii) With respect to matters relating to taxable years of a taxpayer beginning before the entry into force of the Convention (but beginning on or after January 1, 1977 and not barred by the statute of limitations), paragraph 2(d)(ii) of Article 7 limits Bermuda's obligation to provide assistance with respect to civil tax matters (other than civil fraud) if the provision of such assistance would entail breach of an obligation to maintain confidentiality of information under the laws of Bermuda in effect on the date of signature of the Convention. Under this standard, confidential information would only include information protected by Bermudian statutory and common law. It is understood that under Bermudian common law confidential information would include information protected by the common law solicitor-client privilege and banker-client privilege. It was agreed that if a taxpayer claims that other categories of information are protected under Bermudian common law, and if the United States so requests, the Government of Bermuda will have such a claim determined in the courts of Bermuda.

(iii) Bermuda's obligation under subparagraph 2(c) of Article 7 to provide assistance with respect to criminal tax matters (and tax matters involving civil fraud) relating to taxable years of a taxpayer beginning before the entry into force of the Convention (but on or after January 1, 1977 and not barred by the statute of limitations) would only be limited by the confidentiality obligations of the solicitor-client privilege.

(iv) Bermuda's obligation under the Convention to provide assistance with respect to civil tax matters (other than civil fraud) relating to a taxpayer's taxable years beginning after the entry into force of the Convention will not require it to cause any person to breach a legal obligation to maintain confidentiality of documents or information, properly asserted by such person under the laws of Bermuda as in effect on the date of signature of the Convention, where such documents or information were created in or derived from periods prior to the date of entry into force of the Convention. However, the limitation on Bermuda's obligation described in the preceding sentence will not apply to documents or information created in or derived from a date preceding the entry into force of the Convention that are relevant to a request relating to taxable years after the entry into force of the Convention and are of a kind that have a continuing operational effect. For example, if assistance is requested with respect to a taxpayer's bank transactions occurring after the entry into force of the Convention and the signature card for the account in question was executed prior to the entry into force of the Convention, Bermuda's obligation to provide assistance with respect to such a signature card would not be affected by confidentiality restrictions. Similarly, if a taxpayer's depreciation deduction for a year after entry into force of the Convention is under examination, Bermuda's obligation to provide assistance with respect to information about the purchase price of the property in question, if such property was acquired before the entry into force of the Convention, would not be affected by any confidentiality restrictions of Bermudian law.

(6) The representatives of the United States Government expressed concerns regarding whether assistance would be provided in a form which would permit its use in judicial or administrative proceedings. The representatives of the United States and Bermuda agreed that under Article 5 of the Convention, it was intended that, if specifically requested by a competent authority of a Covered Jurisdiction, the competent authority of the other Covered Jurisdiction shall provide information in the form of depositions of witnesses and authenticated copies of original documents (including books, papers, statements, records, accounts and writings) to the same extent such depositions and documents can be obtained under the laws and administrative practices of that other Jurisdiction.

(7) Representatives of Bermuda also expressed concerns as to the scope for use of unilateral compulsory measures by one Covered Jurisdiction to obtain documents, records, or other materials located in the territory of the other Covered Jurisdiction, and within the scope of assistance under the Convention, after entry into force of the Convention. In this context the representatives of the United States Government confirmed that, with respect to documents, records, or other materials in the custody of a resident of a Covered Jurisdiction and located in the territory of that Jurisdiction, it shall be the policy of the United States, where practicable, to request assistance pursuant to the provisions of the Convention before using unilateral measures.

(8) The representatives of the United States Government inquired whether shares of a company organized under the laws of Bermuda could be issued in bearer form. The representatives of Bermuda informed the United States representatives that the laws of Bermuda did not permit the issuance of company shares to an unnamed person.

(9) The United States representatives sought clarification that matters that were the subject of assistance under the Convention but that are made public in accordance with Article 6 of the Convention would not be further subject to Article 6. The representatives of the United States and Bermuda agreed that matters that are the subject of assistance under

the Convention but that are made public in accordance with the Convention would not be further subject to Article 6.

(10) The representatives of the Government of the United States observed that, under the legal system applicable in Bermuda, the Convention is not self-executing and that legislation would be required in order to implement the provisions of the Convention. The representatives of Bermuda understood that instruments of ratification would not be exchanged until such legislation as may be required to implement the provisions of the Convention has been enacted. It was further understood that the Convention would be ratified and other necessary steps, such as the adoption of implementing legislation necessary to meet the obligations of the Convention, would be taken so as to permit the exchange of instruments of ratification at the earliest possible date.

(11) The representatives of Bermuda inquired whether, following the entry into force of the Convention, the Secretary of the Treasury of the United States would be prepared to certify that assistance under the Convention, and subject to the understandings of this Note, would be satisfactory for purposes of section 927(e)(3) of the Internal Revenue Code of 1954, as amended (the "Code"), relating to countries qualifying as a jurisdiction in which a Foreign Sales Corporation (FSC) may be organised. The representatives of Bermuda also enquired whether the assistance provided for in the Convention, subject to the understandings of this Note, would be satisfactory for purposes of eligibility for convention tax benefits under section 274(h)(6) of the Code.

The representatives of the United States stated that upon entry into force of the Convention, and subject to the understandings contained in this Note, the Secretary of the Treasury, or his delegate, will be prepared to certify Bermuda for purposes of section 927(e)(3) of the Code such that a company organized under the laws of Bermuda may qualify as a FSC. Such certification would be published in the Federal Register and may be terminated effective six months after the date of publication of a notice of termination in the Federal Register. The United States Government also stated that, upon entry into force of the Convention, the Secretary of the Treasury, or his delegate, will be prepared to execute on behalf of the United States Government an executive agreement satisfying the requirements of section 274(h)(6) of the Code, which would incorporate by cross-reference the provisions of Articles 5 and 6 of the Convention and this Note, and would allow persons incurring expenses for attending business conventions in Bermuda to claim deductions for such expenses as though Bermuda were included as part of the "North American area."

(12) The representatives of Bermuda emphasized the necessity of including in the Convention additional provisions intended to prevent changes in US income tax treaty policy from adversely affecting the economic position of Bermuda's insurance and tourism industries relative to those of US treaty partners in similar circumstances under current US tax treaty policy. The United States representatives were not able to accept such provisions. However, the United States Government recognises that insurance and tourism currently play a vital role in the Bermudian economy. If, in the future, the income tax treaty policies of the United States change in a manner which would have a material, adverse effect on such Bermudian business activities, compared with existing circumstances, the United States Government would be prepared to reopen the discussions in order to take account of such change in policies.

Her Britannic Majesty's Embassy have the honour to confirm to the Department of State that such understandings are acceptable to the Government of the United Kingdom of Great Britain and Northern Ireland on behalf of Bermuda.

The Embassy avail themselves of this opportunity to renew to the Department of State their assurances of their highest considerations.

RONALD REAGAN

PRESIDENT OF THE UNITED STATES OF AMERICA

TO ALL TO WHOM THESE PRESENTS SHALL COME, GREETING:

CONSIDERING THAT:

The Convention between the Government of the United States of America and the Government of the United Kingdom of Great Britain and Northern Ireland (on behalf of the Government of Bermuda) relating to the Taxation of Insurance Enterprises and Mutual Assistance in Tax Matters, with a Related Exchange of Notes, was signed at Washington on July 11, 1986; and

The Senate of the United States of America by its resolution of October 22, 1988, two-thirds of the Senators present concurring therein, gave its advice and consent to ratification of the Convention and exchange of notes, subject to the following reservations:

(1) Effective January 1, 1990, said Convention shall not operate to prevent the imposition by the United States of any excise taxes on insurance premiums paid to foreign insurers, whether or not such premiums constitute income of an enterprise of insurance of a Covered Jurisdiction; and

(2) Said Convention shall in no event operate to prevent the imposition by the United States of any excise taxes on insurance premiums paid to foreign insurers except with respect to insurance premiums that either:

(a) constitute income of an enterprise of insurance of a Covered Jurisdiction carried on by a company in a taxable year in which the company is a controlled foreign corporation within the meaning of section 957(a) or (b) of title 26 of the United States Code as in effect for such taxable year; or

(b) constitute income of an enterprise of insurance of a Covered Jurisdiction carried on by a company in a taxable year in which:

(i) the company is subject to the rules of the section 953(c) of the Internal Revenue Code of 1986, and

(ii) the company is a controlled foreign corporation within the meaning of section 957(a) of the Internal Revenue Code of 1986 as modified by section 953(c)(1) of said Code, and

the premiums constitute related person insurance income within the meaning of section 953(c) of the Internal Revenue Code of 1986.

NOW, THEREFORE, I, Ronald Reagan, President of the United States of America, ratify and confirm the said Convention and related exchange of notes, subject to the aforesaid reservations.

IN TESTIMONY WHEREOF, I have signed this instrument of ratification and caused the Seal of the United States of America to be affixed.

DONE at the city of Washington this twenty-eighth day of November in the year of our Lord one thousand nine hundred eighty-eight and of the Independence of the United States of America the two hundred thirteenth.

By the President:
(Ronald Reagan)

(George P. Shultz)
GEORGE P. SHULTZ
Secretary of State

PROTOCOL OF EXCHANGE OF INSTRUMENTS OF RATIFICATION

The undersigned, George P. Shultz, Secretary of State of the United States of America, and John Swan, Premier of Bermuda, being duly authorized for the purpose by their respective Governments, have met for the purpose of exchanging instruments of ratification of the Convention between the Government of the United States of America and the Government of the United Kingdom of Great Britain and Northern Ireland (on behalf of the Government of Bermuda) relating to the Taxation of Insurance Enterprises and Mutual Assistance in Tax Matters, with a Related Exchange of Notes, signed at Washington on July 11, 1986. The United States ratification is subject to the following reservations:

(1) Effective January 1, 1990, said Convention shall not operate to prevent the imposition by the United States of any excise taxes on insurance premiums paid to foreign insurers, whether or not such premiums constitute income of an enterprise of insurance of a Covered Jurisdiction; and

(2) Said Convention shall in no event operate to prevent the imposition by the United States of any excise taxes on insurance premiums paid to foreign insurers except with respect to insurance premiums that either:

(a) constitute income of an enterprise of insurance of a Covered Jurisdiction carried on by a company in a taxable year in which the company is a controlled foreign corporation within the meaning of section 957(a) or (b) of title 26 of the United States Code as in effect for such taxable year; or

(b) constitute income of an enterprise of insurance of a Covered Jurisdiction carried on by a company in a taxable year in which:

(i) the company is subject to the rules of the section 953(c) of the Internal Revenue Code of 1986, and
(ii) the company is a controlled foreign corporation within the meaning of section 957(a) of the Internal Revenue Code of 1986 as modified by section 953(c)(1) of said Code, and

the premiums constitute related person insurance income within the meaning of section 953(c) of the Internal Revenue Code of 1986.

The respective instruments of ratification having been compared and found to be in due form, the exchange took place this day.

IN WITNESS WHEREOF, the respective Plenipotentiaries have signed the present Protocol of Exchange of Instruments of Ratification.

DONE in duplicate in the English language at Washington this second day of December, 1988.

FOR THE GOVERNMENT OF THE UNITED STATES OF AMERICA:

(George P. Shultz)
GEORGE P. SHULTZ

FOR THE GOVERNMENT OF THE UNITED KINGDOM OF GREAT BRITAIN AND NORTHERN IRELAND (ON BEHALF OF THE GOVERNMENT OF BERMUDA):

(John Swan)
JOHN SWAN

TREASURY DEPARTMENT'S TECHNICAL EXPLANATION OF THE U.S.-BERMUDA INSURANCE ENTERPRISES AND MUTUAL ASSISTANCE TAX TREATY SIGNED ON JULY 11, 1986.

INTRODUCTION

This is a technical explanation of the Convention between the United States and the United Kingdom (on behalf of Bermuda) signed on July 11, 1986 (the ''Convention''). This explanation is an official guide to the Convention. It reflects policies behind particular Convention provisions, as well as understandings reached with respect to the interpretation and application of the Convention. This explanation also refers to the provisions of the diplomatic notes (the ''Note'') exchanged by the United States and the United Kingdom at the time of signing the Convention.

Article 1. GENERAL DEFINITIONS

Paragraph 1 defines the principal terms used in the Convention. Unless the context otherwise requires, a term defined in this paragraph has a uniform meaning throughout the Convention. A number of important terms are, however, defined in other Articles. For example, the terms ''resident'' and ''permanent establishment'' are defined in Articles 2 (Residence) and 3 (Permanent Establishment), respectively. The term ''United States'' is defined to mean the United States of America. Neither Puerto Rico, the Virgin Islands, Guam, nor any other U.S. possession or territory is within the definition of the United States.

The term ''Bermuda'' means the islands in the Atlantic Ocean known as Bermuda.

The term ''person'' is defined to include an individual, an estate, a trust, a company, a partnership, and any other body of persons. The term ''company'' means any body corporate or any entity which is treated as a body corporate for tax purposes.

The term ''enterprise of insurance'' means an enterprise of which the predominant business activity during the taxable year is the issuing of insurance of annuity contracts or acting as the reinsurer of risks underwritten by insurance companies, together with the investing or reinvesting of assets held in respect of insurance reserves, capital, and surplus incident to the carrying on of the insurance business.

The terms "enterprise of a Covered Jurisdiction" and "enterprise of the other Covered Jurisdiction" mean an enterprise carried on by a resident, as defined in Article 2, of the United States or Bermuda, as the context requires.

The term "competent authority" is defined to mean, in the case of the United States, the Secretary of the Treasury or his delegate. In the case of Bermuda, the term means the Minister of Finance or his delegate.

The term "insurance obligation" is defined to mean any obligation which, in accordance with normal industry practice, an insurer undertakes under the terms of a contract of insurance, to make payments or incur expenses in connection with the insurance protection offered under the contract, including any such obligation to pay claims to or for the benefit of the insured resulting from damages connected with the covered risk, to pay interest on such claims, and to pay the costs of defending an insured against such damages, but in no event including any obligation to pay premiums or other costs of reinsuring the covered risk. The obligation to pay premiums or other costs of reinsuring a risk covered under an insurance contract is, thus, excluded from the definition of insurance obligation, regardless of whether such obligation arises under or outside of the insurance contract covering the risk.

The term "Covered Jurisdiction" is defined to mean the United States or Bermuda, as the context requires.

Paragraph 2 provides that in the case of a term not defined in the Convention, the domestic law of the Covered Jurisdiction applying the Convention shall control, unless the context in which the term is used requires otherwise or the competent authorities reach agreement on a meaning pursuant to the third sentence of paragraph 2. Where the United States is the Covered Jurisdiction applying the Convention, the domestic tax law shall be the domestic law referred to in the preceding sentence. The term "context" refers to the purpose and background of the provisions in which the term appears. An agreement by the competent authorities with respect to the meaning of a term used in the Convention would supersede conflicting meanings in the domestic laws of the Covered Jurisdictions.

Article 2. RESIDENCE

This Article sets forth rules for determining the residence of individuals, companies, and other persons for purposes of the Convention. Article 2 is important because, except as otherwise provided, only a resident of a Covered Jurisdiction may claim benefits under the Convention. A determination of residence under this Article applies for all other provisions of the Convention. In general, the determination of residence in the case of the United States begins with a person's liability to tax as a resident under the taxation laws of the United States. In the case of Bermuda, the determination depends upon other factors, as discussed below. The Convention definition is, of course, exclusively for purposes of the Convention.

The term "resident of Bermuda" is defined as an individual who has the status of a legal resident of Bermuda, or a company, partnership, trust, or association created under the laws of Bermuda.

The term "resident of the United States" is defined as a person (except a company) resident in the United States for purposes of its tax. This includes a resident alien individual, who is subject to tax by the United States on his worldwide income, or an alien present in the United States who makes an election under Internal Revenue Code ("Code") section 6013(g) or (h), as well as a resident U.S. citizen. The term also includes a company which is created or organized under the laws of the United States or a political subdivision thereof.

This Article also provides that a partnership, estate, or trust is a resident of the United States only to the extent that the income derived by such person is subject to tax by the United States as the income of a resident, either in its hands or in the hands of its partners or beneficiaries. For example, under current United States law, a partnership is never, and an estate or trust is often not, taxed as such. Thus, under the Convention, a partnership, estate, or trust not taxed as such will be treated as a resident of the United States only to the extent that income derived by such partnership, estate, or trust is subject to tax in the hands of its partners or beneficiaries as the income of a U.S. resident.

Article 3. PERMANENT ESTABLISHMENT

This Article defines the term "permanent establishment" which is relevant particularly to the taxation of business profits of an enterprise of insurance under Article 4 (Taxation of Insurance Enterprises). Paragraph 1 defines the term "permanent establishment" as a regular place of business through which the business of an enterprise of insurance is wholly or partly carried on. No difference in meaning is intended between the use of the term "regular place of business" in the Convention and the more commonly used term "fixed place of business".

Paragraph 2 provides an illustrative list of regular places of business which constitute a permanent establishment. The list includes: a place of management; a branch; an office; and premises used as a sales outlet. The term "place of management" is used in the OECD Model Income Tax Convention. Since a place of management would in most cases require an office, which is specifically listed in paragraph 2, the insertion of "place of management" will generally not cause a regular place of business to be a permanent establishment if it would not otherwise be a permanent establishment. The reference to premises used as a "sales outlet" does not mean that premises used by an enterprise of insurance for the mere delivery of insurance contracts or related documents is a permanent establishment; additional significant activity by the enterprise at the premises, such as the negotiation of contracts, is necessary for the premises to constitute a "sales outlet" and a permanent establishment of the enterprise.

Paragraph 3 provides that the furnishing of services, including consultancy, management, technical and supervisory services, within a Covered Jurisdiction by an enterprise of insurance through employees or other persons constitutes a permanent establishment, but only if: the activities continue within that Jurisdiction for a period or periods aggregating more than 90 days in any 12 month period (and for 30 days or more in the taxable year); or the services are performed within that Jurisdiction for an associated enterprise. For this purpose, any two enterprises are considered "associated" if either participates directly or indirectly in the management, control, or capital of the other, or if the same persons participate directly or indirectly in the management, control, or capital of both.

Paragraph 4 overrides paragraphs 1 and 2 to provide that a regular place of business may be used for one or more of the following activities and not be a permanent establishment:

(a) the maintenance of a regular place of business solely for the purpose of purchasing goods or merchandise, or of collecting information, for the enterprise of insurance; or

(b) the maintenance of a regular place of business solely for the purpose of advertising, for the supply of information, for scientific research or for similar activities which have a preparatory or auxiliary character, for the enterprise.

The reference in subparagraph (b) to advertising, scientific research, and the supply of information is not intended to suggest that such activities are always auxiliary or that other activities cannot be auxiliary.

Paragraphs 5 and 6 describe the permanent establishment implications of employees and agents. Under paragraph 5, a person (other than an agent of independent status to whom paragraph 6 applies) acting in a Covered Jurisdiction on behalf of an enterprise of insurance of the other Covered Jurisdiction shall be deemed to be a permanent establishment of that enterprise in the first-mentioned Jurisdiction if he has and habitually exercises in the first-mentioned Jurisdiction an authority to conclude contracts on behalf of the enterprise, unless his activities are limited to those listed in paragraph 4.

Paragraph 6 provides that if an enterprise of insurance of one Covered Jurisdiction merely carries on business in the other Covered Jurisdiction through a broker, a general commission agent, or any other agent of independent status acting in the ordinary course of his business, the enterprise will not thereby be considered to have a permanent establishment in that other Jurisdiction. Paragraph 6 also provides, however, that such broker or agent will not be considered independent, and paragraph 6 shall not apply, if all his activities are devoted wholly, or almost wholly, on behalf of that enterprise and the transactions between the two are not conducted under arm's-length conditions.

Paragraph 7 provides that the fact that a company which is a resident of one Covered Jurisdiction either controls or is controlled by a company which is a resident of the other Covered Jurisdiction, or which is a resident of any Jurisdiction and carries on business in that other Covered Jurisdiction, does not automatically render either company a permanent establishment of the other.

Article 4. TAXATION OF INSURANCE ENTERPRISES

This Article provides rules for the taxation by a Covered Jurisdiction of income derived by a resident of the other Jurisdiction from carrying on the business of insurance in the first-mentioned Jurisdiction.

Paragraph 1 provides that the business profits of an enterprise of insurance of a Covered Jurisdiction derived from carrying on the business of insurance (including insubstantial amounts of income incidental to such business) shall not be taxable in the other Covered Jurisdiction unless the enterprise carries on or has carried on business in the other Jurisdiction through a permanent establishment situated therein. The term "permanent establishment" is defined in Article 3 (Permanent Establishment). If the enterprise of insurance does have a permanent establishment in the other Covered Jurisdiction, that Jurisdiction may tax that portion of the enterprise's business profits which is attributable to the permanent establishment. Paragraph 1 also contains the traditional "savings clause" under which the United States reserves the right to tax its residents, as determined under Article 2 (Residence), and its citizens as if the Convention had not come into effect.

Paragraph 2 provides that the profits to be attributed to the permanent establishment itself are those which it might be expected to make if it were a distinct and independent enterprise engaged in the same or similar activities under the same or similar conditions. The term profits "attributable to" a permanent establishment means that the limited "force-of-attraction" rule of Code section 864(c)-(3) does not apply for U.S. tax purposes under the Convention. Profits may, however, be from sources within or without a Covered Jurisdiction and be "attributable to" a permanent establishment. Thus, items of income described in section 864(c)(4)(C) of the Code which are attributable to a permanent establishment in the United States of an enterprise of insurance are subject to tax by the United States.

Paragraph 2 also provides that in computing the business profits of a permanent estalishment, there shall be allowed as deductions (for purposes of tax other than the excise tax imposed on premiums paid to foreign insurers) those expenses incurred for the purposes of the permanent establishment, whether incurred in the Jurisdiction where the permanent establishment is situated or elsewhere. Deductible expenses include a reasonable allocation to the permanent establishment of administrative expenses, research and development expenses, interest, and other expenses incurred for the purposes of the enterprise. For purposes of the excise tax imposed on premiums paid to foreign insurers, the business profits of an enterprise of insurance means the gross premiums paid to the enterprise.

Paragraph 2 also provides that the same method for determining the profits attributable to a permanent establishment shall be used each year unless there is good and sufficient reason to change. In the United States, such a change may be a change of accounting method requiring the approval of the Internal Revenue Service.

Paragraph 2 further provides that where business profits include dividends, interest, royalties, gains, or compensation for services beneficially owned by a resident of a Covered Jurisdiction, Article 4 shall not affect the taxation of such items by the other Covered Jurisdiction unless the items are attributable to a permanent establishment of such beneficial owner in such other Jurisdiction.

Paragraph 3 ensures that the source basis tax benefits granted by a Covered Jurisdiction pursuant to the Convention are ultimately enjoyed by the intended beneficiaries—the residents of the other Covered Jurisdiction—and not by residents of their Jurisdictions not having a substantial business and tax nexus with the other Jurisdiction.

The first sentence of paragraph 3 provides the general rule, subject to the exception in paragraph 4 as described below, that a resident of a Covered Jurisdiction which derives income from the other Covered Jurisdiction is not entitled to relief from taxation in such other Jurisdiction under Article 4 if either of two conditions is present:

(1) Treaty benefits will not be granted if 50 percent or less of the beneficial interest in the resident is owned, directly or indirectly, by any combination of one or more individual residents of the United States or Bermuda or U.S. citizens. In other words, the treaty benefits will not be granted unless more than 50 percent of the beneficial interest in the resident is owned, directly or indirectly, by any combination of individual residents of the Covered Jurisdictions or U.S. citizens. For purposes of this test, the United States will not treat any individual as owning an interest "indirectly"

through an intermediary entity if the evidence of and rights to the ownership of any interest in such intermediary entity are in bearer form.

(2) Treaty benefits will also not be granted if the income of the resident is used in substantial part, directly or indirectly, to make disproportionate distributions to, or to meet liabilities to, persons who are neither residents of the United States or Bermuda nor U.S. citizens. The term "disproportionate distributions" means distributions made with respect to beneficial ownership interests which are disproportionate to such interests. The term "liabilities" refers to payments which reduce gross premiums or are deductible against gross income, and it includes liabilities for interest, royalties, and other expenses, including premiums paid in connection with reinsuring risks. It does not, however, include liabilities, whether for interest or other expenses, which meet the definition of "insurance obligations" contained in Article 1 (General Definitions). The term "substantial" is not defined. If, however, the sum of (i) the ratio which reinsurance premium payments bears to gross premiums less return premiums and (ii) the ratio which payments of other liabilities bears to (a) gross premiums less return premiums and less reinsurance premium payments plus (b) gross income from all other activities, is no more than 50 percent, such payments will not generally be considered "substantial"; provided, however, that in appropriate circumstances a lower aggregate percentage will be considered "substantial".

Paragraph 3 also provides for competent authority consultation with respect to the denial of benefits in any particular case if the competent authority of the Jurisdiction of residence of the person which has been denied benefits so requests. This provision does not require prior agreement of the competent authorities before benefits may be denied.

Paragraph 4 contains an exception to the general denial of benefits rules of paragraph 3. A company which is a resident of a Covered Jurisdiction and which would not be entitled to benefits by virtue of paragraph 3 would, under paragraph 4, be entitled to the benefits of Article 4 if there is substantial and regular trading in its principal class of shares on a recognized stock exchange. A recognized stock exchange is defined to mean: (1) the NASDAQ System, owned by the National Association of Securities Dealers, Inc.; (2) any stock exchange registered with the Securities and Exchange Commission as a national securities exchange for purposes of the Securities Exchange Act of 1934; and (3) any other stock exchange which the competent authorities may agree is a recognized exchange.

Paragraph 5 provides that no provision of the Convention shall limit the application of any internal law provisions in either Covered Jurisdiction designed to place transactions between related enterprises on an arm's-length basis. Thus, the Convention does not limit the right of the United States to apply section 482 of the Code.

Paragraph 6 identifies the existing taxes to which Article 4 applies. In the United States, these taxes are the Federal income taxes imposed by the Code, but excluding the accumulated earnings tax (Code section 531) and the personal holding company tax (Code section 541). Paragraph 6 also covers the U.S. excise taxes on insurance premiums paid to foreign insurers; provided, however, that such excise taxes are covered only to the extent that risks covered by the premiums are not reinsured with a person not entitled to relief from such taxes under this or any other U.S. Convention. Paragraph 6 further provides that Article 4 shall also apply to any taxes imposed by the United States subsequent to July 11, 1986 which are identical or substantially similar to the taxes existing on that date and covered by the Article. Paragraph 6 does not apply to any existing taxes in Bermuda. If, however, Bermuda should impose any taxes which are identical or substantially similar to the existing U.S. taxes to which the Article applies, those Bermudian taxes would be covered by the Article to the same extent as the existing U.S. taxes. The competent authorities agree to notify each other of any significant changes in their respective tax laws and of any official published material relating to the application of the Convention, including this technical explanation.

Paragraph 7 provides that a Covered Jurisdiction may not impose more burdensome taxes on a permanent establishment in that Jurisdiction of an enterprise of insurance of the other Covered Jurisdiction than the first-mentioned Jurisdiction imposes on its own enterprises of insurance carrying on the same activities. The paragraph clarifies that the basic rule of the preceding sentence is not to be construed as obliging a Covered Jurisdiction to grant to residents of the other Covered Jurisdiction any personal allowances, reliefs, and tax reductions on account of civil status or family responsibilities which it grants to its own residents.

Notwithstanding the prohibition against discriminatory taxation with respect to permanent establishments, paragraph 7 also provides that it shall not be construed to prevent the United States from imposing an additional tax, such as the branch profits tax, on the income of a permanent establishment maintained by a resident of Bermuda in the United States.

Paragraph 7 also prohibits discrimination in the matter of deductions. Interest, royalties, and other disbursements paid by a resident of a Covered Jurisdiction to an enterprise of insurance of the other Covered Jurisdiction must be deductible disbursements for determining taxable profits of such resident in the first-mentioned Covered Jurisdiction as if they had been paid to an enterprise of insurance of such first-mentioned Jurisdiction. An exception to this rule applies where the provisions of paragraph 5 of Article 4, relating to associated enterprises, apply. The term "other disbursements" includes a reasonable allocation of executive and general administrative expenses, research and development expenses, and other expenses incurred for the benefit of a group of related enterprises.

The non-discrimination rules of paragraph 7 apply to taxes which are identified in paragraph 6 as the taxes to which Article 4 applies.

Article 5. MUTUAL ASSISTANCE IN TAX MATTERS

This Article provides that the competent authorities shall provide assistance as appropriate in carrying out the domestic laws concerning taxation. The scope of Article 5 is limited to assistance relating to the domestic tax laws of the Covered Jurisdictions. The text of Article 5 is quite brief, but a number of provisions in the Note contain further details as to the obligation to provide assistance. The provisions of the Note have the same force in law as the Convention provisions themselves. Unless otherwise indicated, references in this explanation are to the provisions of the Convention.

The first sentence of Article 5 provides that the competent authorities of the Covered Jurisdictions shall provide assistance as appropriate in carrying out the laws of the respective Covered Jurisdictions relating to the prevention of tax fraud and the evasion of taxes. The term "tax fraud" is intended to include civil tax fraud, and the term "evasion of taxes" is intended to refer to all tax crimes.

The second sentence provides that the competent authorities shall, through consultations, develop appropriate conditions, methods, and techniques for providing, and shall thereafter provide, assistance as appropriate in carrying out the fiscal laws of the respective Covered Jurisdictions other than those relating to tax fraud and the evasion of taxes. This zzsentence is intended to apply to all civil tax matters other than tax fraud.

The assistance to be provided under this Article shall particularly include the provision of information relating to tax matters. The information to be provided shall not be limited to information relating to persons resident in either of the two Covered Jurisdictions (Note, paragraph 4).

The Covered Jurisdictions have agreed that, if specifically requested by a competent authority of one Covered Jurisdiction, the competent authority of the other Covered Jurisdiction shall provide information in specified forms to be admissible in judicial proceedings of the requesting Jurisdiction (Note, paragraph 6). The specified forms include depositions of witnesses and authenticated copies of original documents (including books, papers, statements, records, accounts, and writings), but only to the extent that such depositions and documents can be obtained under the laws and administrative practices of the requested Jurisdiction. It is intended that, in appropriate cases, the United States be permitted to conduct depositions in Bermuda. Bermuda has enacted legislation which authorizes its competent authority to provide information pursuant to the Convention in the form of depositions of witnesses and authenticated copies of documents to the extent authority exists under Bermuda's laws and administrative practices to make depositions and authenticate copies (U.S.A.-Bermuda Tax Convention Act 1986, enacted August 29, 1986 (the "Bermuda Act")).

It is intended that the competent authorities of the Covered Jurisdictions use any powers available to them under their domestic law, including compulsory measures, to obtain information which is requested under the Convention. The recently enacted Bermuda Act confirms that the competent authority of Bermuda shall use such powers to implement Bermuda's information obligations under the Convention.

Where documents, records, or other materials are in the custody of a resident of Bermuda and are located in Bermuda, the United States shall, where practicable, request assistance of the competent authority of Bermuda pursuant to the provisions of the Convention before resulting to unilateral compulsory measures to obtain such information (Note, paragraph 7).

In cases where the United States requests information with respect to a matter which does not constitute a U.S. criminal or tax fraud investigation, it is intended that a senior official designated by the Secretary of the Treasury shall certify such request as being relevant to and necessary for the determination of the tax liability of a U.S. taxpayer, or the criminal tax liability of a person under the laws of the United States (Note, paragraph 4). It is currently intended that this official be a senior official in the Internal Revenue Service, the Assistant Commissioner (International).

In cases where the United States requests information with respect to a matter, whether civil or criminal, which relates to a person not resident in the United States or Bermuda, it is also intended that a senior official designated by the Secretary of the Treasury shall certify such request as being relevant to and necessary for the determination of the tax liability of a U.S. taxpayer, or the criminal tax liability of a person under the laws of the United States (Note, paragraph 4)). In addition, the U.S. competent authority shall establish to the satisfaction of the competent authority of Bermuda that such assistance is necessary for the proper administration of the fiscal laws of the United States. Where such necessity has been duly established, the competent authorities shall consult as to the appropriate form of the assistance to be provided (Note, paragraph 4).

The United States has agreed, based upon the information exchange provisions of the Convention and the Note, that the Secretary of the Treasury or his delegate will be prepared, upon the entry into force of the Convention, to certify Bermuda for purposes of section 927(e)-(3) of the Code such that a company organized under the laws of Bermuda may qualify as a Foreign Sales Corporation (FSC) (Note, paragraph 11). The United States has also agreed that, upon entry into force of the Convention, the Secretary of the Treasury or his delegate will be prepared to execute on behalf of the United States Government an executive agreement satisfying the requirements of section 274(h)(6)(C) of the Code, which would incorporate by reference the provisions of Articles 5 and 6 of the Convention and of the Note, and would allow persons incurring expenses for attending business conventions in Bermuda to claim deductions for such expenses as though Bermuda were included as part of the "North American area" (Note, paragraph 11).

The parties have agreed that the provisions of Article 5 shall not impose on Bermuda the obligation to provide information which, in the hands of the person from whom the information is sought, is subject to the common law solicitor-client privilege in Bermuda (Note, paragraph 5).

As of the date of signature of the Convention, Bermuda did not have in force any taxation laws which would serve as the basis for a request for assistance under the Convention.

Article 6. CONFIDENTIALITY

This Article provides that the assistance provided (including the information exchanged) pursuant to the provisions of Article 5 (Mutual Assistance in Tax Matters) shall be treated as confidential in the same manner as such matters or items would be under the domestic laws of the Covered Jurisdiction requesting the assistance. Thus, the limitations on disclosure of any tax return or return information under section 6103 of the Code shall apply to information received from Bermuda. The Convention provides, in addition, that the disclosure and use of such information shall be limited in the United States to those persons or authorities (including courts and administrative bodies) involved in the assessment, collection, or administration of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, taxes. In Bermuda, information can be disclosed only to the Minister of Finance or his delegate. The persons to whom information is disclosed in either Jurisdiction may use such information only for purposes of the assessment, collection, or administration of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, taxes. Such information may be disclosed in public court proceedings or public decisions, but shall not be disclosed to any country other than one of the Covered Jurisdictions for any purpose.

The provisions of Article 6 authorize the U.S. competent authority to allow access to information to persons involved in the administration of taxes covered in the Convention. Such persons include legislative bodies involved in the administration of taxes and their agents, such as, for example, the General Accounting Office (GAO), when the GAO is engaged in a study of the administration of U.S. tax laws pursuant to a directive of Congress. The secrecy requirements of Article 6 must, however, be met. Also, matters that are the subject of assistance under the Convention but that are made public in accordance with the Convention shall not be further subject to Article 6 (Note, paragraph 9).

Article 7. ENTRY INTO FORCE AND TERMINATION

Paragraph 1 provides that the Convention be subject to ratification in accordance with the applicable procedures of each party, and that the instruments of ratification be exchanged as soon as possible. The parties intend that instruments of ratification not be exchanged until Bermuda has enacted such legislation as may be required to implement the provisions of the Convention. The Bermuda Act meets this requirement.

Paragraph 2 provides, that the Convention will enter into force upon the exchange of instruments of ratification. Once the Convention enters into force it shall have effect:

1. in respect of excise taxes on insurance premiums paid to foreign insurers, for premiums paid or credited on or after January 1, 1986;

2. in respect of income taxes imposed on the business profits derived by an enterprise of insurance, for such profits derived in taxable years beginning on or after the first day of the calendar year in which the Convention enters into force;

3. in respect of mutual assistance covered by the first sentence of Article 5 (Mutual Assistance in Tax Matters) (i.e., the sentence relating to tax fraud and the evasion of taxes), for taxable years not barred by the statute of limitations of the Covered Jurisdiction requesting such assistance; provided, however, that neither Covered Jurisdiction shall be required by Article 5 to provide such assistance with respect to taxable years beginning prior to January 1, 1977, and

4. in respect of mutual assistance covered by the second sentence of Article 5 and not also described in the first sentence (i.e., the sentence relating to nonfraudulent civil tax matters), for taxable years not barred by the statute of limitations of the Covered Jurisdiction requesting such assistance; provided, however, that neither Covered Jurisdiction shall be required by Article 5 to provide such assistance with respect to:

a. taxable years beginning prior to January 1, 1977; or

b. taxable years beginning prior to the entry into force of the Convention if the provisions of such assistance would cause or result in the breach of an obligation to maintain confidentiality of information under the laws of such Jurisdiction in effect on the date of signature of the Convention.

Thus, for purposes of Article 5 (Mutual Assistance in Tax Matters), Bermuda is not required to provide any information relating to taxable years beginning before January 1, 1977. For any requests involving criminal or civil tax fraud matters, Bermuda is required to provide information pursuant to Article 5 with respect to any taxable years beginning on or after January 1, 1977 (subject to the solicitor-client privilege exception noted above).

With respect to information requests involving nonfraudulent civil tax matters, Bermuda is required to provide information relating to taxable years beginning on or after January 1, 1977 but before the entry into force of the Convention only if the provision of such information would not cause or result in the breach, by the person from whom the information is sought, of any obligation to maintain confidentiality of information pursuant to the laws of Bermuda in existence on July 11, 1986. This protection extends only to information protected by Bermudian statutory and common law. Thus, information properly subject to the Bermudian common law solicitor-client or banker-client privilege would be eligible for such protection. If a taxpayer claims that other categories of information are protected under the common law of Bermuda, it is agreed that the Government of Bermuda will have such a claim determined in the courts of Bermuda if the United States so requests.

For requests relating to nonfraudulent civil tax matters arising in taxable years beginning after the entry into force of the Convention, Bermuda would be required to provide any information not protected by the solicitor-client privilege unless:

1. the documents or information sought was created in or derived from periods prior to the entry into force of the Convention;

2. the provision of such assistance would require Bermuda to cause the person from whom such documents or information is sought to breach a legal obligation to maintain confidentiality of such documents or information, properly asserted by such person under the laws of Bermuda as in effect on July 11, 1986; and

3. such documents or information is not of a kind that has a continuing operational effect (Note, paragraph 5(iv)).

However, the Note provides that if such pre-existing documentation is relevant to a request involving a post-effective date taxable year and does have a continuing operational effect, it will be subject to information exchange under the Convention. For example, if assistance is requested with respect to a taxpayer's bank transactions occurring after the entry into force of the Convention and the signature card for the account in question was executed prior to the entry into force of the Convention, Bermuda's obligation to provide assistance with respect to such a signature card would not be affected by confidentiality restrictions. Similarly, if a taxpayer's depreciation deduction for a year after entry into force of the Convention is under examination, Bermuda's obligation to provide assistance with respect to information about the purchase price of the property in question, if such property was acquired before the entry into force of the Convention, would not be affected by any confidentiality restrictions of Bermudian law.

Paragraph 2 provides that the Convention shall remain in force indefinitely unless terminated by one of the parties. Either party may terminate the Convention by giving notice to the other party on or after June 30 of the year following the calendar year in which the Convention enters into force. In that event, the Convention shall terminate on the first day of the seventh full calendar month following that in which the notice is given.

September 22, 1986

AGREEMENT BETWEEN THE GOVERNMENT OF THE UNITED STATES OF AMERICA AND THE GOVERNMENT OF THE UNITED KINGDOM OF GREAT BRITAIN AND NORTHERN IRELAND (ON BEHALF OF THE GOVERNMENT OF BERMUDA) FOR THE EXCHANGE OF INFORMATION WITH RESPECT TO TAXES

The Government of the United States of America and the Government of the United Kingdom of Great Britain and Northern Ireland (on behalf of the Government of Bermuda), in order to implement the Mutual Assistance in Tax Matters provisions of the Convention between the Government of the United States of America and the Government of the United Kingdom of Great Britain and Northern Ireland (on behalf of the Government of Bermuda) relating to the Taxation of Insurance Enterprises and Mutual Assistance in Tax Matters, with a related exchange of notes, signed at Washington on July 11, 1986, desire to conclude an Agreement for the exchange of information with respect to taxes (hereinafter referred to as the "Agreement"), and have agreed as follows:

ARTICLE 1
TAXES COVERED

1. This Agreement shall apply to the following taxes imposed by or on behalf of a Covered Jurisdiction:

a) in the case of the United States of America,

(i) Federal income taxes,

(ii) Federal taxes on self-employment income,

(iii) Federal taxes on transfers to avoid income tax,

(iv) Federal estate and gift taxes,

(v) Federal excise taxes; and

b) in the case of Bermuda,

(i) any tax imposed by Bermuda which is substantially similar to the existing United States taxes to which this Agreement applies.

2. This Agreement shall apply also to any identical or substantially similar taxes imposed after the date of signature of this Agreement in addition to or in place of the existing taxes. The competent authority of a Covered Jurisdiction shall notify the competent authority of the other Covered Jurisdiction of any significant changes in laws which may affect the obligations of that Covered Jurisdiction pursuant to the Agreement and of any official published material relating to the application of the Agreement.

3. This Agreement shall not apply to the extent that an action or proceeding concerning taxes covered by this Agreement is barred by the applicant Jurisdiction's statute of limitations.

4. This Agreement shall not apply to taxes imposed by states, municipalities or other political subdivisions, or possessions of a Covered Jurisdiction.

ARTICLE 2
DEFINITIONS

1. In this Agreement, unless otherwise defined:

a) The term "company" means any body corporate or any entity which is treated as a body corporate for tax purposes.

b) The term "competent authority" means:

(i) in the case of the United States of America, the Secretary of the Treasury or his delegate; and

(ii) in the case of Bermuda, the Minister of Finance or his delegate.

c) The term "Covered Jurisdiction" means the United States of America or Bermuda, as the context requires.

d) The term "national" means:

(i) in the case of the United States, any United States citizen and any legal person, partnership, company, trust, estate, association, or other entity deriving its status as such from the laws in force in the United States; and

(ii) in the case of Bermuda, any legal person, partnership, company, trust, estate, association, or other entity deriving its status as such from the laws in force in Bermuda.

e) The term "resident" means:

(i) in the case of the United States:

(a) any person, other than a company, resident in the United States for the purpose of United States tax; but in the case of a partnership, estate or trust, only to the extent that the income derived by such partnership, estate or trust is subject to United States tax as the income of a resident, either in its hands or in the hands of its partners or beneficiaries; and

(b) a company created under the laws of the United States or a political subdivision thereof; and

(ii) in the case of Bermuda:

(a) an individual who has the status of a legal resident of Bermuda; and

(b) a company, partnership, trust, or association created under the laws of Bermuda.

f) The term "person" includes an individual and a partnership, company, trust, estate, association or other legal entity.

g) For purposes of determining the geographical area within which jurisdiction to require production of information may be exercised,

(i) the term "United States" means the United States of America, but does not include Puerto Rico, the Virgin Islands, Guam or any other United States possession or territory, and

(ii) the term "Bermuda" means the islands in the Atlantic Ocean known as Bermuda.

h) The term "tax" means any tax to which the Agreement applies.

i) The term "information" means any fact or statement, in any form whatever, that is relevant or material to tax administration and enforcement, including (but not limited to):

(i) testimony of an individual, and

(ii) documents or records of a person or Covered Jurisdiction.

j) The terms "applicant Jurisdiction" and "requested Jurisdiction" mean, respectively, the Covered Jurisdiction applying for or receiving information and the Covered Jurisdiction providing or requested to provide such information.

2. Any term not defined in this Agreement, unless the context otherwise requires or the competent authorities agree to a common meaning, shall have the meaning which it has under the laws of the Covered Jurisdiction relating to the taxes which are the subject of this Agreement.

3. To the extent that any requirement contained in Articles 3 or 5 of this Agreement conflicts with the provisions of the Convention between the Government of the United States of America and the Government of the United Kingdom of Great Britain and Northern Ireland (on behalf of the Government of Bermuda) relating to the Taxation of Insurance Enterprises and Mutual Assistance in Tax Matters, (the "Convention",) with a related exchange of notes, signed at Washington on July 11, 1986, the provisions of said Convention and said notes shall prevail.

ARTICLE 3
EXCHANGE OF INFORMATION

1. The competent authorities of the Covered Jurisdictions shall provide assistance as appropriate in carrying out the laws of the respective Covered Jurisdic-

tions relating to the prevention of tax fraud and the evasion of taxes.

2. The competent authorities of the Covered Jurisuictions shall, through consultations, develop appropriate conditions, methods, and techniques for providing, and shall thereafter provide, assistance as appropriate in carrying out the fiscal laws of the respective Covered Jurisdictions other than those relating to tax fraud and the evasion of taxes.

3. Where a Covered Jurisdiction requests information with respect to a matter which (i) relates to a person not resident in one of the Covered Jurisdictions or (ii) does not constitute a criminal or tax fraud investigation, a senior official designated by the Secretary of the Treasury or the Minister of Finance respectively, of the applicant Jurisdiction shall certify such request as being relevant to and necessary for the determination of the tax liability of a taxpayer of the applicant Jurisdiction, or the criminal tax liability of a person under the laws of the applicant Jurisdiction. If information is requested relating to persons not resident in one of the two Covered Jurisdictions, it also shall be established to the satisfaction of the competent authority of the requested Jurisdiction that such information is necessary for the proper administration and enforcement of the fiscal laws of the applicant Jurisdiction. Where such necessity has been duly established, the competent authorities shall consult as to the appropriate form of assistance.

4. If specifically requested by the competent authority of one of the Covered Jurisdictions, the competent authority of the other Covered Jurisdiction shall provide information in specified forms to be admissible in judicial or administrative proceedings of the applicant Jurisdiction to the same extent that such specified forms can be obtained under the laws and administrative practices of the requested Jurisdiction. The specified forms shall include depositions of witnesses and authenticated copies of original documents, including books, papers, statements, records, accounts, and writings.

5. Where documents, records, or other materials are in the custody of a resident of a Covered Jurisdiction and are located in such Covered Jurisdiction, the other Covered Jurisdiction shall, where practicable, request assistance of the competent authority of the Covered Jurisdiction where such documents, records, or other materials are located before resorting to unilateral compulsory measures to obtain such information.

6. The provisions of this Article shall not impose on either Covered Jurisdiction the obligation to provide information which is subject to the solicitor-client (or attorney-client) privilege in the hands of the person from whom the information is sought. Notwithstanding paragraph 9(b) of this Article, and except as provided in Article 5, no other privilege or confidentiality restriction shall be recognized for the purposes of this Agreement. Claims of privilege under the laws or practices of the applicant Jurisdiction shall be determined exclusively by the courts of that Jurisdiction, and claims of privilege under the laws or practices of the requested Jurisdiction shall be determined exclusively by the courts of that Jurisdiction.

7. The information received by an applicant Jurisdiction pursuant to this Agreement shall be treated as confidential in the same manner as such information or matters would be treated under the domestic laws of the applicant Jurisdiction.

8. The disclosure and use of information exchanged pursuant to this Agreement shall be limited to those persons or authorities (including courts and administrative bodies) involved in the assessment, collection, or administration of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, taxes. The persons to whom such information is disclosed may use the information only for purposes of the assessment, collection, or administration of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, taxes. Information exchanged pursuant to this Agreement may be disclosed in public court proceedings or public decisions of either Covered Jurisdiction but shall not be disclosed to any country, for any purpose, other than one of the Covered Jurisdictions.

9. The provisions of the preceding paragraphs shall not be construed so as to impose on a Covered Jurisdiction the obligation:

(a) to carry out administrative measures at variance with the laws and administrative practices of that Jurisdiction or of the other Covered Jurisdiction;

(b) to supply particular items of information which are not obtainable under the laws of that Jurisdiction or of the other Covered Jurisdiction;

(c) to supply information which would disclose any trade, business, industrial, commercial or professional secret or trade process;

(d) to supply information, the disclosure of which would be contrary to public policy;

(e) to supply information requested by the applicant Jurisdiction to administer or enforce a provision of the tax laws of the applicant Jurisdiction, or any requirement connected therewith, which discriminates against a national of the requested Jurisdiction. A provision of tax law, or connected requirement, will be considered to be discriminatory against a national of the requested Jurisdiction if it is more burdensome with respect to a national of the requested Jurisdiction than with respect to a national of the applicant Jurisdiction in the same circumstances. For the purposes of the preceding sentence, a national of the applicant Jurisdiction who is subject to tax on worldwide income is not in the same circumstances as a national of the requested Jurisdiction who is not subject to tax on worldwide income. The provisions of this subparagraph shall not be construed to prevent the exchange of information with respect to the taxes imposed by a Covered Jurisdiction on branch profits or the excess interest of a branch or on the premium income of foreign insurers.

Except as provided in this paragraph, the provisions of Article 3 shall be construed so as to impose on a Covered Jurisdiction the obligation to use all legal means and its best efforts to execute a request.

ARTICLE 4
OTHER APPLICATIONS OF THE AGREEMENT

This Agreement is consistent with the standards for an exchange of information agreement described in Section 274(h)(6)(C) of the United States Internal Revenue Code of 1986 (the "Code") (relating to deductions for attendance at foreign conventions), and referred to by cross-reference in Section 927(e)(3)(A) of the Code (relating to foreign sales corporations).

ARTICLE 5
ENTRY INTO FORCE

1. This Agreement shall enter into force upon signature by the duly authorized representatives of the Covered Jurisdictions and its provisions shall have effect:

(a) in respect of information covered by paragraph 1 of Article 3, for taxable years not barred by the statute of limitations of the applicant Jurisdiction, provided, however, that neither Covered Jurisdiction shall be required to provide information with respect to taxable years beginning prior to January 1, 1977;

(b) in respect of information covered by paragraph 2 (and not also covered by paragraph 1) of Article 3, for taxable years not barred by the statute of limitations of the applicant Jurisdiction, provided that such assistance is not with respect to:

(i) taxable years beginning prior to January 1, 1977; or

(ii) taxable years beginning prior to the entry into force of this Agreement (but beginning on or after January 1, 1977) if the provision of such assistance would cause or result in the breach of an obligation to maintain confidentiality of information under the laws of the requested Jurisdiction in effect on the date of signature of the Convention. For purposes of this subsection, confidential information includes information protected by the common law solicitor-client privilege and banker-client privilege. If a taxpayer claims that other categories of information are protected under the common law of the requested Jurisdiction, and if the applicant Jurisdiction so requests, the government of the requested Jurisdiction shall have such claim determined in the courts of the requested Jurisdiction; and

(c) in respect of information covered by paragraph 2 (and not also covered by paragraph 1) of Article 3, for taxable years beginning after the entry into force of this Agreement unless:

(i) the document or information sought was created in or derived from periods prior to the entry into force of this Agreement;

(ii) the provision of such assistance would require the requested Jurisdiction to cause the person from whom such document or information is sought to breach a legal obligation to maintain confidentiality of such document under the laws of the requested Jurisdiction as in effect on July 11, 1986; and

(iii) such document or information is not of a kind that has a continuing operational effect.

ARTICLE 6
AMENDMENT AND TERMINATION

1. This Agreement may be modified or amended by the mutual consent of the competent authorities of the Covered Jurisdictions.

2. This Agreement shall continue in force indefinitely, but either party may give notice of termination to the other party on or after June 30 of the year following the calendar year in which this Agreement is executed and in such event the Agreement shall terminate on the first day of the seventh full calendar month following that in which the notice is given.

Done at Washington, in duplicate, this second day of December, 1988.

FOR THE GOVERNMENT OF THE UNITED STATES OF AMERICA

George P. Shultz

(George P. Shultz)

FOR THE GOVERNMENT OF THE UNITED KINGDOM OF GREAT BRITAIN AND NORTHERN IRELAND (ON BEHALF OF THE GOVERNMENT OF BERMUDA)

John Swan
(John Swan)

TAX IMPLEMENTATION AGREEMENT BETWEEN THE UNITED STATES OF AMERICA AND GUAM

The Government of the United States of America and the Government of Guam desiring to conclude an Agreement (hereinafter referred to as the "Agreement") for the exchange of information and mutual assistance with respect to taxes in order to prevent the evasion or avoidance of United States or Guam taxes have agreed as follows:

Article 1
SCOPE OF AGREEMENT

This Agreement is intended to provide for mutual assistance in tax matters, including exchanges of information, for purposes of administering the tax laws of the respective Governments and especially to prevent avoidance or evasion of the Governments' respective fiscal laws. This Agreement is the implementing agreement described in Sections 1271 and 1277 of the Tax Reform Act of 1986, Public Law 99-514. The provisions of this Agreement are subject to provisions of the statutes, regulations, and published procedures of the Contracting Governments.

Upon entry into force, this Agreement replaces any and all prior tax coordination agreements and implementing agreements between the respective Governments.

Article 2
TAXES COVERED

1. This Agreement shall apply to the following taxes imposed by or on behalf of a Contracting Government:

a. in the case of the United States of America, all taxes imposed by the Code, and

b. in the case of Guam, all taxes imposed by the Code as it applies in Guam and all income taxes imposed by Guam as authorized by the Tax Reform Act of 1986.

2. This Agreement shall apply also to any identical or substantially similar taxes imposed after the date of signature of the Agreement in addition to or in place of the existing taxes. The competent authority of each Government shall notify the other of significant changes in laws which may affect the obligations of that Government pursuant to this Agreement.

3. This Agreement shall not apply to the extent that an action or proceeding concerning taxes covered by this Agreement is barred by the applicant Government's statute of limitations.

Article 3
DEFINITIONS

1. In this Agreement, unless otherwise defined:

a. The term "Code" shall mean the Internal Revenue Code of 1986, as amended, and any predecessor or successor statutes.

b. The term "competent authority" means:

i. in the case of the United States of America, the Secretary of the Treasury or his delegate, and

ii. in the case of Guam, the Director of the Department of Revenue and Taxation or his delegate.

c. The term "Contracting Government" means the United States or Guam as the context requires.

d. The term "non-Guam source income" means income for which the source (under source rules set forth in the Code or promulgated consistently with the Code by the Internal Revenue Service) is not Guam.

e. The term "person" includes an individual and a partnership, corporation, company, trust, estate, association or other legal entity.

f. The term "tax" means any tax to which the Agreement applies.

g. The term "taxpayer" means:

i. in the case of the United States, any person subject to the provisions of the Code, and

ii. in the case of Guam, any person subject to the provisions of the Code as it applies in Guam or any income tax laws imposed by Guam.

h. For purposes of determining the geographical area in respect of which jurisdiction to compel production of information under this Agreement may be exercised, the term "United States" means the United States of America, including Puerto Rico, American Samoa, the Virgin Islands, the Commonwealth of the Northern Mariana Islands, and any other United States possession or territory and the territorial waters thereof, but not including Guam. Such jurisdiction may be exercised if the information or the custodian of the information is located within the United States.

i. For purposes of determining the geographical area in respect of which jurisdiction to compel production of information under this Agreement may be exercised, the term "Guam" means the territorial domain, lands and waters acquired by the United States through cession of the Territory of Guam by the Treaty of Paris between the United States of America and Spain entered into in 1898. Such jurisdiction may be exercised if the information or the custodian of the information is located within Guam.

2. Any term not defined in this Agreement, unless the context otherwise requires or the competent authorities agree to a common meaning pursuant to the provisions of Article 5, shall have the meaning which it has under the laws of the Contracting Governments relating to the taxes which are the subject of this Agreement.

Article 4
EXCHANGE OF INFORMATION

1. The competent authorities of the Contracting Governments shall exchange information to administer and enforce the domestic laws of the Contracting Governments concerning taxes covered by this Agreement. Information shall be exchanged to fulfill the purposes of this Agreement without regard to whether the information relates to, or is held by a taxpayer of a Contracting Government. Procedures for exchange of information are set forth in Appendix A, Limitations on Disclosure of Tax Information, which is incorporated by reference and made a part of this Agreement.

2. The competent authorities of the Contracting Governments shall automatically transmit information to each other for the purposes referred to in paragraph 1. The competent authorities shall determine the items of information to be exchanged pursuant to this paragraph and the procedures to be used to exchange such items of information.

a. It is intended that the United States shall routinely supply to Guam the following information, to the extent available and subject to the tolerances and criteria to be agreed upon by the competent authorities:

i. copies of reports of individual, partnership, corporate, and employment audit changes (with associated reports of experts) that disclose information relevant to Guam;

ii. copies of Forms 5335 (Income Subject to Withholding under Chapter 3, Internal Revenue Code, as reported on Form 1042S, and any successor or comparable forms) that disclose information relevant to Guam;

iii. copies of Schedule K-1 of Form 1065 (U.S. Partnership Return of Income) and audit results, when the partnership return is examined and it appears the examination will affect returns of Guam taxpayers;

iv. copies of responses to Forms 4901, 4902, and 4903, Requests for Information About Tax Forms, where such reply indicates that the taxpayer has filed a return with Guam;

v. copies of Forms 1099 and all other information returns where the recipient of income is a Guam resident or lists a Guam address or the income is from Guam sources;

vi. copies of the W-2 combined wage reporting tape summarizing Forms W-2G (Guam Wage and Tax Statement) and Forms W3SS (Transmittal of Wage and Tax Statements) filed with the Social Security Administration by employers in Guam, which tape is provided annually to the Internal Revenue Service by the Social Security Administration; and

vii. copies of Forms 8279 (Election to be Treated as a FSC or as a Small FSC) that indicate creation or organization of any Foreign Sales Corporation (as defined in Section 922 of the Code) in Guam.

b. It is intended that Guam shall routinely supply to the United States the following information, to the extent available and subject to the tolerances and criteria to be agreed upon by the competent authorities:

i. copies of reports of individual partnership, corporate, and employment audit changes (with associated reports of experts) that disclose information relevant to the United States;

ii. information about the ownership interests of all corporations subject to the Guam tax with non-Guam source income that receive a rebate, subsidy or reduction of Guam taxes;

iii. information about any taxpayer subject to the Guam tax with non-Guam source income who files an income tax return with Guam claiming for the first time to be a Guam resident;

iv. all corporate information about ownership interests in any Foreign Sales Corporation (as defined in Section 922 of the Code) established in Guam;

v. such information about corporations electing application of Section 936 of the Code as may be agreed upon by the competent authorities; and

vi. information about any rebates, subsidies or reductions of tax provided by Guam for income derived by a Guam taxpayer from other United States possessions.

c. The competent authorities of the Contracting Governments may agree to expand or limit the information to be routinely exchanged.

3. The competent authority of a Contracting Government shall spontaneously transmit to the competent authority of the other Government information which has come to the attention of the first-mentioned Government and which is likely to be relevant to, and bear significantly on, administration and enforcement of the domestic laws concerning taxes of the second-mentioned Government. The competent authorities shall determine the information to be exchanged pursuant to this paragraph and take such measures

and implement such procedures as are necessary to ensure that the information is forwarded to the competent authority of the other Government.

4. The competent authority of the requested Government shall endeavor to provide information upon request by the competent authority of the applicant Government for the administration and enforcement of the domestic laws of the Contracting Governments concerning taxes. If the information available in the tax files of the requested Government is not sufficient to enable compliance with the request, that Government shall take the necessary measures to provide the applicant Government with the information requested. If information is requested by a Contracting Government in accordance with this Article, the other Contracting Government shall obtain the information to which the request relates in the same manner (including issuance and enforcement of administrative summonses) and to the same extent as if the tax of the first-mentioned Government were the tax of that other Government and were being imposed by that other Government. Notwithstanding the foregoing, the United States may exercise its rights under Section 7602 *et. seq.* of the Code to obtain information in Guam without resorting to the procedures set forth in this Agreement. However, in the event the United States so exercises its rights within the territory of Guam, it shall notify the competent authority of Guam prior to taking action or as soon as practicable, unless the competent authorities agree to limit notification with respect to certain classes of cases.

5. The provisions of the preceding paragraphs shall not be construed so as to impose on a Contracting Government the obligation:

a. to supply particular items of information which are not obtainable under the laws of that Government or of the other Contracting Government;

b. to supply information which would disclose any trade, business, industrial, commercial or professional secret or trade process;

c. to supply information, the disclosure of which would be contrary to public policy; or

d. to disclose information if such disclosure would identify a confidential informant or seriously impair a civil or criminal tax investigation.

6. Any information received by a Contracting Government shall be subject to Appendix A, Limitations on Disclosure of Tax Information.

Article 5
MUTUAL AGREEMENT PROCEDURE AND COSTS

1. The competent authorities of the Contracting Governments shall implement a program to carry out the purposes of this Agreement. In particular, the competent authorities of the Contracting Governments may amend Appendix A, by mutual agreement, as they deem necessary within the limitations of this Agreement and the Code.

2. The competent authorities of the Contracting Governments shall endeavor to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of this Agreement and may communicate directly for this purpose. In particular, the competent authorities may agree to the common meaning of a term and may determine when costs are extraordinary for purposes of this Article.

3. Unless the competent authorities of the Contracting Governments otherwise agree, ordinary costs incurred in providing assistance shall be borne by the requested Government and extraordinary costs incurred in providing assistance shall be borne by the applicant Government. The competent authorities of the Contracting Governments may agree not to charge each other for the costs of reproduction of information routinely exchanged.

Article 6
MUTUAL AGREEMENT PROCEDURE ON POTENTIAL DOUBLE TAXATION

1. When by reason of inconsistent positions taken by the Contracting Governments, a taxpayer is or would be subject to inconsistent tax treatment by the two jurisdictions, the competent authorities of the Contracting Governments shall endeavor to agree upon the facts and circumstances necessary to achieve consistent application of the tax laws of the respective Governments. In particular, but not by way of limitation, the competent authorities of the Contracting Governments may consult together to endeavor to agree:

a. To the same allocation of income under Section 482 of the Code;

b. To the same determination of residency of a particular taxpayer; or

c. To the same determination of the source of particular items of income.

Article 7
OTHER APPLICATIONS OF AGREEMENT

1. The Contracting Governments agree that when they have knowledge that a taxpayer has changed residence from one taxing jurisdiction to the other and seeks to change methods of accounting (or to make an initial election), no such change or election shall be permitted until the competent authorities have consulted and determined that such change or election will not lead to the evasion or avoidance of taxes imposed by either of the Contracting Governments. This paragraph includes initial adoption of an accounting method or an election inconsistent with a method or election previously utilized in the other jurisdiction by the taxpayer.

2. The Contracting Governments agree that a Guam corporation owned or controlled directly or indirectly by a person whose beneficial ownership is undisclosed (such as through bearer shares) shall be treated as owned or controlled to that extent by a foreign person for purposes of the respective Governments' tax laws.

3. The Contracting Governments agree that for purposes of determining whether a person qualifies as a bona-fide resident of Guam under Section 931 of the Code the definition to be used shall be the definition contained in the then-applicable regulations promulgated by the United States.

4. The Contracting Governments agree that the United States may use its regulatory authority over sourcing rules under Sections 931(d)(2) and 7654(e) of the Code to determine that certain income is U.S. source income. The United States will consult as appropriate with the competent authority of Guam before issuing final regulations under Sections 931 or 7654 of the Code that affect Guam taxation.

5. Any taxpayer information disclosed to the United States shall become "taxpayer return information" as defined by Section 6103(b)(3) of the Code and may be redisclosed only in accordance with provisions of the Code or an applicable treaty.

6. Subject to the restrictions and other provisions of this Agreement and the availability of enforcement resources, the competent authorities will develop a cooperative return selection and examination program with the objective of avoiding unnecessary duplication of examination coverage.

7. Subject to the restrictions and other provisions of this Agreement, the Contracting Governments will develop a simultaneous examination program for both civil and criminal investigations.

8. To the extent permitted by law and subject to the availability of enforcement resources, the United States will assist in collecting taxes, together with interest and additions to tax, owed to Guam by Guamanian taxpayers present in the United States. The competent authorities will discuss appropriate procedures for facilitating such collections. Any taxes collected shall be remitted to Guam, less the reasonable expenses incurred in collection.

9. In addition to the exchange of tax and other information, the competent authorities will, to the extent feasible, extend to each other assistance in other tax administration matters. This may include such activities as taxpayer assistance, stocking tax forms for the public, training of personnel, preparing special statistical studies and compilations of data, lending of skilled personnel for limited periods, conducting public education programs with regard to tax law changes made by the Tax Reform Act of 1986 and subsequent legislative revisions, and development and improvement of tax administration systems and procedures, as well as such other activities as may improve tax administration.

Article 8

ENTRY INTO FORCE

This Agreement shall enter into force on January 1, 1991 or on such earlier date as may be mutually agreed to by the Contracting Governments.

Article 9

AMENDMENT AND TERMINATION

1. This Agreement may be modified or amended by mutual consent of the Contracting Governments.

2. This Agreement shall remain in force until terminated by one of the Contracting Governments. Either Contracting Government may terminate the Agreement at any time after the Agreement enters into force provided that at least six (6) months' prior notice of termination has been given.

3. Any unauthorized use or disclosure of Federal returns or Federal return information as defined by Section 6103(b)(1) and (2) of the Code furnished pursuant to this Agreement or inadequate procedures for safeguarding the confidentiality of such returns and return information, constitutes grounds for immediate termination of this Agreement and the exchange of information thereunder, subject to the rights of administrative appeal as provided by regulations prescribed by Section 6103(p)(7) of the Code.

DONE by the Government of Guam at Agana, Guam, In duplicate, this 3rd day of April, 1989.

FOR THE GOVERNMENT OF GUAM

JOSEPH F. ADA,
Governor of Guam.

JOAQUIN G. BLAZ,
Director, Department of
Revenue and Taxation
Government of Guam.

DONE by the Government of the United States of America at Washington, D.C., in duplicate, this 5th day of April, 1989.

FOR THE GOVERNMENT OF THE UNITED STATES OF AMERICA

J.G. WILKINS,
Assistant Secretary (Tax Policy)
Department of the Treasury.

APPENDIX A
LIMITATIONS ON DISCLOSURE OF TAX INFORMATION

SECTION 1. Definitions

For purposes of this appendix, the following definitions apply:

1.1 Department. The term **"Department"** means the Department of Revenue and Taxation, Government of Guam and any successor agency.

1.2 The term **"IRS"** means the Internal Revenue Service, U.S. Department of Treasury.

1.3 Possession Audit Agency. The term **"Possession Audit Agency"** means the agency, body or commission which is charged under the laws of Guam with the responsibility of auditing Possession revenues and programs.

1.4 Possession. The term **"Possession"** means Guam.

1.5 Department Representative. The term **"Department Representative"** means a Department officer or employee designated in writing by the head of the Department, to the Assistant Commissioner (International) at Washington, D.C. and the Service Center Director at Philadelphia, PA, as an individual who is to inspect or receive Federal returns or Federal return information on behalf of the Department as provided by Section 6103(d) of the Code, but only so long as the duties and employment of such officer or employee require access to Federal returns and Federal return information for purposes of Possession tax administration.

1.6 IRS Representative. The term **"IRS Representative"** means an officer or employee of the IRS who has been designated in writing to the head of the Department by the Assistant Commissioner (International) at Washington, D.C., or the Service Center Director at Philadelphia, PA, as an individual who is to inspect or receive Possession returns or Possession return information on behalf of the IRS, but only so long as the duties and employment of such officer or employee require access to Possession returns and return information for the purpose of Federal tax administration.

1.7 Federal Return. The term **"Federal Return"** is defined in the same manner as provided in Section 6103(b)(1) of the Code.

1.8 Federal Return Information. The term **"Federal Return Information"** is defined in the same manner as provided in Section 6103(b)(2) of the Code. However, "Federal Return Information" does not include information in the hands of the Possession which it obtained wholly from sources independent from the IRS.

1.9 Possession Return. The term **"Possession Return"** is defined in the same manner as provided in Section 6103(b)(1) of the Code as it applies in Guam.

1.10 Possession Return Information. The term **"Possession Return Information"** means a taxpayer's identity, the nature, source, or amount of his/her income, payments, receipts, deductions, exemptions, credits, assets, liabilities, net worth, tax liability, tax withheld, deficiencies, overassessments, or tax payments, whether the taxpayer's Possession return was, is being, or will be examined or subject to other investigation or processing, or any other data received by, recorded by, prepared by, furnished to, or collected by the Department with respect to a Possession return or with respect to determination of the existence, or possible existence, of liability (or the amount thereof) of any person under the internal revenue laws, or related statutes, of the Possession, for any tax, penalty, interest, fine, forfeiture, or other imposition, or offense.

1.11 Inspection. The term **"Inspection"** means any examination of a return or return information.

1.12 Disclosure. The term **"Disclosure"** means the making known to any person in any manner whatever a return or return information.

1.13 Possession Tax Administration. The term **"Possession Tax Administration."**

a. means ...

i. the administration, management, conduct, direction, and supervision of the execution and application of the revenue laws, or related statutes of the Possession, and

ii. the development and formulation of Possession tax policy relating to existing or proposed internal revenue laws, or related statutes, of the Possession; and

b. includes assessment, collection, enforcement, litigation, publication, and statistical-gathering functions under such laws or statutes.

1.14 Code. The term **"Code"** means the Internal Revenue Code of 1986, as amended, and any predecessor or successor statutes.

SECTION 2. Disclosure of Federal Returns and Federal Return Information

2.1 Pursuant to the laws of the Possession, the Department is charged with the responsibility for the administration of Possession taxes imposed on income, inheritance, gifts, gross receipts from the conduct of a trade or business, real property and excise taxes on imports used in the conduct of a trade or business. Federal returns, and Federal return information (whether originals, paper copy, photocopy, microfilm, magnetic media, or any other form) received from the IRS will be used for the purpose of, and only to the extent necessary in, Possession tax administration.

2.2 This Agreement and Appendix constitute the requisite authorization pursuant to Section 6103(d)(1) of the Code for the IRS to disclose to, and permit inspection by, a Department Representative of Federal returns and Federal return information relating to taxes imposed by chapters one, two, six, eleven, twelve, twenty-one, twenty-three, twenty-four, thirty-one, thirty-two, forty-four, forty-five, fifty-one, fifty-two, and subchapter D of chapter thirty-six of the Code.

2.3 Upon the occurrence of any change in employment, duties, or other relevant matters affecting a Department Representative's right to access to Federal returns and Federal return information or status as a Department Representative, the head of the Department shall promptly advise in writing the Assistant Commissioner (International) at Washington, D.C. and the Service Center Director at Philadelphia, PA, that such individual is no longer a Department Representative.

2.4 A Department Representative to whom a Federal return or Federal return information has been disclosed may thereafter disclose such return or return information:

a. to another employee of the Department for the purpose of and only to the extent necessary in the administration of the Possession tax laws for which the Department is responsible;

b. to a person described in Section 6103(n) of the Code or to any officer or employee of such person, solely for the purpose of Possession tax administration and in a manner consistent with applicable regulations, published rules or procedures, or written communications;

c. to a legal representative of the Department personally and directly engaged in, and solely for use in, preparation for a civil or criminal proceeding (or investigation which may result in a proceeding) before a Possession administration body, grand jury, or court in a matter involving Possession tax administration, if the returns and return information satisfy one or more of the criteria established in Section 6103(h)(4)(A), (B) or (C); and

d. to an officer or employee of the Possession Audit Agency for the purpose of and only to the extent necessary in making an audit of the Department.

2.5 A Federal return or Federal return information may be disclosed in a judicial or administrative proceeding pertaining to Possession tax administration, but only if the criteria established in Section 6103(h)(4)(A), (B) or (C) of the Code are met.

2.6 Notwithstanding any other provision of this section, the IRS will not disclose a Federal return or Federal return information under this section if such disclosure would identify a confidential informant or seriously impair a Federal civil or criminal tax investigation. The Department agrees that neither it nor its legal representatives will make any further use or disclosure of a Federal return or Federal return information disclosed to a Department Representative by the IRS if the IRS notifies the head of the Department in writing that such further use or disclosure would identify a confidential informant or seriously impair a Federal civil or criminal tax investigation. The Department further agrees that prior to the disclosure of any Federal return or Federal return information in a Possession judicial proceeding or to any party other than the taxpayer or his/her designee in a Possession administrative proceeding if the return or return information satisfies one or more of the criteria established in Section 6013(h)(4)(A), (B) or (C) of the Code, the head or legal representative of the Department will notify in writing the Service Center Director or Assistant Commissioner (International), from whom the return or return information was received, of the intention to make such disclosure. No officer, employee or legal representative shall disclose a Federal return or Federal return information in a Possession judicial or administrative proceeding if the Service Center Director or Assistant Commissioner (International) or their delegate, within 30 days following receipt of such written notice, informs the head or legal representative of the Department that such disclosure would identify a confidential informant or seriously impair a Federal civil or criminal tax Investigation.

2.7 Additionally, the Department agrees that it will notify the Assistant Commissioner (International) when, during an audit of the Department by the Possession Audit Agency, Federal returns and Federal return information are disclosed to the Possession Audit Agency and such information is made part of the Possession Audit Agency's workpapers.

SECTION 3. Disclosure of Possession Returns and Possession Return Information

3.1 This Agreement and Appendix constitute the requisite authorization for the Department to disclose to, and permit inspection by, IRS Representatives of Possession returns and Possession return information for the purpose of, and only to the extent necessary in the administration of the internal revenue laws, or related statutes, of the United States. Any Possession returns and Possession return information so disclosed to, or inspected by, an IRS Representative become, in the hands of the IRS, "taxpayer return information" as defined by Section 6013(b)(3) of the Code and may be redisclosed by the IRS only in accordance with provisions of the Code or an applicable treaty.

SECTION 4. Safeguards and Other Requirements

4.1 As an express condition for the inspection and disclosure of Federal returns and Federal return information, the Department agrees to comply with the safeguards and requirements prescribed by Section 6103(p)(4) of the Code and any implementation of such safeguards and requirements as may be provided by regulations and published procedures including:

a. furnishing an annual report to the IRS describing the procedures established and utilized by the Department ensuring the confidentiality of such returns and return information;

b. permitting the IRS to review the extent to which the Department is complying with the requirements of this paragraph; and

c. informing in writing all Department Representatives and other persons to or by whom disclosure or inspection of Federal returns or Federal return information is authorized of the criminal penalties and civil liability provided by Sections 7213 and 7431 of the Code for a disclosure of such returns and return information which is unauthorized by the Code.

4.2 As an express condition for the inspection and disclosure of Possession returns and Possession return information, the IRS agrees to comply with the safeguards and requirements prescribed by Section 6013(p)(4) of the Code and any implementation of such safeguards and requirements as may be provided by regulations and published procedures.

4.3 Processing of Federal returns and Federal return information received by the Department from the IRS in the form of microfilms, photo-impressions, magnetic media or other format (including reformatting or reproduction, or conversion to magnetic media, punch cards, or hard copy printout) and transmission and storage of such Federal returns or Federal return information by or on behalf of the Department may be performed by Department owned and/or operated computer facilities, facilities shared by the Department with other Possession agencies, or by any other person described in Section 6103(n) of the Code. In those cases where such facilities used by the Department are shared with other Possession agencies or operated by any other person described in Section 6103(n) of the Code, the Department will insure the confidentiality of the Federal returns and Federal return information provided to such shared facility or person. As part of this responsibility, the terms of any contract or agreement between the Department and a shared computer facility or other person to whom Federal returns or Federal return information is or may be disclosed for a purpose described in this subsection, will provide, or will be amended to provide, that such person, and officers and employees of the person, will comply with the applicable safeguard conditions contained in regulations, published rules and procedures, or written communications.

4.4 Because some taxpayers may be unaware that Department tax officials are authorized under Federal law to obtain Federal returns and Federal return information for Possession tax administration purposes, the Department will publicize, in a manner satisfactory to the IRS, that such returns or return information were obtained pursuant to specific authority granted by the Code. Similar publicity will be provided by the IRS for Possession tax information furnished to the IRS pursuant to Possession law.

SECTION 5. Limitations

5.1 Pursuant to the provisions of section 6103(p)(2) of the Code, and of Possession law, if any, charges for furnishing returns and return information shall be governed by Article 5, paragraph 3 of the Agreement.

5.2 Under no circumstances will the Department permit any Federal return or Federal return information to be inspected by or disclosed to an individual who is the chief executive officer of the Possession or any person other than one described in Section 2 of this Appendix.

5.3 Notwithstanding any other provision of this Appendix, the IRS will not disclose or make known in any manner whatever to any person other than one described in Section 2 of this Appendix:

a. any original, copy, or abstract of any return, payment, or registration made pursuant to chapter 35 of the Code (relating to taxes on wagering);

b. any record required for making any such return, payment, or registration made or required pursuant to chapter 35 which the IRS is permitted by the taxpayer to examine or which is produced pursuant to Section 7602 of the Code (relating to the examination of books and witnesses); or

c. any information obtained by the exploitation of any such return, payment, registration, or record made or required pursuant to chapter 35.

5.4 Notwithstanding any other provision of this Agreement or Appendix, the Internal Revenue Service will disclose or make known in any manner to any person described in Section 2 of this Appendix taxpayer information which was obtained pursuant to a tax convention or exchange of information agreement between the United States and a foreign government only if such disclosure is authorized by both the relevant convention or agreement and the Code.

SECTION 6. Officials to Contact for Obtaining Information

6.1 Requests by the Department for Federal returns and Federal return information should be made to the officials named below:

a. Requests by the Department for Federal return information in magnetic media should be made to the Assistant Commissioner (International), Attn: Disclosure Officer, who will be responsible for coordinating the requests with the IRS National Office;

b. Requests for physical inspection or copying of Federal returns, or requests for audit abstracts and reports pertaining to such returns, showing addresses within the possession should be made to the Director, Internal Revenue Service Center, Philadelphia, PA, Attn: Disclosure Officer, who will be responsible for making the proper arrangements for inspection or copying; and

c. Requests by the head of the Department for Federal returns of taxpayers or Federal return information relating to taxpayers showing addresses outside the possession should be made to the Assistant Commissioner (International), Attn: Disclosure Officer.

6.2 Requests by authorized officers and employees of the IRS for inspection or copying of Possession Returns and Possession Return Information should be made to the Director of the Department of Revenue and Taxation of the Government of Guam.

TAX IMPLEMENTATION AGREEMENT BETWEEN THE UNITED STATES OF AMERICA AND THE VIRGIN ISLANDS

The Government of the United States of America and the Government of the Virgin Islands desiring to conclude an Agreement (hereinafter referred to as the "Agreement") for the exchange of information and mutual assistance with respect to taxes in order to prevent the evasion or avoidance of United States or Virgin Islands taxes have agreed as follows:

Article 1

SCOPE OF AGREEMENT

This Agreement is intended to provide for mutual assistance in tax matters, including exchanges of information, for purposes of administering the tax laws of the respective Governments and especially to prevent avoidance or evasion of the Governments' respective fiscal laws. This Agreement is the implementing agreement described in section 1277 of the Tax Reform Act of 1986, Pub. L. No. 99-514. The provisions of this Agreement are subject to provisions of the statutes, regulations, and published procedures of the Contracting Governments.

Upon entry into force, this Agreement replaces any and all prior tax coordination agreements and implementing agreements between the respective Governments.

Article 2

TAXES COVERED

1. This Agreement shall apply to the following taxes imposed by or on behalf of a Contracting Government:
   a) in the case of the United States of America, all taxes imposed by the Code, and
   b) in the case of the Virgin Islands, all taxes imposed by the Code as it applies in the Virgin Islands and all local income taxes imposed by the Virgin Islands as authorized by the Tax Reform Act of 1986.

2. This Agreement shall apply also to any identical or substantially similar taxes imposed after the date of signature of the Agreement in addition to or in place of the existing taxes. The competent authority of each Government shall notify the other of significant changes in laws which may affect the obligations of that Government pursuant to this Agreement.

3. This Agreement shall not apply to the extent that an action or proceeding concerning taxes covered by this Agreement is barred by the applicant Government's statute of limitations.

Article 3

DEFINITIONS

1. In this Agreement, unless otherwise defined:
   a) The term "Code" shall mean the Internal Revenue Code of 1986, as amended, and any predecessor or successor statutes.
   b) The term "competent authority" means:
      (i) in the case of the United States of America, the Secretary of the Treasury or his delegate, and
      (ii) in the case of the Virgin Islands, the Director, Virgin Islands Bureau of Internal Revenue or his delegate.
   c) The term "Contracting Government" means the United States or the Virgin Islands as the context requires.
   d) The term "non-Virgin Islands source income" means income for which the source (under source rules promulgated by the U.S. Internal Revenue Service) is not the Virgin Islands.
   e) The term "person" includes an individual and a partnership, corporation, company, trust, estate, association or other legal entity.
   f) The term "tax" means any tax to which the Agreement applies.
   g) The term "taxpayer" means:
      (i) in the case of the United States, any person subject to the provisions of the Code, and
      (ii) in the case of the Virgin Islands, any person subject to the provisions of the Code as it applies in the Virgin Islands or any local income tax laws imposed by the Virgin Islands.
   h) For purposes of determining the geographical area within which jurisdiction to compel production of information under this Agreement may be exercised, the term "United States" means the United States of America, including Puerto Rico, Guam, American Samoa, the Commonwealth of the Northern Mariana Islands, and any other United States possession or territory and the territorial waters thereof, but not including the Virgin Islands. Such jurisdiction may be exercised if the information or the custodian of the information is located within the United States.
   i) For purposes of determining the geographical area within which jurisdiction to compel production of information under this Agreement may be exercised, the term "Virgin Islands" means the territorial domain, lands and waters acquired by the United States through cession of the Danish West Indian Islands by the Convention between the United States of America and His Majesty the King of Denmark entered into August 4, 1916, and ratified by the Senate on September 7, 1916 (39 Stat. 1706). Such jurisdiction may be exercised if the information or the custodian of the information is located within the Virgin Islands.

2. Any term not defined in this Agreement, unless the context otherwise requires or the competent authorities agree to a common meaning pursuant to the provisions of Article 5, shall have the meaning which it has under the laws of the Contracting Governments relating to the taxes which are the subject of this Agreement.

Article 4

EXCHANGE OF INFORMATION

1. The competent authorities of the Contracting Governments shall exchange information to administer and enforce the domestic laws of the Contracting Governments concerning taxes covered by this Agreement. Information shall be exchanged to fulfill the purposes of this Agreement without regard to whether the information relates to, or is held by, a taxpayer of a Contracting Government. Procedures for exchange of information are set forth in Appendix A, Limitations on Disclosure of Tax Information, which is incorporated by reference and made a part of this Agreement.

2. The competent authorities of the Contracting Governments shall automatically transmit information to each other for the purposes referred to in paragraph 1. The competent authorities shall determine the items of information to be exchanged pursuant to this paragraph and the procedures to be used to exchange such items of information.
   a) It is intended that the United States shall routinely supply to the Virgin Islands the following information, to the extent available and subject to the tolerances and criteria to be agreed upon by the competent authorities:
      (i) copies of reports of individual, partnership, corporate,

and employment audit changes that disclose information relevant to the Virgin Islands;

(ii) copies of Forms 5335 (Income Subject to Withholding under Chapter 3, Internal Revenue Code as reported on Form 1042S, and any successor forms) that disclose information relevant to the Virgin Islands;

(iii) copies of Schedule K-1 of Form 1065 (U.S. Partnership Return of Income) and audit results, when the partnership return is examined and it appears the examination will affect returns of Virgin Islands taxpayers;

(iv) copies of responses to Forms 4901, 4902, and 4903, Requests for Information About Tax Forms, where such reply indicates that the taxpayer has filed a return with the Virgin Islands;

(v) copies of Forms 1099 and all other information returns where the recipient of income is a Virgin Islands resident or lists a Virgin Islands address or the income is from Virgin Islands sources;

(vi) copies of the W-2 combined wage reporting tape summarizing Forms W-2VI (U.S. Virgin Islands Wage and Tax Statement) and Forms W-3SS (Transmittal of Wage and Tax Statements) filed with the Social Security Administration by employers in the Virgin Islands, which tape is provided annually to the Internal Revenue Service by the Social Security Administration; and

(vii) copies of Forms 8279 (Election to be Treated as a FSC or as a Small FSC) that indicate creation or organization of any Foreign Sales Corporation (as defined in Section 922 of the Code) in the Virgin Islands.

b) It is intended that the Virgin Islands shall routinely supply to the United States the following information, to the extent available and subject to the tolerances and criteria to be agreed upon by the competent authorities:

(i) copies of reports of individual, partnership, corporate, and employment audit changes that disclose information relevant to the United States;

(ii) information about the ownership interests of all corporations subject to Virgin Islands tax with non-Virgin Islands source income that receive a rebate, subsidy or reduction of Virgin Islands taxes;

(iii) information about any taxpayer subject to Virgin Islands tax with non-Virgin Islands source income who files an income tax return with the Virgin Islands claiming for the first time to be a Virgin Islands resident;

(iv) all corporate information about ownership interests in any Foreign Sales Corporation (as defined in section 922 of the Code) established in the Virgin Islands;

(v) such information about corporations electing application of section 936 of the Code as may be agreed upon by the competent authorities; and

(vi) information about any rebates, subsidies or reductions of tax provided by the Virgin Islands for income derived by a Virgin Islands taxpayer from other United States possessions and territories.

c) The competent authorities of the Contracting Governments may agree to expand or limit the information to be routinely exchanged.

3. The competent authority of a Contracting Government shall spontaneously transmit to the competent authority of the other Government information which has come to the attention of the first-mentioned Government and which is likely to be relevant to, and bear significantly on, administration and enforcement of the domestic laws concerning taxes of the second-mentioned Government. The competent authorities shall determine the information to be exchanged pursuant to this paragraph and take such measures and implement such procedures as are necessary to ensure that the information is forwarded to the competent authority of the other Government.

4. The competent authority of the requested Government shall endeavor to provide information upon request by the competent authority of the applicant Government for the administration and enforcement of the domestic laws of the Contracting Governments concerning taxes. If the information available in the tax files of the requested Government is not sufficient to enable compliance with the request, that Government shall take the necessary measures to provide the applicant Government with the information requested. Notwithstanding the foregoing, the United States may exercise its rights under section 7602 et seq. of the Code to obtain information in the Virgin Islands without resorting to the procedures set forth in this Agreement. However, in the event the United States so exercises its rights within the Virgin Islands it shall notify the competent authority of the Virgin Islands prior to taking action or as soon as practicable, unless the competent authorities agree to limit notification with respect to certain classes of cases.

5. The provisions of the preceding paragraphs shall not be construed so as to impose on a Contracting Government the obligation:

a) to supply particular items of information which are not obtainable under the laws of that Government or of the other Contracting Government;

b) to supply information which would disclose any trade, business, industrial, commercial or professional secret or trade process;

c) to supply information, the disclosure of which would be contrary to public policy; or

d) to disclose information if such disclosure would identify a Confidential informant or seriously impair a civil or criminal tax investigation.

6. Any information received by a Contracting Government shall be subject to Appendix A, Limitations on Disclosure of Tax Information.

Article 5

MUTUAL AGREEMENT PROCEDURE AND COSTS

1. The competent authorities of the Contracting Governments shall imple-

ment a program to carry out the purposes of this Agreement. In particular, the competent authorities of the Contracting Governments may amend Appendix A as they deem necessary within the limitations of this Agreement and the Code.

2. The competent authorities of the Contracting Governments shall endeavor to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of this Agreement and may communicate directly for this purpose. In particular, the competent authorities may agree to the common meaning of a term and may determine when costs are extraordinary for purposes of this Article.

3. Unless the competent authorities of the Contracting Governments otherwise agree, ordinary costs incurred in providing assistance shall be borne by the requested Government and extraordinary costs incurred in providing assistance shall be borne by the applicant Government. The competent authorities of the Contracting Governments may agree not to charge each other for the costs of reproduction of information routinely exchanged.

Article 6

MUTUAL AGREEMENT PROCEDURE ON POTENTIAL DOUBLE TAXATION

1. When by reason of inconsistent positions taken by the Contracting Governments, a taxpayer is or would be subject to inconsistent tax treatment by the two jurisdictions, the competent authorities of the Contracting Governments shall endeavor to agree upon the facts and circumstances necessary to achieve consistent application of the tax laws of the respective Governments. In particular, but not by way of limitation, the competent authorities of the Contracting Governments may consult together to endeavor to agree:

a) To the same allocation of income under section 482 of the Code;

b) To the same determination of residency of a particular taxpayer; or

c) To the same determination of the source of particular items of income.

Article 7

OTHER APPLICATIONS OF AGREEMENT

1. The Contracting Governments agree that when they have knowledge that a taxpayer has changed residence from one taxing jurisdiction to the other and seeks to change methods of accounting (or to make an initial election), no such change or election shall be permitted until the competent authorities have consulted and determined that such change or election will not lead to the evasion or avoidance of taxes imposed by either of the Contracting Governments. This paragraph includes initial adoption of an accounting method or an election inconsistent with a method or election previously utilized in the other jurisdiction by the taxpayer.

2. The Contracting Governments agree that a Virgin Islands corporation owned or controlled directly or indirectly by a person whose beneficial ownership is undisclosed (such as through bearer shares) shall be treated as owned or controlled to that extent by a U.S. person for purposes of the respective Governments' tax laws.

3. The Contracting Governments agree that for purposes of determining whether a person qualifies as a bona fide resident of the Virgin Islands under section 932 of the Code the definition to be used shall be the definition contained in the then applicable regulations promulgated by the United States.

4. The Contracting Governments agree that the United States may use its regulatory authority over sourcing rules to determine that certain income (such as income from the sale of property) earned by certain former residents of the United States who become residents of the Virgin Islands is U.S.-source income for purposes of section 934(b) of the Code and therefore tax on such income may not be reduced or rebated by the Virgin Islands.

5. Any taxpayer information disclosed to the United States shall become "taxpayer return information" as defined by section 6103(b)(3) of the Code and may be redisclosed only in accordance with provisions of the Code or an applicable treaty.

6. Subject to the restrictions and other provisions of this Agreement and the availability of enforcement resources, the competent authorities will develop a cooperative return selection and examination program with the objective of avoiding unnecessary duplication of examination coverage.

7. Subject to the restrictions and other provisions of this Agreement, the Contracting Governments will develop a simultaneous examination program for both civil and criminal investigations.

8. To the extent permitted by law and subject to the availability of enforcement resources, the United States will assist in collecting taxes owed to the Virgin Islands by Virgin Islands taxpayers present in the United States. The competent authorities will discuss appropriate procedures for facilitating such collection. Any taxes collected shall be remitted to the Virgin Islands, less the reasonable expenses incurred in collection.

9. In addition to the exchange of tax and other information, the competent authorities will, to the extent feasible, extend to each other assistance in other tax administration matters. This may include such activities as taxpayer assistance, stocking tax forms for the public, training of personnel, preparing special statistical studies and compilations of data, development and improvement of tax administration systems and procedures, as well as such other activities as may improve tax administration.

Article 8

ENTRY INTO FORCE

This Agreement shall enter into force upon signature by the duly authorized representatives of the Contracting Governments.

Article 9

AMENDMENT AND TERMINATION

1. This Agreement may be modified or amended by mutual consent of the Contracting Governments.

2. This agreement shall remain in force until terminated by one of the Contracting Governments. Either Contracting Government may terminate the Agreement at any time after the Agreement enters into force provided that at least 6 months prior notice of termination has been given.

3. Any unauthorized use or disclosure of Federal returns or Federal return information as defined by section 6103(b)(1) and (2) of the Code furnished pursuant to this Agreement or inadequate procedures for safeguarding the confidentiality of such returns and return information, constitutes grounds for immediate termination of this Agreement and the exchange of information thereunder, subject to the rights of administrative appeal as provided by regulations prescribed by section 6103(p)(7) of the Code.

DONE at Washington, D.C., in duplicate, this 24th day of February, 1987.

FOR THE GOVERNMENT OF THE UNITED STATES OF AMERICA

J. Roger Mentz

Assistant Secretary (Tax Policy)
Department of Treasury

FOR THE GOVERNMENT OF THE VIRGIN ISLANDS OF THE UNITED STATES

Alexander A. Farrelly

Governor of the Virgin Islands

Anthony P. Olive

Director, Bureau of Internal Revenue of the Virgin Islands

APPENDIX A
LIMITATIONS ON DISCLOSURE OF TAX INFORMATION

Section 1. Definitions

For purposes of this appendix, the following definitions apply:

1.1 Bureau. The term "Bureau" means the V.I. Bureau of Internal Revenue and any successor agency.

1.2 IRS. The term "IRS" means the Internal Revenue Service, U.S. Department of Treasury.

1.3 Possession Audit Agency. The term "Possession Audit Agency" means the agency, body or commission which is charged under the laws of the Virgin Islands with the responsibility of auditing Possession revenues and programs.

1.4 Possession. The term "Possession" means the Virgin Islands of the United States.

1.5 Bureau Representative. The term "Bureau Representative" means a Bureau officer or employee designated in writing by the head of the Bureau, to the Assistant Commissioner (International) at Washington, D.C. and the Service Center Director at Philadelphia, PA, as an individual who is to inspect or receive Federal returns or Federal return information on behalf of the Bureau as provided by section 6103(d) of the Code, but only so long as the duties and employment of such officer or employee require access to Federal returns and Federal return information for purposes of Possession tax administration.

1.6 IRS Representative. The term "IRS Representative" means an officer or employee of the IRS who has been designated in writing to the head of the Bureau by the Assistant Commissioner (International) at Washington, D.C., or the Service Center Director at Philadelphia, PA, as an individual who is to inspect or receive Possession returns or Possession return information on behalf of the IRS, but only so long as the duties and employment of such officer or employee require access to Possession returns and return information for the purpose of Federal tax administration.

1.7 Federal Return. The term "Federal Return" is defined in the same manner as provided in section 6103(b)(1) of the Code.

1.8 Federal Return Information. The term "Federal Return Information" is defined in the same manner as provided in section 6103(b)(2) of the Code. However, "Federal Return Information" does not include information in the hands of the Possession which it obtained wholly from sources independent from the IRS.

1.9 Possession Return. The term "Possession Return" is defined in the same manner as provided in section 6103(b)(1) of the Code as it applies in the Virgin Islands.

1.10 Possession Return Information. The term "Possession Return Information" means a taxpayer's identity, the nature, source, or amount of his/her income, payments, receipts, deductions, exemptions, credits, assets, liabilities, net worth, tax liability, tax withheld, deficiencies, overassessments, or tax payments, whether the taxpayer's Possession return was, is being, or will be examined or subject to other investigation or processing, or any other data received by, recorded by, prepared by, furnished to, or collected by the Bureau with respect to a Possession return or with respect to determination of the existence, or possible existence, of liability (or the amount thereof) of any person under the internal revenue laws, or related statutes, of the Possession, for any tax, penalty, interest, fine, forfeiture, or other imposition, or offense.

1.11 Inspection. The term "Inspection" means any examination of a return or return information.

1.12 Disclosure. The term "Disclosure" means the making known to any person in any manner whatever a return or return information.

1.13 Possession Tax Administration. The term "Possession Tax Administration"

(a) means—
  (i) the administration, management, conduct, direction, and supervision of the execution and application of the revenue laws, or related statutes of the Possession, and
  (ii) the development and formulation of Possession tax policy relating to existing or proposed internal revenue laws, or related statutes, of the Possession; and

(b) includes assessment, collection, enforcement, litigation, and statistical-gathering functions under such laws or statutes.

1.14 Code. The term "Code" means the Internal Revenue Code of 1986, as amended, and any predecessor or successor statutes.

SECTION 2. Disclosure of Federal Returns and Federal Return Information

2.1 Pursuant to the laws of the Possession, the Bureau is charged with the responsibility for the administration of Possession taxes imposed on income, inheritance, gifts, gross receipts from the conduct of a trade or business, real property and excise taxes on imports used in the conduct of a trade or business. Federal returns, and Federal return information (whether originals, paper copy, photocopy, microfilm, magnetic media, or any other form) received from the IRS will be used for the purpose of, and only to the extent necessary in, Possession tax administration.

2.2 This Agreement and Appendix constitute the requisite authorization pursuant to section 6103(d)(1) of the Code for the IRS to disclose to, and permit inspection by, a Bureau Representative of Federal returns and Federal return information relating to taxes imposed by chapters one, two, six, eleven, twelve, twenty-one, twenty-three, twenty-four, thirty-one, thirty-two, forty-four, forty-five, fifty-one, fifty-two, and subchapter D of chapter thirty-six of the Code.

2.3 Upon the occurrence of any change in employment, duties, or other relevant matters affecting a Bureau Representative's right to access to Federal returns and Federal return information or status as a Bureau Representative, the head of the Bureau shall promptly advise in writing the Assistant Commissioner (International) at Washington, D.C. and the Service Center Director at Philadelphia, PA, that such individual is no longer a Bureau Representative.

2.4 A Bureau Representative to whom a Federal return or Federal return information has been disclosed, may thereafter disclose such return or return information:

(a) to another employee of the Bureau for the purpose of and only to the extent necessary in the administration of the Possession tax laws for which the Bureau is responsible;

(b) to a person described in section 6103(n) of the Code or to any officer or employee of such person, solely for the purpose of Possession tax administration and in a manner consistent with applicable regulations, published rules or procedures, or written communications;

(c) to a legal representative of the Bureau personally and directly engaged in, and solely for use in, preparation for a civil or criminal proceeding (or investigation which may result in a proceeding) before a Possession administration body, grand jury, or court in a matter involving Possession tax administration, if the returns and return information satisfy one or more of the criteria established in section 6103(h)(4)(A), (B) or (C); and

(d) to an officer or employee of the Possession audit agency for the purpose of and only to the extent necessary in making an audit of the Bureau.

2.5 A Federal return or Federal return information may be disclosed in a judicial or administrative proceeding pertaining to Possession tax administration, but only if the criteria established in section 6103(h)(4)(A), (B) or (C) of the Code are met.

2.6 Notwithstanding any other provision of this section, the IRS will not disclose a Federal return or Federal return information under this section if such disclosure would identify a confidential informant or seriously impair a Federal civil or criminal tax investigation. The Bureau agrees that neither it nor its legal representative will make any further use or disclosure of a Federal return or Federal return information disclosed to a Bureau Representative by the IRS if the IRS notifies the head of the Bureau in writing that such further use or disclosure would identify a confidential informant or seriously impair a Federal civil or criminal tax investigation. The Bureau further agrees that prior to the disclosure of any Federal return or Federal return information in a Possession judicial proceeding or to any party other than the taxpayer or his/her designee in a Possession administrative proceeding if the return or return information satisfies one or more of the criteria established in section 6103(h)(4)(A), (B) or (C) of the Code, the head or legal representative of the Bureau will notify in writing the Service Center Director or Assistant Commissioner (International), from whom the return or return information was received, of the intention to make such disclosure. No officer, employee or legal representative shall disclose a Federal return or Federal return information in a Possession judicial or administrative proceeding if the Service Center Director or Assistant Commissioner (International) or their delegate, within 30 days following receipt of such written notice, informs the head or legal representative of the Bureau that such disclosure would identify a confidential informant or seriously impair a Federal civil or criminal tax investigation.

2.7 Additionally, the Bureau agrees that it will notify the Assistant Commissioner (International) when, during an audit of the Bureau by the Possession Audit Agency, Federal returns and Federal return information are disclosed to the Possession Audit Agency and such information is made part of the Possession Audit Agency's workpapers.

SECTION 3. Disclosure of Possession Returns and Possession Return Information

3.1 This Agreement and Appendix constitute the requisite authorization for the Bureau to disclose to, and permit inspection by, IRS Representative of Possession returns and Possession return information for the purpose of, and only to the extent necessary in the administration of the internal revenue laws, or related statutes, of the United States. Any Possession returns and Possession return information so disclosed to, or inspected by, an IRS Representative become, in the hands of the IRS, ''taxpayer return information'' as defined by section 6103(b)(3) of the Code and may be redisclosed by the IRS only in accordance with provisions of the Code or an applicable treaty.

SECTION 4. Safeguards and Other Requirements

4.1 As an express condition for the inspection and disclosure of Federal returns and Federal return information, the Bureau agrees to comply with the safeguards and requirements prescribed by section 6103(p)(4)) of the Code and any implementation of such safeguards and requirements as may be provided by regulations and published procedures including:

(a) furnishing an annual report to the IRS describing the procedures established and utilized by the Bureau for ensuring the confidentiality of such returns and return information;

(b) permitting the IRS to review the extent to which the Bureau is complying with the requirements of this paragraph; and

(c) informing in writing all Bureau Representatives and other persons to or by whom disclosure or inspection of Federal returns or Federal return information is authorized of the criminal penalties and civil liability provided by sections 7213 and 7431 of the Code for a disclosure of such returns and return information which is unauthorized by the Code.

4.2 As an express condition for the inspection and disclosure of Possession returns and Possession return information, the IRS agrees to comply with the safeguards and requirements prescribed by section 6103(p)(4) of the Code and any implementation of such safeguards and requirements as may be provided by regulations and published procedures.

4.3 Processing of Federal returns and Federal return information received by the Bureau from the IRS in the form of microfilms, photo-impressions, magnetic media or other format (including reformatting or reproduction, or conversion to magnetic media, punch cards, or hard copy printout) and transmission and storage of such Federal returns or Federal return information by or on behalf of the Bureau may be performed by Bureau owned and/or operated computer facilities, facilities shared by the Bureau with other Possession agencies, or by any other person described in section 6103(n) of the Code. In those cases where such facilities used by the Bureau are shared with other Possession agencies or operated by any other person described in section 6103(n) of the Code, the Bureau will insure the confidentiality of the Federal returns and Federal return information provided to such shared facility or person. As part of this responsibility, the terms of any contract or agreement between the Bureau and a shared computer facility or other person to whom Federal returns or Federal return information is or may be disclosed for a purpose described in this subsection, will provide, or will be amended to provide, that such person, and officers and employees of the person, will comply with the applicable safeguard conditions contained in regulations, published rules and procedures, or written communications.

4.4 Because some taxpayers may be unaware that Bureau tax officials are authorized under Federal law to obtain Federal returns and Federal return information for Possession tax administration purposes, the Bureau will publicize, in a manner satisfactory to the IRS, that such returns or return information were obtained pursuant to specific authority granted by the Code. Similar publicity will be provided by the IRS for Possession tax information furnished to the IRS pursuant to Possession law.

SECTION 5. Limitations

5.1 Pursuant to the provisions of section 6103(p)(2) of the Code, and of Possession law, if any, charges for furnishing returns and return information shall be governed by Article 5, paragraph 3 of the Agreement.

5.2 Under no circumstances will the Bureau permit any Federal return or Federal return information to be inspected by, or disclosed to an individual who is the chief executive officer of the Possession or any person other than one described in section 2 of this Appendix.

5.3 Notwithstanding any other provision of this Appendix, the IRS will not disclose or make known in any manner whatever to any person other than one described in section 2 of this Appendix—

(a) any original, copy, or abstract of any return, payment, or registration made pursuant to chapter 35 of the Code (relating to taxes on wagering);

(b) any record required for making any such return, payment, or registration made or required pursuant to chapter 35 which the IRS is permitted by the taxpayer to examine or which is produced pursuant to section 7602 of the Code (relating to the examination of books and witnesses); or

(c) any information obtained by the exploitation of any such return, payment, registration, or record made or required pursuant to chapter 35.

5.4 Notwithstanding any other provision of this Agreement or Appendix, the Internal Revenue Service will disclose or make known in any manner to any person described in section 2 of this Appendix taxpayer information which was obtained pursuant to a tax convention or exchange of information agreement between the United States and a foreign government only if such disclosure is authorized by both the relevant convention or agreement and the Code.

SECTION 6. Officials to Contact for Obtaining Information

6.1 Requests by the Bureau for Federal returns and Federal return information should be made to the officials named below:

(a) Requests by the Bureau for Federal return information in magnetic media should be made to the Assistant Commissioner (International), who will be responsible for coordinating the requests with the IRS National Office;

(b) Requests for physical inspection or copying of Federal returns, or requests for audit abstracts and reports pertaining to such returns, showing addresses within the possession should be made to the Director, Internal Revenue Service Center, Philadelphia, PA, who will be responsible for making the proper arrangements for inspection or copying; and

(c) Requests by the head of the Bureau for Federal returns of taxpayers or Federal return information relating to taxpayers showing addresses outside the possession should be made to the Assistant Commissioner (International).

6.2 Requests by authorized officers and employees of the IRS for inspection or copying of possession returns and possession return information should be made to the Director, Virgin Islands Bureau of Internal Revenue.

United States-United Kingdom Income Tax Convention

1980-1 C.B. 394

(Also income tax conventions between the United States and Austria, Belgium, Denmark, Egypt, West Germany, Finland, France, Greece, Hungary, Iceland, Ireland, Italy, Jamaica, Japan, Korea, Luxembourg, Netherlands, Norway, Pakistan, Philippines, Poland, Romania, Sweden, Switzerland, Trinidad and Tobago, and the Union of Soviet Socialist Republics.)

Teachers - Researchers. The first day of the period of exemption is the date of the individuals last entry into the U.S. before beginning the teaching or research services.

Rev. Rul. 89-5

ISSUE

What is the first day of a period of tax exemption under Article 20(1) of the United States-United Kingdom Income Tax Convention, 1980-1 C.B. 394 (the "Convention"), under the circumstances described below?

FACTS

A, an individual, is a citizen of the United Kingdom. During all of 1986, *A* was a resident of the United Kingdom as defined in Article 4 of the Convention. On August 1, 1986, *A* arrived in the United States for the purpose of taking a personal vacation. On August 25, 1986, *A* left the United States and entered a foreign country. On August 31, 1986, *A* entered the United States for the purpose of teaching at a recognized educational institution within the United States. *A* began teaching on September 1, 1986. During the period from August 1, 1986, through August 31, 1986, *A* derived no income from any source within the United States. *A* was not a resident of the United States for United States tax purposes at any time during 1986. Before August 31, 1986, *A* had not claimed any benefit under the Convention.

LAW AND ANALYSIS

Article 20(1) of the Convention provides a two-year period of tax exemption for certain income earned by an individual who visits the United States for two years or less for the purpose of teaching or engaging in research at a recognized educational institution, if the individual was a United Kingdom resident immediately before the visit. The period of exemption begins on the date the individual first visits the United

States for the purpose of teaching or engaging in research. For *A*, that date was August 31, 1986, and A's period of exemption begins on that date if *A* is otherwise qualified to claim the treaty benefit. The period of exemption is not affected by earlier visits to the United States for other purposes, such as personal vacations, during which no treaty benefits were claimed.

HOLDING

For an individual otherwise eligible for exemption under Article 20(1) of the Convention, the first day of the period of exemption is the date of the individual's last entry into the United States before beginning the teaching or research services, provided that the individual had claimed no benefits under the Convention before that date.

Tax treaties with the following countries contain provisions that for purposes of this revenue ruling are similar to Article 20(1) of the Convention: Austria (Article XII); Belgium (Article 20); Denmark (Article XIV); Egypt (Article 22); Federal Republic of Germany (Article XII); Finland (Article 20); France (Article 17); Greece (Article XII); Hungary (Article 17); Iceland (Article 21); Ireland (Article XVIII); Italy (Article 20); Jamaica (Article 22); Japan (Article 19); Korea (Article 20); Luxembourg (Article XIII); Netherlands (Article XVII); Norway (Article 15); Pakistan (Article XII); Philippines (Article 21); Poland (Article 17); Romania (Article 19); Sweden (Article XII); Switzerland (Article XII); Trinidad and Tobago (Article 18); and the Union of Soviet Socialist Republics (Article VI). The holding of this revenue ruling applies to individuals claiming a teacher's or researcher's exemption under these treaties.

Public Law 100–360
100th Congress[1]

An Act

To amend title XVIII of the Social Security Act to provide protection against catastrophic medical expenses under the medicare program, and for other purposes.

July 1, 1988
[H.R. 2470]

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

Medicare Catastrophic Coverage Act of 1988.
Aged persons.
Insurance.
Health and medical care.
Health care facilities.
42 USC 1305 note.

SECTION 1. SHORT TITLE; REFERENCES IN ACT; TABLE OF CONTENTS.

(a) SHORT TITLE.—This Act may be cited as the "Medicare Catastrophic Coverage Act of 1988".

(b) AMENDMENTS TO THE SOCIAL SECURITY ACT.—Except as otherwise specifically provided, whenever in this Act an amendment is expressed in terms of an amendment to or repeal of a section or other provision, the reference shall be considered to be made to that section or other provision of the Social Security Act.

(c) TABLE OF CONTENTS.—The table of contents of this Act is as follows:

[1]Conference Report 100-661, page 490.

TITLE I—PROVISIONS RELATING TO PART A OF MEDICARE PROGRAM AND SUPPLEMENTAL MEDICARE PREMIUM

Subtitle A—Expansion of Medicare Part A Benefits

SEC. 101. EXPANDING SCOPE OF BENEFITS UNDER PART A.

Section 1812 (42 U.S.C. 1395d) is amended—

(1) in subsection (a), by striking paragraphs (1) through (4) and inserting the following:

"(1) inpatient hospital services;

"(2) extended care services for up to 150 days during any calendar year;

"(3) home health services; and

"(4) in lieu of certain other benefits, hospice care with respect to the individual during up to two periods of 90 days each, a subsequent period of 30 days, and a subsequent extension period with respect to which the individual makes an election under subsection (d)(1).";

(2) by amending subsection (b) to read as follows:

"(b) Payment under this part for services furnished to an individual may not be made for—

"(1) extended care services furnished to the individual during a calendar year after such services have been furnished to the individual for 150 days during that year, or

"(2) inpatient psychiatric hospital services furnished to the individual after such services have been furnished to the individual for a total of 190 days during his lifetime.";

(3) by amending subsection (c) to read as follows:

"(c)(1) If an individual is an inpatient of a psychiatric hospital on the first day of medicare entitlement (as defined in paragraph (4)(A)) payment may not be made under this part during the period described in paragraph (2) for inpatient mental health services (as defined in paragraph (4)(B)) in excess of the number of days specified in paragraph (3).

"(2) The period described in this paragraph—

"(A) begins on the first day of medicare entitlement, and

"(B) ends at the end of the first period of 60 consecutive days thereafter on each of which the individual is not receiving inpatient mental health services.

"(3) The number of days specified in this paragraph for an individual is 150 days less the number of days (during the 150-day period immediately before the first day of medicare entitlement) during which the individual was an inpatient of a psychiatric hospital.

"(4) In this subsection:

"(A) The term 'first day of medicare entitlement' means, for an individual, the first day of the first month for which the individual is entitled to benefits under this part.

"(B) The term 'inpatient mental health services' means—

"(i) inpatient psychiatric hospital services, and

"(ii) inpatient hospital services for an individual who is an inpatient primarily for the diagnosis or treatment of mental illness.";

(4) in subsection (d)—

(A) in paragraph (1), by striking "and one subsequent period of 30 days" and inserting ", a subsequent period of 30 days, and a subsequent extension period", and

(B) in paragraph (2)(B), by inserting "or a subsequent extension period" after "30-day period";

(5) in subsection (e), by striking "post-hospital"; and

(6) by striking subsections (f) and (g).

SEC. 102. DEDUCTIBLES AND COINSURANCE UNDER PART A.

Section 1813 (42 U.S.C. 1395e) is amended—

(1) by amending paragraphs (1) through (3) of subsection (a) to read as follows:

"(1)(A) Subject to subparagraph (C), the amount payable for inpatient hospital services furnished to an individual during the individual's first period of hospitalization to begin during a calendar year shall be reduced by a deduction equal to the inpatient hospital deductible for that year or, if less, the charges imposed with respect to such individual for such services, except that, if the customary charges for such services are greater than the charges so imposed, such customary charges shall be considered to be the charges so imposed.

"(B) For purposes of subparagraph (A), the term 'period of hospitalization' means, with respect to an individual, the period beginning on the first day the individual is furnished inpatient hospital services and ending on the individual's date of discharge (as established by the Secretary for purposes of section 1886) from the hospital (or, in the case of a transfer, hospitals) involved.

"(C) In the case of an individual with respect to whom—

"(i) a period of hospitalization begins during December of any calendar year,

"(ii) an inpatient hospital deductible is imposed with respect to such period of hospitalization, and

"(iii) a period of hospitalization begins during January of the following calendar year,

no inpatient hospital deductible shall be imposed with respect to a period of hospitalization beginning in January of such following year (but such period of hospitalization shall not be taken into account in determining the application of an inpatient hospital deductible for any period of hospitalization beginning for such individual after January 31 of such following year).

Contracts.

"(D) If the Secretary terminates a contract under section 1876 during a year, no inpatient hospital deductible shall be imposed during the remainder of the year in the case of an individual who can demonstrate to the satisfaction of the Secretary that, during a period of enrollment with the organization in the year, the individual was admitted to a hospital for inpatient hospital services for which the organization was obligated to make payment under such section.

"(2)(A) The amount payable to any provider of services under this part for services furnished an individual shall be further reduced by a deduction equal to the expenses incurred for the first three pints of whole blood (or equivalent quantities of packed red blood cells, as defined under regulations) furnished to the individual during each calendar year, except that such deductible for such blood shall in accordance with regulations be appropriately reduced to the extent that there has been a replacement of such blood (or equivalent quantities of packed red blood cells, as so defined); and for such purposes blood (or equivalent quantities of packed red blood cells, as so defined) furnished such individual shall be deemed replaced when the institution or other person furnishing such blood (or such equivalent quantities of packed red blood cells, as so defined) is given one pint of blood for each pint of blood (or equivalent quantities of packed red blood cells, as so defined) furnished such individual with respect to which a deduction is made under this sentence.

"(B) The deductible under subparagraph (A) for blood or blood cells furnished an individual in a year shall be reduced to the extent that a deductible has been imposed under section 1833(b) to blood or blood cells furnished the individual in the year.

"(3)(A) The amount payable for extended care services furnished an individual in any calendar year shall be reduced by the coinsurance amount (promulgated under subparagraph (C) for that year) for each day (before the 9th day) on which he is furnished such services during the year.

"(B) Before September 1 of each year (beginning with 1988), the Secretary shall estimate the national average per diem reasonable cost recognized under this title for extended care services which will be furnished in the succeeding calendar year.

"(C) The Secretary shall, in September of each year (beginning with 1988) promulgate the coinsurance amount which shall apply to extended care services furnished in the succeeding year. Such amount shall be equal to 20 percent of the national average per diem cost estimated under subparagraph (B) in that year. If the coinsurance amount determined under the preceding sentence is not a multiple of 50 cents, it shall be rounded to the nearest multiple of 50 cents (or, if it is a multiple of 25 cents but not a multiple of 50 cents, to the next higher multiple of 50 cents)."; and

(2) by striking paragraph (3) of subsection (b).

SEC. 103. PART A PREMIUM FOR MEDICARE BUY-INS.

Subsection (d) of section 1818 (42 U.S.C. 1395i) is amended to read as follows: 42 USC 1395i-2.

"(d)(1) The Secretary shall, during September of each year (beginning with 1988), estimate the monthly actuarial rate for months in the succeeding year. Such actuarial rate shall be one-twelfth of the amount which the Secretary estimates (on an average, per capita basis) is equal to 100 percent of the benefits and administrative costs which will be payable from the Federal Hospital Insurance Trust Fund for services performed and related administrative costs incurred in the succeeding year with respect to individuals age 65 and over who will be entitled to benefits under this part during that entire year.

"(2) The Secretary shall, during September of each year determine and promulgate the dollar amount which shall be applicable for premiums for months occurring in the following year. Such amount shall be equal to the monthly actuarial rate determined under paragraph (1) for that following year. Any amount determined under the preceding sentence which is not a multiple of $1 shall be rounded to the nearest multiple of $1 (or, if it is a multiple of 50 cents but not a multiple of $1, to the next higher multiple of $1).

"(3) Whenever the Secretary promulgates the dollar amount which shall be applicable as the monthly premium under this section, he shall, at the time such promulgation is announced, issue a public statement setting forth the actuarial assumptions and bases employed by him in arriving at the amount of an adequate actuarial rate for individuals 65 and older as provided in paragraph (1).". Public information.

SEC. 104. EFFECTIVE DATES, TRANSITION, AND CONFORMING AMENDMENTS.

(a) Effective Date.— 42 USC 1395d note.

(1) In general.—Except as provided in paragraphs (2) and (3), the amendments made by this subtitle shall take effect on January 1, 1989, and shall apply—

(A) to the inpatient hospital deductible for 1989 and succeeding years,

(B) to care and services furnished on or after January 1, 1989,

(C) to premiums for January 1989 and succeeding months, and

(D) to blood or blood cells furnished on or after January 1, 1989.

(2) ELIMINATION OF POST-HOSPITAL REQUIREMENT FOR EXTENDED CARE SERVICES.—The amendments made by this subtitle, insofar as they eliminate the requirement (under section 1812(a)(2) of the Social Security Act) that extended care services are only covered under title XVIII of such Act if they are post-hospital extended care services, shall only apply to extended care services furnished pursuant to an admission to a skilled nursing facility occurring on or after January 1, 1989.

42 USC 1395e note.

(b) HOLD HARMLESS PROVISIONS.—In the case of an individual for whom a spell of illness (as defined in section 1861(a) of the Social Security Act, as in effect on December 31, 1988) began before January 1, 1989, and had not yet ended as of such date—

(1) the amendment made to section 1813(a)(1) of such Act shall not apply to services furnished during that spell of illness during 1989 or 1990, and

(2) the amount of any deductible under section 1813(a)(2) of such Act (as amended by this subtitle) shall be reduced during that spell of illness during 1989 or 1990 to the extent the deductible under such section was applied during the spell of illness.

42 USC 1395ww note.

(c) ADJUSTMENTS IN PAYMENTS FOR INPATIENT HOSPITAL SERVICES.—

(1) PPS HOSPITALS.—In adjusting DRG prospective payment rates under section 1886(d) of the Social Security Act, outlier cutoff points under section 1886(d)(5)(A) of such Act, and weighting factors under section 1886(d)(4) of such Act for discharges occurring on or after October 1, 1988, the Secretary of Health and Human Services shall, to the extent appropriate, take into consideration the reductions in payments to hospitals by medicare beneficiaries resulting from the elimination of a day limitation on medicare inpatient hospital services (under the amendments made by section 101).

(2) PPS-EXEMPT HOSPITALS.—In adjusting target amounts under section 1886(b)(3) of the Social Security Act for cost reporting periods beginning on or after October 1, 1988, the Secretary shall, on a hospital-specific basis, take into consideration the reductions in payments to hospitals by medicare beneficiaries resulting from the elimination of a day limitation on medicare inpatient hospital services (under the amendments made by section 101).

(d) MISCELLANEOUS CONFORMING AMENDMENTS.—

(1) Section 1811 (42 U.S.C. 1395c) is amended by striking "hospital, related post-hospital" and inserting "inpatient hospital services, extended care services".

(2) Section 1814 (42 U.S.C. 1395f) is amended—

(A) in paragraphs (2)(B) and (6) of subsection (a), by striking "post-hospital" each place it appears;

(B) in subsection (a)(2)(B), by striking ", for any of the conditions" and all that follows up to the semicolon;

(C) in subsection (a)(7)(A)—

(i) by striking "and" at the end of clause (i),

(ii) by striking the semicolon at the end of clause (ii) and inserting ", and", and

(iii) by adding at the end the following new clause: "(iii) in a subsequent extension period, the medical director or physician described in clause (i)(II) recertifies at the beginning of the period that the individual is terminally ill;"; and

(D) in subsection (d)(3)—

(i) by striking "60 percent" and "80 percent" and inserting "100 percent" both places, and

(ii) by striking "two-thirds of".

(3) Section 1832(b) (42 U.S.C. 1395k(b)) is amended by striking " 'spell of illness'," and the comma before "and".

(4) Section 1861 (42 U.S.C. 1395x) is amended—

(A) by striking subsection (a);

(B) in subsection (e)—

(i) in the matter before paragraph (1), by striking "paragraph (7) of this subsection, and subsection (i) of this section" and inserting "and paragraph (7) of this subsection",

(ii) in the third sentence, by striking "section 1814(f)(2), and subsection (i) of this section" and inserting "and section 1814(f)(2)",

(iii) in the fifth sentence, by striking ", except for purposes of subsection (a)(2),", and

(iv) by striking the second sentence;

(C) by striking subsection (i);

(D) in subsections (v)(1)(G)(i), (v)(2)(A), and (v)(3), by striking "post-hospital" each place it appears; and

(E) in subsection (y)—

(i) by striking "Post-Hospital" in the heading and by striking "post-hospital" each place it appears,

(ii) in paragraph (1), by striking "(except for purposes of subsection (a)(2))",

(iii) in paragraphs (2) and (3), by striking "spell of illness" and "spell" each place either appears and inserting "year",

(iv) in paragraph (2)(A)(i), by striking "30 days" and inserting "45 days",

(v) in paragraph (3), by striking "one-eighth" and all that follows through "31st day" and inserting "the coinsurance amount established under section 1813(a)(3)(C) for each day before the 46th day", and

(vi) by striking paragraph (4).

(5) Section 1866(d) (42 U.S.C. 1395cc(d)) is amended by striking "post-hospital" each place it appears.

(6) Subsections (d)(1) and (f) of section 1883 (42 U.S.C. 1395tt) are amended by striking "post-hospital" each place it appears.

Subtitle B—Supplemental Medicare Premium

SEC. 111. IMPOSITION OF SUPPLEMENTAL MEDICARE PREMIUM.

(a) General Rule.—Subchapter A of chapter 1 of the Internal Revenue Code of 1986 (relating to determination of tax liability) is amended by adding at the end thereof the following new part:

Taxes.

"PART VIII—SUPPLEMENTAL MEDICARE PREMIUM

26 USC 59B.

"SEC. 59B. SUPPLEMENTAL MEDICARE PREMIUM.

"(a) IMPOSITION OF PREMIUM.—In the case of an individual to whom this section applies, there is hereby imposed (in addition to any other amount imposed by this subtitle) for each taxable year a supplemental premium equal to the annual premium for such year determined under subsection (c).

"(b) INDIVIDUALS SUBJECT TO PREMIUM.—This section shall apply to an individual for any taxable year if—

"(1) such individual is a medicare-eligible individual for more than 6 full months beginning in the taxable year, and

"(2) such individual's adjusted income tax liability for the taxable year equals or exceeds $150.

"(c) DETERMINATION OF AMOUNT OF SUPPLEMENTAL PREMIUM.—For purposes of this section—

"(1) IN GENERAL.—Except as otherwise provided in this subsection, the annual premium determined under this subsection with respect to any individual for any taxable year shall be equal to the product of—

"(A) the supplemental premium rate determined under subsection (d) or (e) (whichever applies) for the taxable year, multiplied by

"(B) the amount determined by dividing—

"(i) the individual's adjusted income tax liability for the taxable year, by

"(ii) $150.

"(2) LIMITATION ON ANNUAL PREMIUM.—

"(A) YEARS BEFORE 1994.—In the case of any taxable year beginning before 1994, the annual premium determined under this subsection with respect to any individual shall not exceed the limitation determined under the following table:

"In the case of taxable years beginning in:	The limitation is:
1989	$800
1990	850
1991	900
1992	950
1993	1,050.

"(B) YEARS AFTER 1993.—In the case of any taxable year beginning in a calendar year after 1993, the annual premium determined under this subsection with respect to any individual shall not exceed—

"(i) the limitation which would be in effect under this paragraph for taxable years beginning in the preceding calendar year without regard to the last sentence of this subparagraph, increased by

"(ii) the percentage (if any) by which—

"(I) the medicare-part B value for the 2nd preceding calendar year, exceeds

"(II) such value for the 3rd preceding calendar year.

If the limitation determined under the preceding sentence is not a multiple of $50, such limitation shall be rounded to the nearest multiple of $50.

"(C) MEDICARE-PART B VALUE.—

"(i) IN GENERAL.—For purposes of subparagraph (B), the term 'medicare-part B value' means, with respect to any calendar year, an amount equal to the excess of—

"(I) the average per capita part B outlays for the year, over

"(II) 12 times the monthly premium for months in such calendar year established under section 1839 of such Act (without regard to subsections (b), (f), (g)(4), and (g)(5) thereof).

"(ii) AVERAGE PER CAPITA PART B OUTLAYS.—For purposes of clause (i), the term 'average per capita part B outlays' means, with respect to a calendar year—

"(I) the outlays under part B of title XVIII of the Social Security Act for the year, divided by

"(II) the average number of individuals covered under such part during the year.

"(iii) SPECIAL RULE FOR COVERED OUTPATIENT DRUGS.—In applying the limitation under subparagraph (B) with respect to taxable years beginning in any calendar year before 1998, for purposes of this subparagraph—

"(I) the term 'outlays' does not include outlays for covered outpatient drugs (as defined in section 1861(t)(2) of the Social Security Act), and

"(II) the monthly premium shall be computed under clause (i)(II) excluding premiums under section 1839(g) of such Act attributable to the prescription drug monthly premium.

"(3) TABLES.—The annual premium shall be determined under tables which shall be prescribed by the Secretary. Such tables shall be based on the foregoing provisions of this subsection; except that such tables may have adjusted income tax liability brackets of less than $150.

"(d) DETERMINATION OF SUPPLEMENTAL PREMIUM RATE FOR YEARS BEFORE 1994.—In the case of any taxable year beginning before 1994, the supplemental premium rate determined under this subsection shall be the sum of the catastrophic coverage premium rate and the prescription drug premium rate determined under the following table:

"In the case of any taxable year beginning in:	The catastrophic coverage premium rate is:	The prescription drug premium rate is:
1989	$22.50	0
1990	27.14	$10.36
1991	30.17	8.83
1992	30.55	9.95
1993	29.55	12.45.

"(e) SUPPLEMENTAL PREMIUM RATE FOR YEARS AFTER 1993.—

"(1) IN GENERAL.—In the case of any taxable year beginning in a calendar year after 1993, except as provided in paragraph (2), the supplemental premium rate determined under this subsection shall be the sum of—

"(A) the catastrophic coverage premium rate (which would be in effect under this section for taxable years beginning in the preceding calendar year if paragraph (2) did not apply to any preceding calendar year) adjusted by the percentage determined under paragraph (3) for the calendar year in which the taxable year begins, and

"(B) the prescription drug premium rate (which would be in effect under this section for taxable years beginning in the preceding calendar year if paragraph (2) did not apply to any preceding calendar year) adjusted by the percentage determined under paragraph (4) for the calendar year in which the taxable year begins.

"(2) SUPPLEMENTAL PREMIUM RATE CANNOT GO DOWN, AND CANNOT GO UP BY MORE THAN $1.50.—

"(A) IN GENERAL.—In no event shall the supplemental premium rate determined under this subsection for any taxable year beginning in a calendar year after 1993—

"(i) be less than, or

"(ii) exceed by more than $1.50,

the supplemental premium rate in effect under this section for taxable years beginning in the preceding calendar year.

"(B) DETERMINATION OF COMPONENT RATES WHERE SUBPARAGRAPH (A) APPLIES.—If subparagraph (A) affects the supplemental premium rate determined under this subsection for taxable years beginning in any calendar year, the supplemental premium rate determined after the application of subparagraph (A) shall be allocated between the catastrophic coverage premium rate and the prescription drug premium rate on the basis of the respective amounts of such rates without regard to the application of subparagraph (A).

"(3) PERCENTAGE ADJUSTMENT FOR CATASTROPHIC COVERAGE PREMIUM RATE.—

"(A) IN GENERAL.—The percentage determined under this paragraph for any calendar year shall be the sum of—

"(i) the outlay-premium percentage, and

"(ii) the reserve account percentage.

For purposes of the preceding sentence, negative percentages shall be taken into account as negatives.

"(B) OUTLAY-PREMIUM PERCENTAGE.—

"(i) IN GENERAL.—Except as otherwise provided in this subparagraph, the outlay-premium percentage for any calendar year is—

"(I) the percentage by which the per capita catastrophic outlays in the 2nd preceding calendar year exceed such outlays in the 3rd preceding calendar year, reduced (including below zero) by

"(II) the percentage by which the per capita catastrophic coverage premium liability for the 2nd preceding calendar year exceeds such liability for the 3rd preceding calendar year (determined as if the catastrophic coverage premium rate for the 2nd preceding calendar year were the same as the rate in effect for the 3rd preceding calendar year).

If there is no excess described in subclause (I) or (II), such subclause shall be applied by substituting 'is less than' for 'exceeds' and the percentage determined with such substitution shall be taken into account as a negative percentage.

"(ii) ADJUSTMENT FOR MORE RECENT INCREASES IN COST-OF-LIVING.—If—

"(I) the percentage increase in the CPI for the 12-month period ending with May of the preceding calendar year, exceeds (or is less than)

"(II) such increase for the 12-month period ending with May of the 2nd preceding calendar year,

by at least 1 percentage point, the percentage determined under clause (i) for the calendar year shall be adjusted up (or down, respectively) by ½ of the amount by which such excess (or shortage, respectively) exceeds 1 percent.

"(C) RESERVE ACCOUNT PERCENTAGE.—

"(i) IN GENERAL.—The reserve account percentage for any calendar year is the percentage which the rate change determined under clause (ii) is of the catastrophic coverage premium rate which would be in effect under this section for taxable years beginning in the preceding calendar year if paragraph (2) did not apply to any preceding calendar year. If there is an excess determined under clause (iii), the percentage determined under the preceding sentence shall be taken into account as a negative percentage.

"(ii) DETERMINATION OF RATE CHANGE.—The rate change determined under this clause for any calendar year is the adjustment in the catastrophic coverage premium rate (otherwise in effect for taxable years beginning in the 2nd preceding calendar year) which the Secretary determines would have resulted in an aggregate increase (or decrease) in the premiums imposed by this section for such taxable years equal to 63 percent of the shortfall or excess determined under clause (iii) for the calendar year.

"(iii) DETERMINATION OF SHORTFALL OR EXCESS.—The shortfall (or excess) determined under this clause for any calendar year is the amount by which—

"(I) 20 percent of the outlays during the 2nd preceding calendar year from the Medicare Catastrophic Coverage Account created under section 1841B of the Social Security Act, exceeds (or is less than)

"(II) the balance in such Account as of the close of such 2nd preceding calendar year (determined by taking into account previous premium increases by reason of the reserve account percentage under this subsection or by reason of section 1839(g)(2) of the Social Security Act but not credited to the Account).

"(D) DEFINITIONS.—For purposes of this paragraph—

"(i) PER CAPITA CATASTROPHIC OUTLAYS.—The term 'per capita catastrophic outlays' means, with respect to any calendar year, the amount (as determined by the Secretary of Health and Human Services) equal to—

"(I) the outlays during such year from the Medicare Catastrophic Coverage Account created under section 1841B of the Social Security Act, divided by

"(II) the average number of individuals entitled to receive benefits under part A of title XVIII of the Social Security Act during such calendar year.

"(ii) PER CAPITA CATASTROPHIC COVERAGE PREMIUM LIABILITY.—The term 'per capita catastrophic coverage premium liability' means, with respect to any calendar year, the amount (as determined by the Secretary) equal to—

"(I) the aggregate premiums imposed by this section for taxable years beginning in such calendar year to the extent attributable to the catastrophic coverage premium rate, divided by

"(II) the number of individuals who had premium liability under this section for such taxable years.

"(iii) PERCENTAGE INCREASE IN CPI.—The percentage increase in the CPI for any 12-month period shall be the percentage by which the Consumer Price Index (as defined in section 1(f)(5)) for the last month of such period exceeds such Index for the last month of the preceding 12-month period.

"(4) PERCENTAGE ADJUSTMENT FOR PRESCRIPTION DRUG PREMIUM RATE.—The percentage determined under this paragraph for any calendar year shall be determined under rules similar to the rules of paragraph (3); except that—

"(A) in determining the prescription drug premium rate for any calendar year before 1998, the following percentages shall be substituted for 20 percent in paragraph (3)(C)(iii)(I):

"In the case of calendar year:	The percentage is:
1994	75
1995	50
1996	25
1997	25,

"(B) no adjustment by reason of the outlay-premium percentage shall be made for any calendar year before 1998,

"(C) any reference to the Medicare Catastrophic Coverage Account shall be treated as a reference to the Federal Catastrophic Drug Insurance Trust Fund, and

"(D) any reference to the catastrophic coverage premium rate shall be treated as a reference to the prescription drug premium rate.

"(f) DEFINITIONS AND SPECIAL RULES.—

"(1) MEDICARE-ELIGIBLE INDIVIDUAL.—For purposes of this section—

"(A) IN GENERAL.—Except as otherwise provided in this paragraph, the term 'medicare-eligible individual' means, with respect to any month, any individual who is entitled to (or, on application without the payment of an additional premium, would be entitled to) benefits under part A of title XVIII of the Social Security Act for such month.

"(B) EXCEPTIONS.—The term 'medicare-eligible individual' shall not include for any month—

"(i) any individual who is entitled to benefits under part A of title XVIII of the Social Security Act for such month solely by reason of the payment of a premium under section 1818 of such Act, or "(ii) any qualified nonresident.

"(2) SPECIAL RULES FOR JOINT RETURNS.—In the case of a joint return—

"(A) WHERE PREMIUM APPLIES TO BOTH SPOUSES.—If both spouses meet the requirements of subsection (b)(1) for the taxable year—

"(i) such spouses shall be treated as 1 individual for purposes of applying this section, except that

"(ii) the limitation of subsection (c)(2) shall be twice the amount which would otherwise apply.

"(B) WHERE PREMIUM APPLIES TO ONLY 1 SPOUSE.—If only 1 spouse meets the requirements of subsection (b)(1) for the taxable year—

"(i) this section shall be applied separately with respect to such spouse, and

"(ii) the adjusted income tax liability of such spouse shall be determined under paragraph (4)—

"(I) by taking into account one-half of the income tax liability determined with respect to the joint return, and

"(II) by taking into account under clause (ii) of paragraph (4)(C) only amounts attributable to such spouse.

"(3) SEPARATE RETURNS BY MARRIED INDIVIDUALS.—If an individual is married as of the close of the taxable year (within the meaning of section 7703) but does not file a joint return for the taxable year and such individual does not live apart from his spouse at all times during the taxable year—

"(A) the limitation of subsection (c)(2) shall be twice the amount which would otherwise apply if both the individual and the spouse of the individual meet the requirements of subsection (b)(1) with respect to the calendar year in which the taxable year begins (determined without regard to subparagraph (B) of this paragraph),

"(B) if such individual does not otherwise meet the requirements of subsection (b)(1), such individual shall be treated as meeting the requirements of subsection (b)(1) for the taxable year if the spouse of such individual meets such requirements with respect to the calendar year in which the taxable year begins, and

"(C) in applying subparagraph (C) of paragraph (4)—

"(i) the dollar limitation of clause (i) thereof shall be ½ of the amount which applies to a joint return where both spouses meet the requirements of subsection (b)(1), and

"(ii) the individual shall be deemed to receive social security benefits during the taxable year in an amount not less than ½ of the aggregate social security benefits received by such individual and his spouse during the taxable year.

"(4) ADJUSTED INCOME TAX LIABILITY.—For purposes of this section—

"(A) IN GENERAL.—The term 'adjusted income tax liability' means an amount equal to the income tax liability, reduced by the excess (if any) of—

"(i) 15 percent of the governmental retiree exclusion amount (if any) determined under subparagraph (C) for the taxable year, over

"(ii) the amount of the credit allowable under section 22 for the taxable year.

"(B) INCOME TAX LIABILITY.—The term 'income tax liability' means—

"(i) the tax imposed by this chapter (determined without regard to this section), reduced by

"(ii) the credits allowed under part IV of this subchapter (other than under sections 31, 33, and 34).

"(C) GOVERNMENTAL RETIREE EXCLUSION AMOUNT.—The governmental retiree exclusion amount for any taxable year is the lesser of—

"(i) $6,000 ($9,000 in the case of a joint return where both spouses meet the requirements of subsection (b)(1) for the taxable year), or

"(ii) the amount which is received as an annuity (whether for a period certain or during 1 or more lives) under a governmental plan (as defined in the 1st sentence of section 414(d)) and which is includible in gross income under section 72 for the taxable year.

The amount determined under the preceding sentence shall be reduced by the social security benefits (as defined in section 86(d)) received during the taxable year.

"(D) INDEXING.—In the case of any taxable year beginning in a calendar year after 1989, subparagraph (C)(i) shall be applied by substituting for each dollar amount contained in such subparagraph an amount equal to—

"(i) the dollar amount which would be in effect under subparagraph (C)(i) for taxable years beginning in the preceding calendar year without regard to the last sentence of this subparagraph, increased by

"(ii) the cost-of-living adjustment determined under section 215(i) of the Social Security Act for the calendar year in which the taxable year begins.

Any amount determined under the preceding sentence shall be rounded to the nearest multiple of $50.

"(5) QUALIFIED NONRESIDENT.—

"(A) IN GENERAL.—For purposes of paragraph (1), the term 'qualified nonresident' means, with respect to any month during the taxable year, any individual if—

"(i) such individual is not furnished during such taxable year or any of the 4 preceding taxable years any service for which a claim for payment is made under part A of title XVIII of the Social Security Act,

"(ii) such individual is not entitled to benefits under part B of title XVIII of the Social Security Act at any time during such taxable year or any of the 4 preceding taxable years, and

"(iii) such individual is present in a foreign country or countries for at least 330 full days during—

"(I) the 12-month period ending at the close of the taxable year, and

"(II) each of the 4 consecutive preceding 12-month periods.

"(B) SPECIAL RULE FOR INDIVIDUALS WHO DIE DURING THE TAXABLE YEAR.—An individual who dies during the taxable year shall be treated as meeting the requirement of subparagraph (A)(iii)(I) if such individual is present in a foreign country or countries for at least a number of full days equal to 90 percent of the days during such taxable year before the date of death.

"(6) COORDINATION WITH OTHER PROVISIONS.—

"(A) NOT TREATED AS MEDICAL EXPENSE.—For purposes of section 213, the supplemental premium imposed by this section for any taxable year shall not be treated as an expense paid for medical care.

"(B) NOT TREATED AS TAX FOR CERTAIN PURPOSES.—The supplemental premium imposed by this section shall not be treated as a tax imposed by this chapter for purposes of determining—

"(i) the amount of any credit allowable under this chapter, or

"(ii) the amount of the minimum tax imposed by section 55.

"(C) TREATED AS TAX FOR SUBTITLE F.—For purposes of subtitle F, the supplemental premium imposed by this section shall be treated as if it were a tax imposed by section 1.

"(D) SECTION 15 NOT TO APPLY.—Section 15 shall not apply to the supplemental premium imposed by this section.

"(7) SECTION NOT TO AFFECT LIABILITY TO POSSESSIONS, ETC.—This section shall not apply for purposes of determining liability to any possession of the United States. For purposes of sections 932 and 7654, the supplemental premium imposed by this section shall not be treated as a tax imposed by this chapter.

"(8) SHORT TAXABLE YEARS.—In the case of a taxable year of less than 12 months, this section shall be applied under regulations prescribed by the Secretary."

(b) INFORMATION REPORTING.—

(1) Subsection (a) of section 6050F of such Code is amended by striking "and" at the end of paragraph (1), by redesignating paragraph (2) as paragraph (3), and by inserting after paragraph (1) the following new paragraph: 26 USC 6050F.

"(2) whether any individual meets the requirements of section 59B(b)(1) with respect to the calendar year (determined without regard to section 59B(f)(1)(B)(ii)), and".

(2) Section 6050F(b) of such Code is amended—

(A) by inserting "or making the determination under subsection (a)(2)" after "payments" in paragraph (1), and

(B) by inserting "and the information required under subsection (a)(2)," after "reductions," in paragraph (2).

(3) Section 6050F(c)(1)(A) of such Code is amended by inserting "and the information required under subsection (a)(2)" after "section 86(d)(1)(A)".

(c) CLERICAL AMENDMENT.—The table of parts for subchapter A of chapter 1 of such Code is amended by adding at the end thereof the following new item:

"Part VIII. Supplemental medicare premium."

(d) ANNOUNCEMENT OF SUPPLEMENTAL PREMIUM RATE.—In the case of calendar year 1993 or any calendar year thereafter— 26 USC 59B note.

(1) not later than July 1 of such calendar year, the Secretary of the Treasury or his delegate shall make an announcement of the estimated supplemental premium rate under section 59B of the Internal Revenue Code of 1986 for taxable years beginning in the following calendar year, and

(2) not later than October 1 of such calendar year, the Secretary of the Treasury or his delegate shall make an announcement of the actual supplemental premium rate under such section for such taxable years.

26 USC 59B note.

(e) EFFECTIVE DATE.—

(1) IN GENERAL.—The amendments made by this section shall apply to taxable years beginning after December 31, 1988.

(2) WAIVER OF ESTIMATED TAX REQUIREMENT FOR YEARS BEGINNING IN 1989.—In the case of a taxable year beginning in 1989, the premium imposed by section 59B of the Internal Revenue Code of 1986 (as added by this section) shall not be treated as a tax for purposes of applying section 6654 of such Code.

SEC. 112. ESTABLISHMENT OF FEDERAL HOSPITAL INSURANCE CATASTROPHIC COVERAGE RESERVE FUND.

(a) IN GENERAL.—Part A of title XVIII is amended by inserting after section 1817 the following new section:

"FEDERAL HOSPITAL INSURANCE CATASTROPHIC COVERAGE RESERVE FUND

42 USC 1395i-1a.

"SEC. 1817A. (a)(1) There is hereby created on the books of the Treasury of the United States a trust fund to be known as the 'Federal Hospital Insurance Catastrophic Coverage Reserve Fund' (in this section referred to as the 'Reserve Fund'). The Reserve Fund shall consist of such gifts and bequests as may be made as provided in section 201(i)(1) and amounts appropriated under paragraph (2).

"(2) There are hereby appropriated to the Reserve Fund, from the supplemental premiums imposed by section 59B of the Internal Revenue Code of 1986 attributable to the supplemental catastrophic premium rate, amounts equivalent to 100 percent of the amount of outlays made under this part attributable to the amendments made by the Medicare Catastrophic Coverage Act of 1988. The amounts appropriated by the preceding sentence shall be transferred from time to time (not less frequently than monthly) from the general fund in the Treasury to the Reserve Fund, such amounts to be determined on the basis of estimates by the Secretary of the Treasury of the premiums, specified in the preceding sentence, paid to or deposited into the Treasury and on the basis of outlays, specified in the previous sentence, made; and proper adjustments shall be made in amounts subsequently transferred to the extent prior estimates were in excess of or were less than the appropriate amounts specified in such sentence. At the close of each year, the transfers under this subsection shall reflect all premiums (described in this paragraph) paid or deposited into the Treasury in the year.

"(3) With respect to monies transferred to the Reserve Fund, no transfers, authorizations of appropriations, or appropriations are permitted.

"(b) The provisions of subsections (b) through (e) of section 1817 shall apply to the Reserve Fund in the same manner as they apply to the Federal Hospital Insurance Trust Fund, except that the Board of Trustees and Managing Trustee of the Reserve Fund shall be composed of the members of the Board of Trustees and the Managing Trustee, respectively, of the Federal Hospital Insurance Trust Fund.

"(c) In this part, with respect to the Reserve Fund, the terms 'outlays' and 'receipts' mean, with respect to a quarter or other period, gross outlays and receipts, as such terms are employed in the 'Monthly Treasury Statement of Receipts and Outlays of the United States Government (MTS)', as published by the Department of the Treasury, for months in such quarter or other period.".

(b) INTEREST ADJUSTMENT.—In July 1990, the Secretary of the Treasury shall calculate the interest lost to the Federal Hospital Insurance Catastrophic Coverage Reserve Fund due to the lag between the outlays (attributable to the amendments made by this Act) from the Federal Hospital Insurance Trust Fund during 1989 and the transfers made to such Reserve Fund to cover such outlays. Appropriations under section 1817A(a)(2) of the Social Security Act (as inserted by subsection (a)) shall include the amount calculated under the previous sentence. 42 USC 1395i-1a note.

SEC. 113. STUDY OF TAX INCENTIVES FOR PURCHASE OF COVERAGE FOR LONG-TERM CARE.

(a) IN GENERAL.—The Secretary of the Treasury (in this section referred to as the "Secretary") shall conduct a study of Federal tax policies to promote the private financing of long-term care (as defined in subsection (d)). The study shall identify alternative methods of creating incentives, through the tax system, to encourage individuals to purchase insurance coverage for long-term care. The study shall also consider the cost to the United States Treasury and the potential benefits to consumers, including whether the incentives would benefit all or most of the population requiring protection.

(b) CONSULTATION.—The Secretary shall conduct the study required by subsection (a) in consultation with representatives of the insurance industry, providers of long-term care, and consumers.

(c) REPORT.—The Secretary shall report the results of the study required by subsection (a) to the Congress not later than November 30, 1988, together with the Secretary's recommendations for any changes in Federal law that the Secretary determines to be appropriate to promote the private financing of long-term care.

(d) LONG-TERM CARE DEFINED.—For purposes of this section, the term "long-term care" includes care and services provided by nursing homes, home health agencies, and other mechanisms for the delivery of long-term care services.

TITLE II—PROVISIONS RELATING TO PART B OF THE MEDICARE PROGRAM AND TO MEDICARE SUPPLEMENTAL HEALTH INSURANCE

Subtitle A—Expansion of Medicare Part B Benefits

SEC. 201. LIMITATION ON MEDICARE PART B COST-SHARING.

(a) IN GENERAL.—Section 1833 (42 U.S.C. 1395l) is amended—

(1) in subsection (c)—

(A) by striking "subsections (a) and (b)" and inserting "subsection (a) through (c)",

(B) by redesignating paragraphs (1) and (2) as subparagraphs (A) and (B),

(C) by striking "this subsection" and inserting "this paragraph", and

(D) by striking "(c)" and inserting "(d)(1)";

(2) by redesignating subsection (d) as paragraph (2);

(3) in subsection (g), by striking "(a) and (b)" and inserting "(a) through (c)"; and

(4) by inserting after subsection (b) the following new subsection:

"(c)(1) Notwithstanding subsections (a) and (b), if an individual has incurred out-of-pocket part B cost sharing (as defined in paragraph (2)) in a calendar year (beginning with 1990) in an amount equal to the part B catastrophic limit (established under paragraph (3)) for the year, payment under this part with respect to any additional incurred expenses in the calendar year shall be made as if—

"(A) the deduction described in the second sentence of subsection (b) (relating to blood) no longer applied, and

"(B) '100 percent' and '0 percent' were substituted for '80 percent' and '20 percent', respectively, each place either appears in subsections (a) and (i)(2), in sections 1834(a)(1)(A), 1834(e)(1)(C), 1835(b)(2), and 1866(a)(2)(A), and in subsections (b)(2) and (b)(3) of section 1881, except as such provisions may apply to in-home care.

"(2) In this subsection, the term 'out-of-pocket part B cost sharing' means, with respect to an individual covered under this part, the amounts of expenses that the individual incurs that are attributable to—

"(A) the deductions established under subsection (b), and

"(B) the difference between the payment amount provided under this part and the payment amount that would be provided if '100 percent' and '0 percent' were substituted for '80 percent' and '20 percent', respectively, each place either appears in subsections (a) and (i)(2), in sections 1834(a)(1)(A), 1834(e)(1)(C), 1835(b)(2), and 1866(a)(2)(A), and in subsections (b)(2) and (b)(3) of section 1881.

"(3)(A) The part B catastrophic limit for 1990 is $1,370. The part B catastrophic limit for any succeeding year shall be such an amount (rounded to the nearest multiple of $1) as the Secretary estimates will result, in that succeeding year, in 7 percent of the average number of individuals enrolled under this part (other than individuals enrolled with an eligible organization under section 1876 or an organization described in subsection (a)(1)(A)) during the year becoming entitled to benefits under this subsection.

"(B) Not later than September 1 of each year (beginning with 1990), the Secretary shall promulgate the part B catastrophic limit under this paragraph for the succeeding year.

Contracts.

"(4) In the case of an organization receiving payment under clause (A) of subsection (a)(1) or under a reasonable cost reimbursement contract under section 1876, in applying paragraph (1), the Secretary shall provide for an appropriate adjustment in the payment amounts otherwise made to reflect the aggregate increase in payments that would otherwise be made with respect to enrollees in such an organization if payments were made other than under such clause or such a contract on an individual-by-individual basis.

"(5)(A) Except as provided in subparagraph (B), expenses incurred by a medicare beneficiary for out-of-pocket part B cost-sharing shall be counted (consistent with subparagraph (C)) whether or not, at the time the expenses were incurred, the beneficiary was enrolled in a plan under section 1833(a)(1)(A) or under section 1876. In this paragraph, with respect to a medicare beneficiary enrolled in such a plan, the term 'out-of-pocket part B cost-sharing' includes deductibles and coinsurance under the plan for items and services covered under this part.

"(B) In the case of a medicare beneficiary enrolled in a month in a buy-out plan (as defined in subparagraph (D))—

"(i) expenses incurred by the beneficiary for items and services reimbursed under the plan shall not be treated as out-of-pocket part B cost-sharing for purposes of paragraph (1), but

"(ii) the beneficiary is deemed to have incurred, for each month of such enrollment, expenses for out-of-pocket part B cost-sharing in an amount equal to the actuarial value (with respect to a month in the year involved) of the deductible and coinsurance amounts under part B (as computed by the Secretary for purposes of section 1876(e)(1), other than with respect to covered outpatient drugs) applicable on the average to individuals in the United States.

"(C) The Secretary may not enter into a contract with an organization under section 1876, or provide for payment under section 1833(a)(1)(A) with respect to an organization, with respect to a plan that is not a buy-out plan, unless the organization provides assurances, satisfactory to the Secretary, that— Contracts.

"(i) the organization will maintain and make available, for its enrollees and in coordination with the appropriate carriers under this part, an accounting of expenses incurred in each year under the plan for out-of-pocket part B cost-sharing (as defined in subparagraph (A)); and

"(ii) the organization will not undertake to charge a beneficiary during a year for services for which payment may be made under this part (other than for covered outpatient drugs) after the individual has incurred (whether through the organization or otherwise) out-of-pocket part B cost sharing in the year in an amount equal to the part B catastrophic limit established under paragraph (1) for the year.

"(D) In this paragraph, the term 'buy-out plan' means a plan under section 1833(a)(1)(A) or offered by an organization under section 1876 and with respect to which—

"(i) the actuarial value of the coinsurance and deductibles under the plan with respect to benefits (other than covered outpatient drugs) under this title (as determined by the Secretary),

is less than 50 percent of—

"(ii) the actuarial value of the coinsurance and deductibles for such benefits for all medicare beneficiaries (as determined by the Secretary) applicable on the average to individuals in the United States.

"(E) In this subsection, the term 'medicare beneficiary' means, with respect to a month, an individual covered for benefits under this part for the month.".

(b) LIMITATION ON CHARGES WHEN CATASTROPHIC LIMIT REACHED.—Section 1866(a)(2)(A) (42 U.S.C. 1395cc(a)(2)(A)) is amended by adding at the end the following new sentence: "A provider of services may not impose a charge under the first sentence of this subparagraph for services for which payment is made to the provider pursuant to section 1833(c) (relating to catastrophic benefits).".

(c) NOTICE FOR BENEFICIARIES REACHING CATASTROPHIC LIMIT.—Section 1842(b)(3) (42 U.S.C. 1395u(b)(3)) is amended—

(1) by striking "and" at the end of subparagraph (G),

(2) by inserting "and" at the end of subparagraph (H), and

(3) by inserting after subparagraph (H) the following new subparagraph:

"(I) will provide each individual, who is determined to have incurred (or has had paid on the individual's behalf) sufficient out-of-pocket part B cost sharing in a calendar year to qualify for payment for additional incurred expenses to be made pursuant to section 1833(c), with a notice that states that the individual has reached the part B catastrophic limit on out-of-pocket cost sharing for the year;".

(d) CONFORMING AMENDMENT.—The second sentence of section 1866(a)(2)(A) (42 U.S.C. 1395cc(a)(2)(A)) is amended by striking "1833(c)" and inserting "1833(d)(1)".

SEC. 202. COVERAGE OF CATASTROPHIC EXPENSES FOR PRESCRIPTION DRUGS AND INSULIN.

(a) DESCRIPTION OF COVERED OUTPATIENT DRUGS.—Section 1861 (42 U.S.C. 1395x) is amended—

(1) by amending subparagraph (J) of subsection (s)(2) to read as follows:

"(J) covered outpatient drugs (as defined in subsection (t)); and", and

(2) in subsection (t)—

(A) by inserting "and paragraph (2)" after "subsection (m)(5)",

(B) by inserting "(1)" after "(t)", and

(C) by adding at the end the following new paragraphs:

"(2) Subject to paragraph (3), the term 'covered outpatient drug' means—

"(A) a drug which may be dispensed only upon prescription and—

"(i) which is approved for safety and effectiveness as a prescription drug under section 505 or 507 of the Federal Food, Drug, and Cosmetic Act or which is approved under section 505(j) of such Act;

"(ii)(I) which was commercially used or sold in the United States before the date of the enactment of the Drug Amendments of 1962 or which is identical, similar, or related (within the meaning of section 310.6(b)(1) of title 21 of the Code of Federal Regulations) to such a drug, and (II) which has not been the subject of a final determination by the Secretary that it is a 'new drug' (within the meaning of section 201(p) of the Federal Food, Drug, and Cosmetic Act) or an action brought by the Secretary under section 301, 302(a), or 304(a) of such Act to enforce section 502(f) or 505(a) of such Act; or "(iii)(I) which is described in section 107(c)(3) of the Drug Amendments of 1962 and for which the Secretary has determined there is a compelling justification for its medical need, or is identical, similar, or related (within the meaning of section 310.6(b)(1) of title 21 of the Code of Federal Regulations) to such a drug, and (II) for which the Secretary has not issued a notice of an opportunity for a hearing under section 505(e) of the Federal Food, Drug, and Cosmetic Act on a proposed order of the Secretary to withdraw approval of an application for such drug under such section because the Secretary has determined that the drug is less than effective for all conditions of use prescribed, recommended, or suggested in its labeling;

"(B) a biological product which—

"(i) may only be dispensed upon prescription,

"(ii) is licensed under section 351 of the Public Health Service Act, and

"(iii) is produced at an establishment licensed under such section to produce such product; and

"(C) insulin certified under section 506 of the Federal Food, Drug, and Cosmetic Act.

"(3)(A) The term 'covered outpatient drug' does not include any drug, biological product, or insulin provided as, as part of, or as incident to, any of the following (and for which payment may be included under this title):

"(i) Inpatient hospital services (described in subsection (b)(2)).

"(ii) Extended care services (described in subsection (h)(5)).

"(iii) Physicians' services under subparagraph (A) or (B) of subsection (s)(2).

"(iv) Dialysis supplies under subsection (s)(2)(F).

"(v) Antigens under subsection (s)(2)(G).

"(vi) Blood clotting factors for hemophiliacs under subsection (s)(2)(I).

"(vii) Services of a physician assistant under subsection (s)(2)(K)(ii).

"(viii) Pneumococcal, hepatitis B, or influenza vaccines under subsection (s)(10).

"(ix) Rural health clinic services (under subsection (aa)(1)).

"(x) Comprehensive outpatient rehabilitation facility services (under subsection (cc)(1)).

"(xi) Hospice care (as defined in subsection (dd)(1)).

"(xii) Certified nurse-midwife service (as defined in subsection (gg)(1)).

"(xiii) A covered surgical procedure in an ambulatory surgical center (under section 1832(a)(2)(F)(i)).

"(B) With respect to covered outpatient drugs dispensed in 1990, the term 'covered outpatient drug' is limited—

"(i) to drugs described in paragraph (2)(A) used in immunosuppressive therapy, and

"(ii) to covered home IV drugs (as defined in paragraph (4)).

"(C) The term 'covered outpatient drug' does not include a drug that is intravenously administered in a home setting unless it is a covered home IV drug.

"(4)(A) The term 'covered home IV drug' means a covered outpatient drug dispensed to an individual that—

"(i) is intravenously administered in a place of residence used as the individual's home, and

"(ii)(I) is an antibiotic drug and the Secretary has not determined, for the specific drug or for the indication to which it is applied, that the drug cannot generally be administered safely and effectively in a home setting, or

"(II) is not an antibiotic drug and the Secretary has determined, for the specific drug and the indication for which the drug is being applied, that the drug can generally be administered safely and effectively in a home setting.

"(B) Not later than January 1, 1990 (and periodically thereafter), the Secretary shall publish a list of the drugs, and indications for such drugs, that are covered home IV drugs (as defined in subparagraph (A)), with respect to which home intravenous drug therapy may be provided under this title.".

(b) DEDUCTIBLE AND PAYMENT AMOUNTS.—Part B is amended—

(1) in subsection (a)(1) of section 1833 (42 U.S.C. 1395l(b)), as amended by section 411(h)(7)(A)(v)(I) of this Act—

(A) by striking "and" before "(L)", and

(B) by adding at the end the following: "and (M) with respect to expenses incurred for covered outpatient drugs, the amounts paid shall be the amounts determined under section 1834(c)(2)";

(2) in subsection (a)(2) of such section by inserting "(other than covered outpatient drugs)" after "(2) in the case of services";

(3) in subsection (b) of such section—

(A) in clause (1), by inserting "or for covered outpatient drugs" after "1861(s)(10)(A)", and

(B) in clause (2), by inserting "or with respect to covered outpatient drugs" after "home health services"; and

(4) by adding at the end of section 1834 (42 U.S.C. 1395m) the following new subsection:

"(c) PAYMENT FOR COVERED OUTPATIENT DRUGS.—

"(1) DEDUCTIBLE.—

"(A) APPLICATION.—

"(i) IN GENERAL.—Except as provided in clauses (ii) and (iii), payment shall be made under paragraph (2) only with respect to expenses incurred by an individual for covered outpatient drugs during a calendar year on or after such date in the year as the Secretary determines that the individual has incurred expenses in the year for covered outpatient drugs (during a period in which the individual is entitled to benefits under this part) equal to the amount of the catastrophic drug deductible specified in subparagraph (C) for that year.

"(ii) DEDUCTIBLE NOT APPLIED FOR POST-HOSPITAL HOME INTRAVENOUS DRUG THERAPY.—The catastrophic drug deductible established under this paragraph shall not apply to covered home IV drugs dispensed in conjunction with home intravenous drug therapy services which are part of a continuous course of such therapy initiated while the individual was an inpatient in a hospital.

"(iii) DEDUCTIBLE NOT APPLIED TO 1ST YEAR IMMUNOSUPPRESSIVES.—The catastrophic drug deductible established under this paragraph shall not apply to drugs described in section 1861(t)(2)(A) used in immunosuppressive therapy and furnished, to an individual who receives an organ transplant for which payment is made under this title, within 1 year after the date of the transplant.

"(B) RESPONSE TO APPLICATION.—If the system described in section 1842(o)(4) has not been established and an individual applies to the Secretary to establish that the individual has met the requirement of subparagraph (A), the Secretary shall promptly notify the individual (and, if the application was submitted by or through a participating pharmacy, the pharmacy) as to the date (if any) as of which the individual has met such requirement.

"(C) CATASTROPHIC DRUG DEDUCTIBLE AMOUNT.—

"(i) IN GENERAL.—Subject to subparagraph (D), the catastrophic drug deductible specified in this subparagraph for—

"(I) 1990 is $550,

"(II) 1991 is $600,

"(III) 1992 is $652, and

"(IV) any succeeding year, is such an amount as the Secretary determines will result in 16.8 percent of the average number of individuals covered under this part (other than individuals enrolled with an eligible organization under section 1876 or an organization described in section 1833(a)(1)(A)) during that succeeding year having incurred expenses for covered outpatient drugs sufficient to meet the catastrophic drug deductible so determined.

"(ii) ROUNDING.—Any amount determined under this subparagraph which is not a multiple of $1 shall be rounded to the nearest multiple of $1.

"(iii) PUBLICATION.—Before May 1 of each year (beginning with 1992) the Secretary shall publish in the Federal Register a proposed regulation establishing the amount of the catastrophic drug deductible under this subparagraph for the following year. During the last 3 days of September of such year, the Secretary shall publish in the Federal Register the final regulation establishing the amount of such deductible for the following year, which amount may not be greater than the amount specified in the proposed regulation. Federal Register, publication. Regulations.

"(2) PAYMENT AMOUNT.—

"(A) IN GENERAL.—Subject to the catastrophic drug deductible established under paragraph (1)(A) and except as provided in subparagraph (C), the amounts payable under this part with respect to a covered outpatient drug is equal to the payment percent (specified in subparagraph (B)) of the lesser of—

"(i) the actual charge for the drug, or

"(ii) the applicable payment limit established under paragraph (3).

"(B) PAYMENT PERCENT.—For purposes of subparagraph (A), the payment percent is 100 percent minus the applicable coinsurance percent (specified in subparagraph (C)).

"(C) COINSURANCE PERCENT.—For purposes of subparagraph (B), the coinsurance percent—

"(i) for covered home IV drugs and for drugs described in paragraph (1)(A)(iii) (relating to immunosuppressive therapy during the 1st year after transplant), is 20 percent; and

"(ii) for other covered outpatient drugs dispensed—

"(I) in 1990 or 1991, is 50 percent,

"(II) in 1992 is 40 percent, and

"(III) in 1993 or a succeeding year is 20 percent.

Contracts.

"(D) TREATMENT OF CERTAIN COST-BASED PREPAID ORGANIZATIONS.—In applying subparagraph (A) in the case of an organization under a reasonable cost reimbursement contract under section 1876 and in the case of an organization receiving payment under section 1833(a)(1)(A) and providing coverage of covered outpatient drugs, the Secretary shall provide for an appropriate adjustment in the payment amounts otherwise made to reflect the aggregate increase in payments that would otherwise be made with respect to enrollees in such an organization if payments were made other than under such clause or such a contract on an individual-by-individual basis.

"(3) PAYMENT LIMITS.—

"(A) PAYMENT LIMIT FOR NON-MULTIPLE SOURCE DRUGS AND MULTIPLE-SOURCE DRUGS WITH RESTRICTIVE PRESCRIPTIONS.—In the case of a drug that either is not a multiple source drug (as defined in paragraph (9)(A)) or is a multiple source drug and has a restrictive prescription (as defined in paragraph (9)(B)), the payment limit for the drug under this paragraph for a payment calculation period is equal to the lesser of—

"(i) the 90th percentile of the actual charges (computed on a statewide basis, carrier-wide basis, or other appropriate geographic area basis, as specified by the Secretary) for the drug for the second previous payment calculation period, adjusted (as the Secretary determines to be appropriate) to reflect the number of tablets (or other dosage units) dispensed; or

"(ii) the amount of the administrative allowance (established under paragraph (4)) plus the product of—

"(I) the number of tablets (or other dosage units) dispensed, and

"(II) the per tablet or unit average wholesale price for such drug (as determined under subparagraph (C) for the period for purposes of this subparagraph);

except that clause (i) shall not apply to covered outpatient drugs dispensed before January 1, 1992.

"(B) PAYMENT LIMIT FOR MULTIPLE SOURCE DRUGS WITHOUT RESTRICTIVE PRESCRIPTIONS.—In the case of a drug that is a multiple source drug but does not have a restrictive prescription, the payment limit for the drug under this paragraph for a payment calculation period is equal to the amount of the administrative allowance (established under paragraph (4)) plus the product of—

"(i) the number of tablets (or other dosage units) dispensed, and "(ii) the unweighted median of the per tablet or unit average wholesale prices (determined under subparagraph (C) for purposes of this subparagraph) for such drug for the period.

"(C) DETERMINATION OF UNIT PRICE.—

"(i) IN GENERAL.—For purposes of this paragraph, the Secretary shall determine, with respect to the dispensing of a covered outpatient drug in a payment calculation period (beginning on or after January 1, 1990), the per tablet or unit average wholesale price for the drug.

"(ii) BASIS FOR DETERMINATIONS.—

"(I) DETERMINATION FOR NON-MULTIPLE-SOURCE DRUGS.—For purposes of subparagraph (A), such determination shall be based on a biannual survey conducted by the Secretary of a representative sample of direct sellers, wholesalers, or pharmacies (as appropriate) of wholesale (or comparable direct) prices (excluding discounts to pharmacies); except that if, because of low volume of sales for the drug or other appropriate reasons or in the case of covered outpatient drugs during 1990, the Secretary determines that such a survey is not appropriate with respect to a specific drug, such determination shall be based on published average wholesale (or comparable direct) prices for the drug.

"(II) DETERMINATION FOR MULTIPLE-SOURCE DRUGS.—For purposes of subparagraph (B), the Secretary may base the determination under this subparagraph on the published average wholesale (or comparable direct) prices for the drug or on a biannual survey conducted by the Secretary of a representative sample of direct sellers, wholesalers, or pharmacists (as appropriate) of wholesale (or comparable direct) prices (excluding discounts to pharmacies).

"(III) COMPLIANCE WITH SURVEY REQUIRED.—If a wholesaler or direct seller of a covered outpatient drug refuses, after being requested by the Secretary, to provide the information required in a survey under this clause, or deliberately provides information that is false, the Secretary may impose a civil money penalty of not to exceed $10,000 for each such refusal or provision of false information. The provisions of section 1128A (other than subsections (a) and (b)) shall apply to civil money penalties under the previous sentence in the same manner as such provisions apply to a penalty or proceeding under section 1128A(a). Information gathered pursuant to the survey shall not be disclosed except as the Secretary determines to be necessary to carry out the purposes of this part.

Law enforcement and crime.

Classified information.

"(iii) QUANTITY AND TIMING.—Such determination shall be based on the price or prices for purchases in reasonable quantities and shall be made for a payment calculation period based on prices for the first day of the first month of the previous payment calculation period.

"(iv) GEOGRAPHIC BASIS.—The Secretary shall make such determination, and calculate the payment limits under this paragraph, on a national basis; except that the Secretary may make such determination, and calculate such payment limits, on a regional basis to take account of limitations on the availability of drug products and variations among regions in the average wholesale prices for a drug product.

"(4) ADMINISTRATIVE ALLOWANCE FOR PURPOSES OF PAYMENT LIMITS.—

"(A) IN GENERAL.—Except as provided in subparagraph (B), for drugs dispensed in—

"(i) 1990 or 1991, the administrative allowance under this paragraph is—

"(I) $4.50 for drugs dispensed by a participating pharmacy, or

"(II) $2.50 for drugs dispensed by another pharmacy; or

"(ii) a subsequent year, the administrative allowance under this paragraph is the administrative allowance under this paragraph for the preceding year increased by the percentage increase (if any) in the implicit price deflator for gross national product (as published by the Department of Commerce in its 'Survey of Current Business') over the 12-month period ending with August of such preceding year.

Any allowance determined under the clause (ii) which is not a multiple of 1 cent shall be rounded to the nearest multiple of 1 cent.

"(B) ADJUSTMENT IN ALLOWANCE FOR MAIL SERVICE PHARMACIES.—The Secretary may, by regulation and after consultation with pharmacists, elderly groups, and private insurers, reduce the administrative allowances established under subparagraph (A) for any drug dispensed by a mail service pharmacy (as defined by the Secretary) based on differences between such pharmacies and other pharmacies with respect to operating costs and other economies.

"(5) ASSURING APPROPRIATE PRESCRIBING AND DISPENSING PRACTICES.—

Health care professionals.

"(A) IN GENERAL.—The Secretary shall establish a program to identify (and to educate physicians and pharmacists concerning)—

"(i) instances or patterns of unnecessary or inappropriate prescribing or dispensing practices for covered outpatient drugs,

"(ii) instances or patterns of substandard care with respect to such drugs, and

"(iii) potential adverse reactions.

Safety.

"(B) STANDARDS.—In carrying out the program under subparagraph (A), the Secretary shall establish for each covered outpatient drug standards for the prescribing of the drug which are based on accepted medical practice. In establishing such standards, the Secretary shall incorporate standards from such current authoritative compendia as the Secretary may select; except that the Secretary may modify such a standard by regulation on the basis of scientific and medical information that such standard is not consistent with the safe and effective use of the drug.

"(C) PROHIBITION OF FORMULARY.—Nothing in this title (including paragraph (8)), other than sections 1861(t)(4)(A) and 1862(c), shall be construed as authorizing the Secretary to exclude from coverage or to deny payment—

"(i) for any specific covered outpatient drug, or specific class of covered outpatient drug, or

"(ii) for any specific use of such a drug for a specific indication unless such exclusion is pursuant to section 1862(a)(1) based on a finding by the Secretary that such use is not safe or is not effective. Safety.

"(6) TREATMENT OF CERTAIN PREPAID ORGANIZATIONS.—

"(A) GENERAL RULE COUNTING PREPAID PLAN EXPENSES TOWARDS THE CATASTROPHIC DRUG DEDUCTIBLE.—Except as provided in subparagraph (B), expenses incurred by (or on behalf of) a medicare beneficiary for covered outpatient drugs shall be counted (consistent with subparagraph (C)) toward the catastrophic drug deductible established under paragraph (1) whether or not, at the time the expenses were incurred, the beneficiary was enrolled in a plan under section 1833(a)(1)(A) or under section 1876.

"(B) TREATMENT OF DRUG BUY-OUT PLAN EXPENSES.—In the case of a medicare beneficiary enrolled in a month in a drug buy-out plan (as defined in subparagraph (D))—

"(i) expenses incurred by the beneficiary for covered outpatient drugs reimbursed under the plan shall not be counted towards the catastrophic drug deductible, but

"(ii) if the individual disenrolls from the plan during the year, the beneficiary is deemed to have incurred, for each month of such enrollment, expenses for covered outpatient drugs in an amount equal to the actuarial value (with respect to such month) of the deductible for covered outpatient drugs (as computed by the Secretary for purposes of section 1876(e)(1)) applicable on the average to individuals in the United States.

"(C) TREATMENT OF EXPENSES FOR COVERED OUTPATIENT DRUGS INCURRED WHILE ENROLLED IN A PREPAID PLAN OTHER THAN A DRUG BUY-OUT PLAN.—The Secretary may not enter into a contract with an organization under section 1876, or provide for payment under section 1833(a)(1)(A) with respect to an organization which provides reimbursement for covered outpatient drugs, with respect to a plan that is not a drug buy-out plan, unless the organization provides assurances, satisfactory to the Secretary, that—

"(i) the organization will maintain and make available, for its enrollees and in coordination with the appropriate carriers under this part, an accounting of expenses incurred by (or on behalf of) enrollees under the plan for covered outpatient drugs; and

"(ii) the organization will take into account, in any deductibles established under the plan in a year with respect to covered outpatient drugs under this part, the amounts of expenses for covered outpatient drugs incurred in the year by (or on behalf of) the beneficiary and otherwise counted towards the catastrophic drug deductible in the year.

"(D) DRUG BUY-OUT PLAN DEFINED.—In this paragraph, the term 'drug buy-out plan' means a plan under section 1833(a)(1)(A) or offered by an organization under section 1876 and with respect to which—

"(i) the amount of any deductible under the plan with respect to covered outpatient drugs under this title,

is less than 50 percent of—

"(ii) the catastrophic drug deductible specified in paragraph (1)(C).

"(E) MEDICARE BENEFICIARY DEFINED.—In this subsection, the term 'medicare beneficiary' means, with respect to a month, an individual covered for benefits under this part for the month.

"(F) TREATMENT OF PLAN CHARGES.—In the case of covered outpatient drugs furnished by an eligible organization under section 1876(b) or an organization described in section 1833(a)(1)(A) which does not impose charges on covered outpatient drugs dispensed to its members, for purposes of this subsection the actual charges of the organization shall be the organization's standard charges to members, and other individuals, not entitled to benefits with respect to such drugs.

"(7) PHYSICIAN GUIDE.—

"(A) IN GENERAL.—The Secretary shall develop, and update annually, an information guide for physicians concerning the comparative average wholesale prices of at least 500 of the most commonly prescribed covered outpatient drugs. Such guide shall, to the extent practicable, group covered outpatient drugs (including multiple source drugs) in a manner useful to physicians by therapeutic category or with respect to the conditions for which they are prescribed. Such guide shall specify the average wholesale prices on the basis of the amount of the drug required for a typical daily therapeutic regimen.

"(B) MAILING GUIDE.—The Secretary shall provide for mailing, in January of each year (beginning with 1991), a copy of the guide developed and updated under subparagraph (A)—

"(i) to each hospital with an agreement in effect under section 1866,

"(ii) to each physician (as defined in section 1861(r)(1)) who routinely provides services under this part, and

"(iii) to Social Security offices, senior citizen centers, and other appropriate places.

"(8) REPORTS ON OUTLAYS AND RECEIPTS; SPECIAL COST CONTROLS.—

"(A) COMPILATION OF INFORMATION.—The Secretary shall compile information on—

"(i) manufacturers' prices for covered outpatient drugs, and on charges of pharmacists for covered outpatient drugs, and

"(ii) the use of covered outpatient drugs by individuals entitled to benefits under this part.

The information compiled under clause (i) shall include a comparison of the increases in prices and charges for covered outpatient drugs during each 6 month period (beginning with January 1987) with the semiannual average increase in such prices and charges during the 6 years beginning with 1981.

"(B) REPORTS.—The Secretary shall submit to the Committees on Ways and Means and Energy and Commerce of the House of Representatives and the Committee on Finance of the Senate a report, in May and November of 1989 and 1990 and in May of each succeeding year, providing the information compiled under subparagraph (A). For each such report submitted after 1991, the report shall include an explanation of the extent to which the increases in outlays for covered outpatient drugs under this part are due to the factors described in subparagraphs (A)(i) and (A)(ii).

"(C) MONTHLY REPORTS ON OUTLAYS AND RECEIPTS.—Within 30 days after the end of each month (beginning with October 1991 and ending with April 1993), the Secretary shall report to Congress on the outlays and receipts of the Federal Catastrophic Drug Insurance Trust Fund (in this paragraph referred to as the 'Trust Fund') in the month.

"(D) BUDGETARY INFORMATION.—

"(i) IN GENERAL.—In each report submitted under subparagraph (B) after 1991, the Secretary shall include information on—

"(I) the projected budgetary status of the Trust Fund for the succeeding year,

"(II) the projected increases in manufacturers' prices for covered outpatient drugs and in charges of pharmacists for covered outpatient drugs,

"(III) the projected level of utilization of covered outpatient drugs by medicare beneficiaries, and

"(IV) the projected administrative costs relating to covered outpatient drugs.

"(ii) DETERMINATION AND PUBLICATION OF ANY OUTLAY CONTROLS FOR 1993 AND 1994.—For each such report in 1992 and 1993, the Secretary—

"(I) shall determine in the report whether the anticipated outlays and receipts of the Trust Fund for the succeeding year will provide for at least the minimum contingency margin specified in subparagraph (F) for that succeeding year, and

"(II) if not, shall include in the report (and shall publish in the Federal Register by May 1 of the year a proposed regulation to carry out) changes in the provisions of this part (consistent with subparagraph (E)) in order to reduce outlays from the Trust Fund in that succeeding year sufficiently to provide for the minimum contingency margin specified in subparagraph (F).

Federal Register, publication. Regulations.

Any changes described in subclause (II) in such report shall reflect appropriately each of the anticipated causes of increased or unanticipated outlays for covered outpatient drugs.

Federal Register, publication.

"(iii) EFFECTIVENESS OF REGULATORY CHANGES.—If proposed regulations are published under clause (ii)(II) in 1992 or 1993, during the last 3 days of September of such year, the Secretary shall publish in the Federal Register a final regulation to implement the changes described in such clause. Notwithstanding any other provision of this part, but subject to subparagraph (E) and unless otherwise provided by law, such changes shall become effective on January 1 of the succeeding year and shall apply only during that succeeding year. Such final regulation may not revise the proposed regulation in a manner that would result in a greater reduction in outlays than would have been the case under the proposed regulation.

"(E) LIMITATION ON CHANGES.—In making regulatory changes under subparagraph (D), the Secretary may not—

"(i) provide for a formulary (in violation of paragraph (5)(C));

"(ii) change the methodology for determining whether for a year an individual has met the catastrophic drug deductible established under paragraph (1)(A); or

"(iii) increase the coinsurance percent under paragraph (2)(C) for a year above the coinsurance percent in effect during the previous year.

Clause (ii) shall not be construed as prohibiting the Secretary from increasing the amount of the catastrophic drug deductible under paragraph (1)(A).

"(F) MINIMUM CONTINGENCY MARGIN DEFINED.—In this paragraph, the term 'minimum contingency margin' means—

"(i) for 1993, 50 percent, and

"(ii) for 1994, 25 percent.

Such margin shall be determined as of the close of each calendar year and shall be determined based on the total outlays from the Trust Fund during the year.

"(9) DEFINITIONS.—In this subsection:

"(A) MULTIPLE SOURCE DRUG.—

"(i) IN GENERAL.—The term 'multiple source drug' means, with respect to a payment calculation period, a covered outpatient drug for which there are 2 or more drug products which—

"(I) are rated as therapeutically equivalent (under the Food and Drug Administration's most recent publication of 'Approved Drug Products with Therapeutic Equivalence Evaluations'),

"(II) except as provided in clause (ii), are pharmaceutically equivalent and bioequivalent, as defined in clause (iii) and as determined by the Food and Drug Administration, and

"(III) are sold or marketed during the period.

"(ii) EXCEPTION.—Subclause (II) of clause (i) shall not apply if the Food and Drug Administration changes by regulation (after an opportunity for public comment of 90 days) the requirement that, for purposes of the publication described in clause (i)(I), in order for drug products to be rated as therapeutically equivalent, they must be pharmaceutically equivalent and bioequivalent, as defined in clause (iii).

"(iii) DEFINITIONS.—For purposes of this subparagraph:

"(I) PHARMACEUTICALLY EQUIVALENT.—Drug products are pharmaceutically equivalent if the products contain identical amounts of the same active drug ingredient in the same dosage form and meet compendial or other applicable standards of strength, quality, purity, and identity.

"(II) BIOEQUIVALENT.—Drugs are bioequivalent if they do not present a known or potential bioequivalence problem or, if they do present such a problem, are shown to meet an appropriate standard of bioequivalence.

"(III) SOLD OR MARKETED.—A drug is considered to be sold or marketed during a period if it is listed in the publications referred to in clause (i)(I), unless the Secretary determines that such sale or marketing is not actually taking place.

"(B) RESTRICTIVE PRESCRIPTION.—A drug has a 'restrictive prescription' only if—

"(i) in the case of a written prescription, the prescription for the drug indicates, in the handwriting of the physician or other person prescribing the drug and with an appropriate phrase (such as 'brand medically necessary') recognized by the Secretary, that the particular drug must be dispensed, or

"(ii) in the case of a prescription issued by telephone—

"(I) the physician or other person prescribing the drug (through use of such an appropriate phrase) states that the particular drug must be dispensed, and

"(II) the physician or other person submits to the pharmacy involved, within 30 days after the date of the telephone prescription, a written confirmation which is in the handwriting of the physician or other person prescribing the drug and which indicates with such appropriate phrase that the particular drug was required to have been dispensed.

"(C) PAYMENT CALCULATION PERIOD.—The term 'payment calculation period' means the 6-month period beginning with January of each year and the 6-month period beginning with July of each year.

"(D) OUTLAYS; RECEIPTS.—The terms 'outlays' and 'receipts' mean, with respect to a year or other period, gross outlays and receipts, as such terms are employed in the 'Monthly Treasury Statement of Receipts and Outlays of the United States Government (MTS)', as published by the Department of the Treasury, for months in such year or other period.".

(c) PARTICIPATING PHARMACIES; CIVIL MONEY PENALTIES.—

(1) PARTICIPATING PHARMACIES.—Section 1842 (42 U.S.C. 1395t) is amended— 42 USC 1395u.

(A) in subsection (h)(1), by inserting before the period at the end of the second sentence the following: ", except that, with respect to a supplier of covered outpatient drugs, the term 'participating supplier' means a participating pharmacy (as defined in subsection (o)(1))";

(B) in subsection (h)(4), is amended by adding at the end the following: "In publishing directories under this paragraph, the Secretary shall provide for separate directories (wherever appropriate) for participating pharmacies."; and

(C) by adding at the end the following new subsection:

"(o)(1) For purposes of this section, the term 'participating pharmacy' means, with respect to covered outpatient drugs dispensed on or after January 1, 1991, an entity which is authorized under a State law to dispense covered outpatient drugs and which has entered into an agreement with the Secretary, providing at least the following:

"(A) The entity agrees to accept payment under this part on an assignment-related basis for all covered outpatient drugs dispensed to an individual entitled to benefits under this part (in this subsection referred to as a 'medicare beneficiary') during a year after—

"(i) the Secretary has notified the entity, through the electronic system described in subparagraph (D)(i), or

"(ii) in the absence of such a system, the entity is otherwise notified that the Secretary has determined,

that the individual has met the catastrophic drug deductible with respect to such drugs under section 1834(c)(1) for the year.

"(B) The entity agrees—

"(i) not to refuse to dispense covered outpatient drugs stocked by the entity to any medicare beneficiary, and

"(ii) not to charge medicare beneficiaries (regardless of whether or not the beneficiaries are enrolled under a prepaid health plan or with eligible organization under section 1876) more for such drugs than the amount it charges to the general public (as determined by the Secretary in regulations).

"(C) The entity agrees to keep patient records (including records on expenses) for all covered outpatient drugs dispensed to all medicare beneficiaries.

"(D) The entity agrees to submit information (in a manner specified by the Secretary to be necessary to administer this title) on all purchases of covered outpatient drugs dispensed to medicare beneficiaries.

"(E) The entity agrees—

"(i) to offer to counsel, or to offer to provide information (consistent with State law respecting the provision of such information) to, each medicare beneficiary on the appropriate use of a drug to be dispensed and whether there are potential interactions between the drug and other drugs dispensed to the beneficiary; and

"(ii) to advise the beneficiary on the availability (consistent with State laws respecting substitution of drugs) of therapeutically equivalent covered outpatient drugs.

"(F) The entity agrees to provide the information requested by the Secretary in surveys under section 1834(c)(3)(C)(ii).

Nothing in this paragraph shall be construed as requiring a pharmacy operated by an eligible organization (described in section 1876(b)) or an organization described in section 1833(a)(1)(A) for the exclusive benefit of its members to dispense covered outpatient drugs to individuals who are not members of the organization.

"(2) The Secretary shall provide to each participating pharmacy—

"(A) a distinctive emblem (suitable for display to the public) indicating that the pharmacy is a participating pharmacy, and

"(B) upon request, such electronic equipment and technical assistance (other than the costs of obtaining, maintaining, or expanding telephone service) as the Secretary determines may be necessary for the pharmacy to submit claims using the electronic system established under paragraph (4). Claims.

"(3) The Secretary shall provide for periodic audits of participating pharmacies to assure—

"(A) compliance with the requirements for participation under this title, and

"(B) the accuracy of information submitted by the pharmacies under this title.

"(4) The Secretary shall establish, by not later than January 1, 1991, a point-of-sale electronic system for use by carriers and participating pharmacies in the submission of information respecting covered outpatient drugs dispensed to medicare beneficiaries under this part. Science and technology. Communications and telecommunications.

"(5) Notwithstanding subsection (b)(3)(B), payment for covered outpatient drugs may be made on the basis of an assignment described in clause (ii) of that subsection only to a participating pharmacy.".

(2) CIVIL MONEY PENALTIES FOR VIOLATION OF PARTICIPATION AGREEMENT, FOR EXCESSIVE CHARGES FOR NONPARTICIPATING PHARMACIES AND FOR FAILURE TO PROVIDE SURVEY INFORMATION.—Section 1128A(a) (42 U.S.C. 1320a-7a(a)) is amended—

(A) by striking "or" at the end of paragraph (1),

(B) in paragraph (2)(C), by inserting "or to be a participating pharmacy under section 1842(o)" after "1842(h)(1)",

(C) by striking ", or" at the end of paragraph (2) and inserting a semicolon,

(D) by adding "or" at the end of paragraph (3), and

(E) by inserting after paragraph (3) the following new paragraph:

"(4) in the case of a participating or nonparticipating pharmacy (as defined for purposes of part B of title XVIII)—

"(A) presents or causes to be presented to any person a request for payment for covered outpatient drugs dispensed to an individual entitled to benefits under part B of title XVIII and for which the amount charged by the pharmacy is greater than the amount the pharmacy charges the general public (as determined by the Secretary in regulations), or

"(B) fails to provide the information requested by the Secretary in a survey under section 1834(c)(3)(C)(ii);".

(d) LIMITATION ON LENGTH OF PRESCRIPTION.—Section 1862(c) (42 U.S.C. 1395y(c)) is amended—

(1) by redesignating subparagraphs (A) through (D) of paragraph (1) as clauses (i) through (iv), respectively;

(2) in paragraph (2)(A), by striking "paragraph (1)" and inserting "subparagraph (A)";

(3) by redesignating subparagraphs (A) and (B) of paragraph (2) as clauses (i) and (ii), respectively;

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(4) by redesignating paragraphs (1) and (2) as subparagraphs (A) and (B), respectively;

(5) by inserting "(1)" after "(c)"; and

(6) by adding at the end the following new paragraph:

"(2) No payment may be made under part B for any expense incurred for a covered outpatient drug if the drug is dispensed in a quantity exceeding a supply of 30 days or such longer period of time (not to exceed 90 days, except in exceptional circumstances) as the Secretary may authorize.".

(e) USE OF CARRIERS, FISCAL INTERMEDIARIES, AND OTHER ENTITIES IN ADMINISTRATION.—

(1) AUTHORIZING USE OF OTHER ENTITIES IN ELECTRONIC CLAIMS SYSTEM.—Section 1842(f) (42 U.S.C. 1395u(f)) is amended—

(A) by striking "and" at the end of paragraph (1),

(B) by striking the period at the end of paragraph (2) and inserting "; and", and

(C) by adding at the end the following new paragraph:

"(3) with respect to implementation and operation (and related functions) of the electronic system established under subsection (o)(4), a voluntary association, corporation, partnership, or other nongovernmental organization, which the Secretary determines to be qualified to conduct such activities.".

(2) ADDITIONAL FUNCTIONS OF CARRIERS.—Section 1842(b)(3) (42 U.S.C. 1395u(b)(3)), as amended by section 201(c) of this Act, is amended—

(A) by striking "and" at the end of subparagraph (H), and

(B) by inserting after subparagraph (I) the following new subparagraphs:

"(J) if it makes determinations or payments with respect to covered outpatient drugs, will—

"(i) receive information transmitted under the electronic system established under subsection (o)(4), and

"(ii) respond to requests by participating pharmacies (and individuals entitled to benefits under this part) as to whether or not such an individual has met the catastrophic drug deductible established under section 1834(c)(1)(A) for a year; and

Contracts.

"(K) will enter into such contracts with organizations described in subsection (f)(3) as the Secretary determines may be necessary to implement and operate (and for related functions with respect to) the electronic system established under subsection (o)(4) for covered outpatient drugs under this part;".

(3) SPECIAL CONTRACT PROVISIONS FOR ELECTRONIC CLAIMS SYSTEM.—

(A) PAYMENT ON OTHER THAN A COST BASIS.—Section 1842(c)(1)(A) (42 U.S.C. 1395u(c)(1)(A)) is amended—

(i) by inserting "(i)" after "(c)(1)(A)",

(ii) in the first sentence, by inserting ", except as provided in clause (ii)," after "under this part, and", and

(iii) by adding at the end the following new clause:

"(ii) To the extent that a contract under this section provides for implementation and operation (and related functions) of the electronic system established under subsection (o)(4) for covered outpatient drugs, the Secretary may provide for payment for such activities based on any method of payment determined by the Secretary to be appropriate.".

(B) APPLICATION OF DIFFERENT PERFORMANCE STANDARDS.—The Secretary of Health and Human Services, before entering into contracts under section 1842 of the Social Security Act with respect to the implementation and operation (and related functions) of the electronic system for covered outpatient drugs, shall establish standards with respect to performance with respect to such activities. The provisions of section 1153(e)(2), and paragraphs (1) and (2) of section 1153(h), of such Act shall apply to such activities in the same manner as they apply to contracts with peer review organizations, instead of the requirements of the last 2 sentences of section 1842(b)(2) of such Act. Contracts. 42 USC 1395u note.

(C) USE OF REGIONAL CARRIERS.—Section 1842(b)(2) is amended by adding at the end the following new sentence: "With respect to activities relating to implementation and operation (and related functions) of the electronic system established under subsection (o)(4), the Secretary may enter into contracts with carriers under this section to perform such activities on a regional basis.". Contracts.

(4) ADJUSTMENT OF CARRIER OBLIGATIONS.—

(A) NO TOLL-FREE TELEPHONE NUMBER REQUIRED OF LIMITED CARRIERS.—Section 1842(h)(2) (42 U.S.C. 1395u(h)(2)) is amended by inserting "(other than a carrier described in subsection (f)(3))" after "Each carrier".

(B) DELAY IN APPLICATION OF COORDINATED BENEFITS WITH MEDIGAP.—The provisions of subparagraph (B) of section 1842(h)(3) of the Social Security Act shall not apply to covered outpatient drugs (other than drugs described in section 1861(s)(2)(J) of such Act as of the date of the enactment of this Act) dispensed before January 1, 1993. 42 USC 1395u note.

(5) BATCH PROMPT PROCESSING OF CLAIMS.—Section 1842(c) (42 U.S.C. 1395u(c)) is amended—

(A) in paragraphs (2)(A) and (3)(A), by striking "Each" and inserting "Except as provided in paragraph (3), each";

(B) by adding at the end the following new paragraph:

"(4)(A) Each contract under this section which provides for the disbursement of funds, as described in subsection (a)(1)(B), with respect to claims for payment for covered outpatient drugs shall provide for a payment cycle under which each carrier will, on a monthly basis, make a payment with respect to all claims which were received and approved for payment in the period since the most recent date on which such a payment was made with respect to the participating pharmacy or individual submitting the claim. Contracts. Claims.

"(B) If payment is not issued, mailed, or otherwise transmitted within 5 days of when such a payment is required to be made under subparagraph (A), interest shall be paid at the rate used for purposes of section 3902(a) of title 31, United States Code (relating to interest penalties for failure to make prompt payments) for the period beginning on the day after such 5-day period and ending on the date on which payment is made.".

(f) MODIFICATION OF HMO/CMP CONTRACTS.—

(1) SEPARATE ACTUARIAL DETERMINATION FOR COVERED OUTPATIENT DRUG BENEFIT.—Section 1876(e)(1) (42 U.S.C. 1395mm(e)(1)) is amended by adding at the end thereof the following new sentence: "The preceding sentence shall be applied separately with respect to covered outpatient drugs.".

(2) ADDITIONAL OPTIONAL BENEFITS.—Section 1876(g)(3)(A) (42 U.S.C. 1395mm(g)(3)(A)) is amended by striking "rate" and inserting "rates".

(g) REQUIRING SUBMISSION OF DIAGNOSTIC INFORMATION.—Section 1842 (42 U.S.C. 1395u), as amended by subsection (c)(1)(C), is amended by adding at the end the following new subsection:

Health care professionals.

"(p)(1) Each request for payment, or bill submitted, for an item or service furnished by a physician for which payment may be made under this part shall include the appropriate diagnosis code (or codes) as established by the Secretary for such item or service.

"(2) In the case of a request for payment for an item or service furnished by a physician on an assignment-related basis which does not include the code (or codes) required under paragraph (1), payment may be denied under this part.

Law enforcement and crime.

"(3) In the case of a request for payment for an item or service furnished by a physician not submitted on an assignment-related basis and which does not include the code (or codes) required under paragraph (1)—

"(A) if the physician knowingly and willfully fails to provide the code (or codes) promptly upon request of the Secretary or a carrier, the physician may be subject to a civil money penalty in an amount not to exceed $2,000, and

"(B) if the physician knowingly, willfully, and in repeated cases fails, after being notified by the Secretary of the obligations and requirements of this subsection, to include the code (or codes) required under paragraph (1), the physician may be subject to the sanction described in section 1842(j)(2)(A).

The provisions of section 1128A (other than subsections (a) and (b)) shall apply to civil money penalties under subparagraph (A) in the same manner as they apply to a penalty or proceeding under section 1128A(a).".

(h) CONFORMING AMENDMENTS.—

(1) The first sentence of section 1866(a)(2)(A) (42 U.S.C. 1395cc(a)(2)(A)) is amended—

(A) by inserting "1834(c)," after "1833(b),", and

Drugs and drug abuse.

(B) by inserting "and in the case of covered outpatient drugs, applicable coinsurance percent (specified in section 1834(c)(2)(C)) of the lesser of the actual charges for the drugs or the payment limit (established under section 1834(c)(3))" after "established by the Secretary".

(2) Section 1903(i)(5) (42 U.S.C. 1396b(i)(5)) is amended by striking "section 1862(c)" and inserting "section 1862(c)(1)".

42 USC 1395m note.

(i) REPORTS ON MEDICARE BENEFICIARY DRUG EXPENSES.—

(1) HHS.—The Secretary of Health and Human Services, by not later than April 1, 1989—

(A) using data from the 1987 National Medical Expenditures Survey (conducted by the National Center for Health Services Research and Health Care Technology Assessment), shall report to Congress on expenses incurred by medicare beneficiaries for outpatient prescription drugs, and

(B) shall provide the Director of the Congressional Budget Office with such data from that Survey as the Director may request to make the estimates required under paragraph (2).

(2) REESTIMATION OF COSTS.—The Director of the Congressional Budget Office shall transmit to the Congress, not later

than June 1, 1989, or, if later, 60 days after the date of providing data requested under paragraph (1)(B), the Director's estimate of the outlays which will be made (in each of fiscal years 1990, 1991, 1992, and 1993) under the medicare program for covered outpatient drugs (under the amendments made by this section).

(j) PRESCRIPTION DRUG PAYMENT REVIEW COMMISSION.—Part B is amended by adding at the end the following new section:

"PRESCRIPTION DRUG PAYMENT REVIEW COMMISSION

"SEC. 1847. (a)(1) The Director of the Congressional Office of Technology Assessment (in this section referred to as the 'Director' and the 'Office', respectively) shall provide for the appointment of a Prescription Drug Payment Review Commission (in this section referred to as the 'Commission'), to be composed of individuals with expertise in the provision and financing of covered outpatient drugs appointed by the Director (without regard to the provisions of title 5, United States Code, governing appointments in the competitive service). 42 USC 1395w-3.

"(2) The Commission shall consist of 11 individuals. Members of the Commission shall first be appointed by no later than January 1, 1989, for a term of 3 years, except that the Director may provide initially for such shorter terms as will insure that (on a continuing basis) the terms of no more than 4 members expire in any one year.

"(3) The membership of the Commission shall include recognized experts in the fields of health care economics, medicine, pharmacology, pharmacy, and prescription drug reimbursement, as well as at least one individual who is a medicare beneficiary.

"(b)(1) The Commission shall submit to Congress an annual report no later than May 1 of each year, beginning with 1990, concerning methods of determining payment for covered outpatient drugs under this part. Reports.

"(2) Such report, in 1992 and thereafter, shall include, with respect to the previous year, information on—

"(A) increases in manufacturers' prices for covered outpatient drugs and in charges of pharmacists for covered outpatient drugs,

"(B) the level of utilization of covered outpatient drugs by medicare beneficiaries, and

"(C) administrative costs relating to covered outpatient drugs.

"(3) Such report, in 1992 and thereafter, shall include comments on the budgetary status of the Federal Catastrophic Drug Insurance Trust Fund and recommendations for any reductions in outlays that may be required to achieve the contingency margin (established under section 1841A(d) for the following year), taking into account each of the causes of increased or unanticipated outlays for covered outpatient drugs in the year.

"(c) Section 1845(c)(1) shall apply to the Commission in the same manner as it applies to the Physician Payment Review Commission.

"(d) There are authorized to be appropriated such sums as may be necessary to carry out the provisions of this section. Such sums shall be payable from the Federal Catastrophic Drug Insurance Trust Fund.". Appropriation authorization.

(k) ADDITIONAL STUDIES.— Reports.

(1) HHS.—The Secretary of Health and Human Services (in this section referred to as the "Secretary") shall conduct the 42 USC 1395m note.

following studies, and report to Congress on the results of each such study by the following dates:

Diseases.

(A) A study of the possibility of including drugs which have not yet been approved under section 505 or 507 of the Federal Food, Drug, and Cosmetic Act and biological products which have not been licensed under section 351 of the Public Health Service Act but which are commonly used in the treatment of cancer or in immunosuppressive therapy and other experimental drugs and biological products as covered outpatient drugs under the medicare program, for which a report shall be made by January 1, 1990. The study under this subparagraph shall be conducted in consultation with an advisory board of consumers, experts in the fields of cancer chemotherapy and immunosuppressive therapy, representatives of pharmaceutical manufacturers, and such other individuals as the Secretary may select.

Mail.

(B) A study to evaluate the potential to use mail service pharmacies to reduce costs to the medicare program and to medicare beneficiaries, for which a report shall be made by January 1, 1990.

(C) A study of methods to improve utilization review of covered outpatient drugs, for which a report shall be made by January 1, 1993.

(D) A longitudinal study, to be conducted as a follow-up to the data collected under the survey referred to in subsection (i)(1)(A), on the use of outpatient prescription drugs by medicare beneficiaries with respect to medical necessity, potential for adverse drug interactions, cost (including whether lower cost drugs could have been used), and patient stockpiling or wastage, for which a report shall be made by January 1, 1993.

(2) GAO.—The Comptroller General shall conduct the following studies, and report to Congress on the results of each such study by not later than May 1, 1991:

(A) A study comparing average wholesale prices with actual pharmacy acquisition costs by type of pharmacy.

(B) A study to determine the overhead costs of retail pharmacies.

(C) A study of the discounts given by pharmacies to other third-party insurers.

Records.

Pharmacies which fail to provide the Comptroller General with reasonable access to necessary records to carry out the studies under this paragraph are subject to exclusion from the medicare and medicaid programs under section 1128(a) of the Social Security Act.

42 USC 1395m note.

(l) Development of Standard Medicare Claims Form.—

(1) The Secretary shall develop, in consultation with representatives of pharmacies and other interested individuals, a standard claims form (and a standard electronic claims format) to be used in requests for payment for covered outpatient drugs under the medicare program and other third-party payors.

(2) Not later than October 1, 1989, the Secretary shall distribute official sample copies of the format developed under paragraph (1) to pharmacies and other interested parties and by not later than October 1, 1990, shall distribute official sample copies of the form developed under paragraph (1) to pharmacies and other interested parties.

(m) EFFECTIVE DATES.— 42 USC 1395u note.

(1) IN GENERAL.—Except as otherwise provided in this subsection, the amendments made by this section shall apply to items dispensed on or after January 1, 1990.

(2) CARRIERS.—The amendments made by subsection (e) shall take effect on the date of the enactment of this Act; except that the amendments made by subsection (e)(5) shall take effect on January 1, 1991, but shall not be construed as requiring payment before February 1, 1991.

(3) HMO/CMP ENROLLMENTS.—The amendment made by subsection (f) shall apply to enrollments effected on or after January 1, 1990.

(4) DIAGNOSTIC CODING.—The amendment made by subsection (g) shall apply to services furnished after March 31, 1989.

(5) TRANSITION.—With respect to administrative expenses (and costs of the Prescription Drug Payment Review Commission) for periods before January 1, 1990, amounts otherwise payable from the Federal Catastrophic Drug Insurance Trust Fund shall be payable from the Federal Supplementary Medical Insurance Trust Fund and shall also be treated as a debit to the Medicare Catastrophic Coverage Account.

SEC. 203. COVERAGE OF HOME INTRAVENOUS DRUG THERAPY SERVICES.

(a) IN GENERAL.—Section 1832(a)(2)(A) (42 U.S.C. 1395k(a)(2)(A)) is amended by inserting "and home intravenous drug therapy services" before the semicolon.

(b) HOME INTRAVENOUS DRUG THERAPY SERVICES DEFINED.—Section 1861 (42 U.S.C. 1395x) is amended by adding at the end the following new subsection:

"(jj)(1) The term 'home intravenous drug therapy services' means the items and services described in paragraph (2) furnished to an individual who is under the care of a physician—

"(A) in a place of residence used as such individual's home;

"(B) by a qualified home intravenous drug therapy provider (as defined in paragraph (3)) or by others under arrangements with them made by such provider; and

"(C) under a plan established and periodically reviewed by a physician.

"(2) The items and services described in this paragraph are such nursing, pharmacy, and related services (including medical supplies, intravenous fluids, delivery, and equipment) as are necessary to conduct safely and effectively an intravenously administered drug regimen through use of a covered home IV drug (as defined in subsection (t)(4)), but do not include such covered outpatient drugs.

"(3) The term 'qualified home intravenous drug therapy provider' means any entity that the Secretary determines meets the following requirements:

"(i) The entity is capable of providing or arranging for the items and services described in paragraph (2) and covered home IV drugs.

"(ii) The entity maintains clinical records on all patients.

"(iii) The entity adheres to written protocols and policies with respect to the provision of items and services.

"(iv) The entity makes services available (as needed) seven days a week on a 24-hour basis.

"(v) The entity coordinates all services with the patient's physician.

"(vi) The entity conducts a quality assessment and assurance program, including drug regimen review and coordination of patient care.

"(vii) The entity assures that only trained personnel provide covered home IV drugs (and any other service for which training is required to safely provide the service).

"(viii) The entity assumes responsibility for the quality of services provided by others under arrangements with the agency or entity.

"(ix) In the case of an entity in any State in which State or applicable local law provides for the licensing of entities of this nature, (I) is licensed pursuant to such law, or (II) is approved, by the agency of such State or locality responsible for licensing entities of this nature, as meeting the standards established for such licensing.

"(x) The entity meets such other requirements as the Secretary may determine are necessary to assure the safe and effective provision of home intravenous drug therapy services and the efficient administration of the home intravenous drug therapy benefit.".

(c) PAYMENT.—

(1) IN GENERAL.—Part B is amended—

(A) in subsection (a)(2)(B) of section 1833 (42 U.S.C. 1395l), by striking "or (E)" and inserting "(E), or (F)";

(B) in subsection (a)(2)(D) of such section, by striking "and" at the end;

(C) in subsection (a)(2)(E) of such section, by striking the semicolon and inserting "; and";

(D) by inserting after subsection (a)(2)(E) of such section the following new subparagraph:

"(F) with respect to home intravenous drug therapy services, the amounts described in section 1834(d)(1);";

(E) in subsection (b) of such section, by striking "services, (3)" and inserting "services and home intravenous drug therapy services, (3)"; and

(F) by adding at the end of section 1834, as amended by section 202(b)(4) of this Act, the following new subsection:

42 USC 1395m.

"(d) HOME INTRAVENOUS DRUG THERAPY SERVICES.—

"(1) IN GENERAL.—With respect to home intravenous drug therapy services, subject to paragraph (3), payment under this part shall be made in an amount equal to the lesser of the actual charges for such services or the fee schedule established under paragraph (2).

Regulations.

"(2) ESTABLISHMENT OF FEE SCHEDULE.—The Secretary shall establish by regulation before the beginning of calendar year 1990 and each succeeding calendar year a fee schedule for home intravenous drug therapy services for which payment is made under this part. A fee schedule established under this subsection shall be on a per diem basis.

"(3) LIMITATION ON ACCEPTANCE OF, AND PAYMENTS FOR, CERTAIN REFERRALS.—

"(A) IN GENERAL.—Except as provided in subparagraph (B), a home intravenous drug therapy provider may not provide home intravenous drug therapy services under this part to an individual if the individual's referring physician (as defined in subparagraph (D)), or an immediate family member of the physician—

"(i) has an ownership interest in the provider, or
"(ii) receives compensation from the provider.
"(B) EXCEPTIONS.—
"(i) Subparagraph (A)(i) shall not apply—
"(I) if the ownership interest is the ownership of stock which is traded over a publicly-regulated exchange and was purchased on terms generally available to the public, or
"(II) if the provider is a sole home intravenous drug therapy provider (as defined by the Secretary) in a rural area.
"(ii) Subparagraph (A)(ii) shall not apply if the compensation is reasonably related to items or services actually provided by the physician and does not vary in proportion to the number of referrals made by the referring physician, but such exception shall not apply to compensation provided for direct patient care services.
"(iii) Subparagraph (A) shall not be construed to apply to a referring physician whose only ownership or financial relationship with the provider is as an uncompensated officer or director of the provider.
"(iv) Subparagraph (A) also shall not apply in such cases, established by the Secretary in regulations, in which the nature of the ownership or compensation does not pose a substantial risk of program abuse.
"(C) SANCTIONS.—
"(i) DENIAL OF PAYMENT.—No payment may be made under this part for home intravenous drug therapy services which are provided in violation of subparagraph (A).
"(ii) CIVIL MONEY PENALTY FOR IMPROPER CLAIMS.—Any person (including a home intravenous drug therapy provider or physician) that presents or causes to be presented a claim for an item or service that such person knows or should know is for an item or service for which payment may not be made under subparagraph (A) shall be subject to a civil money penalty of not more than $15,000 for each such item or service. The provisions of section 1128A (other than the first sentence of subsection (a) and other than subsection (b)) shall apply to a civil money penalty under the previous sentence in the same manner as such provisions apply to a penalty or proceeding under section 1128A(a).
"(D) REFERRING PHYSICIAN DEFINED.—In this paragraph, the term 'referring physician' means, with respect to providing home intravenous drug therapy services to an individual, a physician who—
"(i) prescribed the covered home IV drug for which the services are to be provided, or
"(ii) established the plan of care for such services.".

(2) PROPAC STUDY.—The Prospective Payment Assessment Commission shall conduct a study, and make recommendations to Congress and the Secretary of Health and Human Services by not later than March 1, 1991, concerning appropriate adjustment to the payment amounts provided under section 1886(d) of the Social Security Act for inpatient hospital services to account 42 USC 1395ww note.

for reduced costs to hospitals resulting from the amendments made by this section.

Health care professionals.

(3) INSPECTOR GENERAL REPORT ON POTENTIALLY ABUSIVE OWNERSHIP OR COMPENSATION ARRANGEMENTS.—The Inspector General of the Department of Health and Human Services shall study and report to Congress, by not later than May 1, 1989, concerning—

(A) physician ownership of, or compensation from, an entity providing items or services to which the physician makes referrals and for which payment may be made under the medicare program;

(B) the range of such arrangements and the means by which they are marketed to physicians;

(C) the potential of such ownership or compensation to influence the decision of a physician regarding referrals and to lead to inappropriate utilization of such items and services; and

Law enforcement and crime.

(D) the practical difficulties involved in enforcement actions against such ownership and compensation arrangements that violate current antikickback provisions.

Such report shall include such recommendations as may be appropriate to strengthen current law provisions to prevent program abuse.

(d) CERTIFICATION.—

(1) IN GENERAL.—Section 1835(a)(2) (42 U.S.C. 1395n(a)(2)) is amended—

(A) by striking "and" at the end of subparagraph (E);

(B) by striking the period at the end of subparagraph (F) and inserting "; and"; and

(C) by inserting after subparagraph (F) the following new subparagraph:

"(G) in the case of home intravenous drug therapy services, (i) such services are or were required because the individual needed such services for the administration of a covered home IV drug, (ii) a plan for furnishing such services has been established and is reviewed periodically by a physician, (iii) such services are or were furnished while the individual is or was under the care of a physician, (iv) such services are administered in a place of residence used as such individual's home, and (v) with respect to such services initiated before January 1, 1993, such services have been reviewed and approved by a utilization and peer review organization under section 1154(a)(16) before the date such services were initiated (or, in the case of services first initiated on an outpatient basis, within 1 working day (except in exceptional circumstances) of the date of initiation of the services).".

(2) PRO PRIOR APPROVAL REQUIRED.—Section 1154(a) (42 U.S.C. 1320c-3(a)) is amended by adding at the end the following new paragraph:

"(16) The organization shall perform the review described in paragraph (1) with respect to home intravenous drug therapy services (as defined in section 1861(jj)(1)) initiated before January 1, 1993, within 1 working day of the date of the organization's receipt of a request for such review. The Secretary shall establish criteria to be used by such an organization in conducting reviews with respect to the appropriateness of home intravenous drug therapy services under this paragraph.".

(e) CERTIFICATION OF HOME INTRAVENOUS DRUG THERAPY PROVIDERS; INTERMEDIATE SANCTIONS FOR NONCOMPLIANCE.—

(1) TREATMENT AS PROVIDER OF SERVICES.—Section 1861(u) (42 U.S.C. 1395x(u)) is amended by inserting "home intravenous drug therapy provider," after "hospice program,".

(2) CONSULTATION WITH STATE AGENCIES AND OTHER ORGANIZATIONS.—Section 1863 (42 U.S.C. 1395z) is amended by striking "and (dd)(2)" and inserting "(dd)(2), and (jj)(3)".

(3) USE OF STATE AGENCIES IN DETERMINING COMPLIANCE.—Section 1864(a) (42 U.S.C. 1395aa(a)) is amended—

(A) in the first sentence, by inserting "or a home intravenous drug therapy provider," after "hospice program", and

(B) in the second sentence, by striking "or hospice program" and inserting "hospice program, or home intravenous drug therapy provider".

(4) APPLICATION OF INTERMEDIATE SANCTIONS.—Section 1846 (42 U.S.C. 1395w-2) is amended—

(A) in the heading, by adding "AND FOR QUALIFIED HOME INTRAVENOUS DRUG THERAPY PROVIDERS" at the end;

(B) in subsection (a), by inserting "or that a qualified home intravenous drug therapy provider that is certified for participation under this title no longer substantially meets the requirements of section 1861(jj)(3)" after "under this part"; and

(C) in subsection (b)(2)(A)(iv) by inserting "or home intravenous drug therapy services" after "clinical diagnostic laboratory tests".

(f) USE OF REGIONAL INTERMEDIARIES IN ADMINISTRATION OF BENEFIT.—Section 1816 (42 U.S.C. 1395h) is amended by adding at the end thereof the following new subsection:

"(k) With respect to carrying out functions relating to payment for home intravenous drug therapy services and covered home IV drugs, the Secretary may enter into contracts with agencies or organizations under this section to perform such functions on a regional basis.". Contracts.

(g) EFFECTIVE DATE.—The amendments made by this section shall apply to items and services furnished on or after January 1, 1990. 42 USC 1320c-3 note.

SEC. 204. COVERAGE OF SCREENING MAMMOGRAPHY.

(a) IN GENERAL.—Section 1861 (42 U.S.C. 1395x) is amended—

(1) in subsection (s)—

(A) by redesignating paragraphs (13) and (14) as paragraphs (14) and (15), respectively,

(B) by striking "and" at the end of paragraph (11),

(C) by striking the period at the end of paragraph (12) and inserting "; and", and

(D) by inserting after paragraph (12) the following new paragraph:

"(13) screening mammography (as defined in subsection (kk)).''; and

(2) by adding at the end the following new subsection:

"Screening Mammography

"(kk) The term 'screening mammography' means a radiologic procedure provided to a woman for the purpose of early detection of breast cancer and includes a physician's interpretation of the results of the procedure.".

(b) PAYMENT AND COVERAGE.—Section 1834 (42 U.S.C. 1395m), as amended by sections 202(b)(4) and 203(c)(1)(F) of this Act, is amended—

(1) in subsection (b)(1)(B), by inserting "and subject to subsection (e)(1)(A)" after "conversion factors", and

(2) by adding at the end the following new subsection:

"(e) PAYMENTS AND STANDARDS FOR SCREENING MAMMOGRAPHY.—

"(1) IN GENERAL.—Notwithstanding any other provision of this part (except as provided in section 1833(c)), with respect to expenses incurred for screening mammography (as defined in section 1861(kk))—

"(A) payment may be made only for screening mammography conducted consistent with the frequency permitted under paragraph (2);

"(B) payment may be made only if the screening mammography meets the quality standards established under paragraph (3); and

"(C) the amount of the payment under this part shall, subject to the deductible established under section 1833(b), be equal to 80 percent of the least of—

"(i) the actual charge for the screening,

"(ii) the fee schedule established under subsection (b) with respect to both the professional and technical components of the screening mammography, in the case of screening mammography subject to such schedule but for this paragraph, or

"(iii) the limit established under paragraph (4) for the screening mammography.

"(2) FREQUENCY COVERED.—

"(A) IN GENERAL.—Subject to revision by the Secretary under subparagraph (B)—

"(i) No payment may be made under this part for screening mammography performed on a woman under 35 years of age.

"(ii) Payment may be made under this part for only 1 screening mammography performed on a woman over 34 years of age, but under 40 years of age.

"(iii) In the case of a woman over 39 years of age, but under 50 years of age, who—

"(I) is at a high risk of developing breast cancer (as determined pursuant to factors identified by the Secretary), payment may not be made under this part for a screening mammography performed within the 11 months of a previous screening mammography, or

"(II) is not at a high risk of developing breast cancer, payment may not be made under this part for a screening mammography performed within the 23 months after a previous screening mammography.

"(iv) In the case of a woman over 49 years of age, but under 65 years of age, payment may not be made under this part for screening mammography performed within 11 months after a previous screening mammography.

"(v) In the case of a woman over 64 years of age, payment may not be made for screening mammography performed within 23 months after a previous screening mammography.

"(B) REVISION OF FREQUENCY.—

"(i) REVIEW.—The Secretary, in consultation with the Director of the National Cancer Institute, shall review periodically the appropriate frequency for performing screening mammography, based on age and such other factors as the Secretary believes to be pertinent.

"(ii) REVISION OF FREQUENCY.—The Secretary, taking into consideration the review made under clause (i), may revise from time to time the frequency with which screening mammography may be paid for under this subsection, but no such revision shall apply to screening mammography performed before January 1, 1992.

"(3) QUALITY STANDARDS.—The Secretary shall establish standards to assure the safety and accuracy of screening mammography performed under this part. Such standards shall include the requirements that— Safety.

"(A) the equipment used to perform the mammography must be specifically designed for mammography and must meet radiologic standards established by the Secretary for mammography;

"(B) the mammography must be performed by an individual who—

"(i) is licensed by a State to perform radiological procedures, or

"(ii) is certified as qualified to perform radiological procedures by such an appropriate organization as the Secretary specifies in regulations;

"(C) the results of the mammography must be interpreted by a physician—

"(i) who is certified as qualified to interpret radiological procedures by such an appropriate board as the Secretary specifies in regulations, or

"(ii) who is certified as qualified to interpret screening mammography procedures by such a program as the Secretary recognizes in regulation as assuring the qualifications of the individual with respect to such interpretation; and

"(D) with respect to the first screening mammography performed on a woman for which payment is made under this part, there are satisfactory assurances that the results of the mammography will be placed in permanent medical records maintained with respect to the woman. Records.

"(4) LIMIT.—

"(A) $50, INDEXED.—Except as provided by the Secretary under subparagraph (B), the limit established under this paragraph—

"(i) for screening mammography performed in 1990, is $50, and "(ii) for screening mammography performed in a subsequent year is the limit established under this paragraph for the preceding year increased by the percentage increase in the MEI for that subsequent year.

"(B) REDUCTION OF LIMIT.—The Secretary shall review from time to time the appropriateness of the amount of the limit established under this paragraph. The Secretary may, with respect to screening mammography performed in a year after 1991, reduce the amount of such limit as it applies nationally or in any area to the amount that the Secretary estimates is required to assure that screening mammography of an appropriate quality is readily and conveniently available during the year.

"(C) APPLICATION OF LIMIT IN HOSPITAL OUTPATIENT SETTING.—The Secretary shall provide for an appropriate allocation of the limit established under this paragraph between professional and technical components in the case of hospital outpatient screening mammography (and comparable situations) where there is a claim for professional services separate from the claim for the radiologic procedure.

Claims.

"(5) LIMITING CHARGES OF NONPARTICIPATING PHYSICIANS.—

"(A) IN GENERAL.—In the case of mammography screening performed on or after January 1, 1990, for which payment is made under this subsection, if a nonparticipating physician or supplier provides the screening to an individual entitled to benefits under this part, the physician or supplier may not charge the individual more than the limiting charge (as defined in subparagraph (B), or, if applicable and if less, as defined in subsection (b)(5)(B)).

"(B) LIMITING CHARGE DEFINED.—In subparagraph (A), the term 'limiting charge' means, with respect to screening mammography performed—

"(i) in 1990, 125 percent of the limit established under paragraph (4),

"(ii) in 1991, 120 percent of the limit established under paragraph (4), and

"(iii) after 1991, 115 percent of the limit established under paragraph (4).

"(C) ENFORCEMENT.—If a physician or supplier knowing and willfully imposes a charge in violation of subparagraph (A), the Secretary may apply sanctions against such physician or supplier in accordance with section 1842(j)(2).".

(c) CERTIFICATION OF SCREENING MAMMOGRAPHY QUALITY STANDARDS.—

(1) Section 1863 (42 U.S.C. 1395z) is amended by inserting "or whether screening mammography meets the standards established under section 1834(e)(3)," after "1832(a)(2)(F)(i),".

(2) The first sentence of section 1864(a) (42 U.S.C. 1395aa(a)) is amended by inserting before the period the following: ", or whether screening mammography meets the standards established under section 1834(e)(3)".

(3) Section 1865(a) (42 U.S.C. 1395bb(a)) is amended by inserting "1834(e)(3)," after "1832(a)(2)(F)(i),".

(d) CONFORMING AMENDMENTS.—

(1) Section 1833(a)(2)(E) (42 U.S.C. 1395l(a)(2)(E)) is amended by inserting ", but excluding screening mammography" after "imaging services".

(2) Section 1862(a) (42 U.S.C. 1395y(a)) is amended—

(A) in paragraph (1)—

(i) in subparagraph (A), by striking "subparagraph (B), (C), (D), or (E)" and inserting "a succeeding subparagraph",

(ii) in subparagraph (D), by striking "and" at the end,

(iii) in subparagraph (E), by striking the semicolon at the end and inserting ", and", and

(iv) by adding at the end the following new subparagraph:

"(F) in the case of screening mammography, which is performed more frequently than is covered under section 1834(e)(2) or which does not meet the standards established under section 1834(e)(3);"; and

(B) in paragraph (7), by inserting "or under paragraph (1)(F)" after "(1)(B)".

(3) Sections 1864(a), 1865(a), 1902(a)(9)(C), and 1915(a)(1)(B)(ii)(I) (42 U.S.C. 1395aa(a), 1395bb(a), 1396a(a)(9)(C), 1396n(a)(1)(B)(ii)(I)) are each amended by striking "paragraphs (13) and (14)" and inserting "paragraphs (14) and (15)".

(e) EFFECTIVE DATE.—The amendments made by this section shall apply to screening mammography performed on or after January 1, 1990. Paragraph (5) of section 1834(e) of the Social Security Act shall only apply until such time as the Secretary of Health and Human Services implements the physician fee schedules based on relative value scale developed under section 1845(e) of such Act. 42 USC 1395m note.

(f) REPORTS.— 42 USC 1395m note.

(1) The Physician Payment Review Commission shall study and report, by July 1, 1989, to the Committees on Ways and Means and Energy and Commerce of the House of Representatives and the Committee on Finance of the Senate concerning the cost of providing screening mammography in a variety of settings and at different volume levels.

(2) The Comptroller General shall study and report, by July 1, 1989, to the Committees specified in paragraph (1) concerning the quality of care of screening mammography in a variety of settings.

SEC. 205. IN-HOME CARE FOR CERTAIN CHRONICALLY DEPENDENT INDIVIDUALS.

(a) IN GENERAL.—Section 1832(a) (42 U.S.C. 1395k(a)) is amended—

(1) in paragraph (2)(A)—

(A) by inserting "(i)" after "(A)", and

(B) by inserting before the semicolon at the end the following: ", and (ii) in-home care for a chronically dependent individual for up to 80 hours in any 12-month period described in section 1861(ll)(4), but not to exceed 80 hours in any calendar year;"; and

(2) by adding at the end the following new sentence:

"In the case of in-home care (described in paragraph (2)(A)(ii)) provided to a chronically dependent individual on any day, such care provided for 3 hours or less on the day shall be counted (for purposes of the limitation in such paragraph) as 3 hours of such care.".

(b) IN-HOME CARE FOR CHRONICALLY DEPENDENT INDIVIDUAL DEFINED.—Section 1861 (42 U.S.C. 1395x), as amended by section 204(a)(2) of this Act, is amended by adding at the end the following new subsection:

"In-Home Care; Chronically Dependent Individual

"(ll)(1) The term 'in-home care' means the following items and services furnished, under the supervision of a registered professional nurse, to a chronically dependent individual (as defined in paragraph (2)) during the period described in paragraph (4) by a home health agency or by others under arrangements with them made by such agency in a place of residence used as such individual's home:

"(A) Services of a homemaker/home health aide (who has successfully completed a training program approved by the Secretary).

"(B) Personal care services.

"(C) Nursing care provided by a licensed professional nurse.

"(2) The term 'chronically dependent individual' means an individual who—

"(A) is dependent on a daily basis on a primary caregiver who is living with the individual and is assisting the individual without monetary compensation in the performance of at least 2 of the activities of daily living (described in paragraph (3)), and

"(B) without such assistance could not perform such activities of daily living.

"(3) The 'activities of daily living', referred to in paragraph (2), are as follows:

"(i) Eating.

"(ii) Bathing.

"(iii) Dressing.

"(iv) Toileting.

"(v) Transferring in and out of a bed or in and out of a chair.

"(4) The 12-month period described in this paragraph is the 1-year period beginning on the date that the Secretary determines that a chronically dependent individual either—

"(A) has become entitled to benefits under section 1833(c) (relating to having incurred out-of-pocket part B cost sharing equal to the part B catastrophic limit), or

"(B) has become entitled to have payments made for covered outpatient drugs under section 1834(c).

In the case of an individual who qualifies under subparagraph (A) or (B) within 12 months after previously qualifying, the subsequent qualification shall begin a new 12-month period under this paragraph. In the case of an individual enrolled in a buy-out plan (as defined in section 1833(c)(5)(D)) or a drug buy-out plan (as defined in section 1834(c)(6)(D)), the Secretary shall establish such procedures as may be appropriate to identify individuals who are deemed to be described in subparagraph (A) or (B), respectively, for purposes of the provision of in-home care under the plan.".

(c) PAYMENT.—Section 1833(a) (42 U.S.C. 1395l(a)) is amended—

(1) in paragraph (2), by inserting "(A)(ii)," after "subparagraphs" the first place it appears,

(2) in paragraph (3), by striking "(D)" and inserting "(A)(ii), (D),", and

(3) by adding at the end the following:

"Payment for in-home care for chronically dependent individuals shall be paid on the basis of an hour of such care provided. In applying paragraph (2) in the case of an organization receiving payment under clause (A) of paragraph (1) or under a reasonable cost reimbursement contract under section 1876 and providing coverage of in-home care, the Secretary shall provide for an appropriate adjustment in the payment amounts otherwise made to reflect the aggregate increase in payments that would otherwise be made with respect to enrollees in the organization if payments were made other than under such clause or such a contract if payments were to be made on an individual-by-individual basis.". Contracts.

(d) CERTIFICATION.—Section 1835(a)(2) (42 U.S.C. 1395n(a)(2)), as amended by section 203(d) of this Act, is amended—

(1) by striking "and" at the end of subparagraph (F);

(2) by striking the period at the end of subparagraph (G) and inserting in lieu thereof "; and"; and

(3) by inserting after subparagraph (G) the following new subparagraph:

"(H) in the case of in-home care provided to a chronically dependent individual during a 12-month period, the individual was a chronically dependent individual during the 3-month period immediately preceding the beginning of the 12-month period.".

(e) STANDARDS FOR UTILIZATION.—

(1) Section 1862(a) (42 U.S.C. 1395y(a)), as amended by section 204(d)(2) of this Act, is amended—

(A) in paragraph (1)—

(i) by striking "and" at the end of subparagraph (E),

(ii) by adding "and" at the end of subparagraph (F), and

(iv) by adding at the end the following new subparagraph:

"(G) in the case of in-home care for chronically dependent individuals, which is not reasonable and necessary to assure the health and condition of the individual is maintained in the individual's noninstitutional residence;"; and

(B) in paragraph (6), by inserting "and except, in the case of in-home care, as is otherwise permitted under paragraph (1)(G)" after "paragraph (1)(C)".

(2) The Secretary of Health and Human Services shall take appropriate efforts to assure the quality, and provide for appropriate utilization of, in-home care for chronically dependent individuals under the amendments made by this section. 42 USC 1395k note.

(f) EFFECTIVE DATE.—The amendments made by this section shall apply to items and services furnished on or after January 1, 1990. 42 USC 1395k note.

(g) STUDY OF ALTERNATIVE OUT-OF-HOME SERVICES.—The Secretary of Health and Human Services shall study, and report to Congress, not later than 18 months after the date of the enactment of this Act, on the advisability of providing, to chronically dependent individuals eligible for in-home care under the amendments made by this section, out-of-home services (such as adult day care services or nursing facility services) as alternative services to in-home care. Reports. 42 USC 1395k note.

SEC. 206. EXTENDING HOME HEALTH SERVICES.

(a) IN GENERAL.—Section 1861(m) (42 U.S.C. 1395x(m)) is amended by adding at the end the following new sentence: "For purposes of paragraphs (1) and (4) and sections 1814(a)(2)(C) and 1835(a)(2)(A), nursing care and home health aide services shall be considered to be provided or needed on an 'intermittent' basis if they are provided or needed less than 7 days each week and, in the case they are provided or needed for 7 days each week, if they are provided or needed for a period of up to 38 consecutive days.".

42 USC 1395x note.

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to services furnished in cases of initial periods of home health services beginning on or after January 1, 1990.

42 USC 1395b-1 note.

SEC. 207. RESEARCH ON LONG-TERM CARE SERVICES FOR MEDICARE BENEFICIARIES.

(a) IN GENERAL.—The Secretary of Health and Human Services, from the funds appropriated under subsection (b), shall provide for research on issues relating to the delivery and financing of long-term care services for medicare beneficiaries. Such research shall include research into at least the following areas:

(1) The financial characteristics of medicare beneficiaries who receive or need long-term care services, including whether such beneficiaries are eligible for medicaid benefits for such services.

(2) How the financial and other characteristics of medicare beneficiaries affect their utilization of institutional and noninstitutional long-term care services.

(3) How relatives of medicare beneficiaries are affected financially and in other ways because the beneficiaries require or receive long-term care services.

(4) The quality of long-term care services (in community-based and custodial settings) and how the provision of long-term care services may reduce expenditures for acute health care services.

Consumer protection.

(5) The effectiveness of, and need for, State and Federal consumer protections which assure adequate access to and protect the rights of medicare beneficiaries who are provided long-term care services (other than in a nursing facility).

(b) AUTHORIZATION OF APPROPRIATIONS.—There are authorized to be appropriated, in equal parts from the Federal Hospital Insurance Trust Fund and from the Federal Supplementary Medical Insurance Trust Fund, $5,000,000 for each of fiscal years 1989, 1990, 1991, 1992, and 1993 to carry out the research described in subsection (a).

(c) LONG-TERM CARE SERVICES DEFINED.—In this section, the term "long-term care services" includes nursing home care, home care, community-based services, and custodial care.

(d) REPORTS.—The Secretary of Health and Human Services shall submit interim reports by December 1, 1990, and by December 1, 1992, and a final report by June 1, 1994, concerning the demonstration projects conducted under this section.

42 USC 1395ll note.

SEC. 208. STUDY OF ADULT DAY CARE SERVICES.

(a) SURVEY OF CURRENT ADULT DAY CARE SERVICES.—The Secretary of Health and Human Services shall conduct a survey of adult day care services in the United States to collect information concerning—

(1) the scope of such services and the extent of their availability;

(2) the characteristics of entities providing such services;

(3) licensure, certification, and other quality standards that are applied to those providing such services;

(4) the cost and financing of such services; and

(5) the characteristics of the people who use such services.

(b) REPORT.—The Secretary shall report to Congress, by not later than 1 year after the date of the enactment of this Act, on the information collected in the survey. Based on such information, the Secretary shall include in the report recommendations concerning appropriate standards for coverage of adult day care services under medicare, including defining chronically dependent individuals, defining services included in adult day care services, establishing qualifications of providers of adult day care services, and establishing a reimbursement mechanism.

(c) ADULT DAY CARE SERVICES DEFINED.—In this section, the term "adult day care services" means medical or social services provided in an organized nonresidential setting to chronically impaired individuals who are not inpatients in a medical institution.

Subtitle B—Medicare Part B Monthly Premium Financing

SEC. 211. ADJUSTMENT IN MEDICARE PART B PREMIUM.

Prescription drugs.

(a) IN GENERAL.—Section 1839 (42 U.S.C. 1395r) is amended by adding at the end the following new subsection:

"(g)(1)(A) Except as provided in this paragraph, paragraphs (4) and (5), and subsections (b) and (f), the monthly premium for each individual enrolled under this part otherwise determined, without regard to this subsection, shall be increased by the sum of the catastrophic coverage monthly premium and the prescription drug monthly premium for months in the year determined under the following table (for months occurring in 1989 through 1993) or determined in accordance with paragraphs (2) and (3) (for months after December 1993):

"In the case of:	The catastrophic coverage monthly premium is:	The prescription drug monthly premium is:
1989	$4.00	0
1990	$4.90	0
1991	$5.46	$1.94
1992	$6.75	$2.45
1993	$7.18	$3.02.

"(B)(i) Except as provided in subparagraph (C), if the amount of the supplemental premium rate otherwise determined under section 59B of the Internal Revenue Code of 1986 for taxable years beginning in a calendar year is increased as a result of subsection (e)(2)(A)(i) of such section or is reduced as a result of subsection (e)(2)(A)(ii) of such section, the monthly premium increase otherwise determined under this paragraph shall be reduced or increased, respectively, by an amount equal to—

"(I) 1/12th of the excess or shortfall, respectively, determined under clause (ii) for the year, as adjusted under clause (iv), divided by

"(II) the average number of individuals covered under this part during the preceding year.

"(ii) The excess or shortfall determined under this clause for a year is the excess or shortfall, determined by the Secretary of the Treasury, of—

"(I) the total amount of the supplemental premiums imposed under section 59B of the Internal Revenue Code of 1986 in the 2nd preceding year, over

"(II) the total amount of such premiums which would have been imposed in such year if the supplemental premium rate under such section had been increased by the shortfall rate, or decreased by the excess rate, described in clause (iii).

"(iii) The excess rate or shortfall rate under this clause for a year is the excess or shortfall of—

"(I) the supplemental premium rate established under section 59B of the Internal Revenue Code of 1986 for taxable years beginning in the year, and

"(II) the amount of such supplemental rate if determined without regard to subsection (e)(2)(A) of such section.

"(iv) The amount determined under clause (i)(I) for a year shall be increased by the percentage by which the per capita catastrophic coverage premium liability (as determined in section 59B(e)(3)(D)(ii) of the Internal Revenue Code of 1986) for the second preceding year exceeds such liability for the fourth preceding year (determined as if the catastrophic coverage premium rate for the second preceding calendar year were the same as the rate in effect for the fourth preceding calendar year).

"(C) In no event shall the monthly premium increase in effect under this paragraph for months in a year after 1993 be less than the monthly premium increase in effect under this paragraph for months in the preceding year.

"(D) If subparagraph (B) or subparagraph (C), or both, affects the increase in the monthly premium determined under this paragraph for a year, the increase in the monthly premium determined after the application of such subparagraph or subparagraphs shall be allocated between the catastrophic coverage monthly premium and the prescription drug monthly premium on the basis of the respective amounts of such premiums without regard to the application of either such subparagraph.

"(2)(A) In the case of months in a year after 1993, the catastrophic coverage monthly premium is the catastrophic coverage monthly premium (in effect under paragraph (1) or this paragraph for months in the preceding year, determined without regard to paragraph (1)(B) or (1)(C)) adjusted by the percentage determined under subparagraph (B) for the year.

"(B) The percentage determined under this subparagraph for a year shall be the sum of—

"(i) the outlay-premium percentage, and

"(ii) the reserve account percentage.

For purposes of the preceding sentence, negative percentages shall be taken into account as negatives.

"(C)(i) Except as provided in clause (ii), the outlay-premium percentage for any year is the percentage by which—

"(I) the per capita catastrophic outlays in the 2nd preceding year exceeds

"(II) such outlays in the 3rd preceding calendar year.

If there is no excess, this clause shall be applied by substituting 'is less than' for 'exceeds' and the percentage determined with such substitution shall be taken into account as a negative percentage.

"(ii) If—

"(I) the percentage increase in the CPI for the 12-month period ending with May of the preceding calendar year, exceeds (or is less than)

"(II) such increase for the 12-month period ending with May of the 2nd preceding calendar year,

by at least 1 percentage point, the percentage determined under clause (i) for any year shall be adjusted up (or down, respectively) by ½ of the amount by which such excess (or shortage, respectively) exceeds 1 percent.

"(D)(i) The reserve account percentage for any calendar year is the percentage which the premium change determined under clause (ii) is of the catastrophic coverage monthly premium in effect under paragraph (1) or this paragraph for the preceding year (determined without regard to paragraph (1)(B) or (1)(C)). If there is an excess determined under clause (iii), the percentage determined under the preceding sentence shall be taken into account as a negative percentage.

"(ii) The premium change determined under this clause for any year is the adjustment in the catastrophic coverage monthly premium (otherwise in effect for the 2nd preceding year) which the Secretary determines would have resulted in an aggregate increase (or decrease) in the premiums imposed by this subsection for such year equal to 37 percent of the shortfall or excess determined under clause (iii) for the calendar year.

"(iii) The shortfall (or excess) determined under this clause for any year is the amount by which—

"(I) 20 percent of the outlays during the 2nd preceding calendar year from the Medicare Catastrophic Coverage Account created under section 1841B, exceeds (or is less than)

"(II) the balance in such Account as of the close of such 2nd preceding calendar year (determined by taking into account previous premium increases by reason of the reserve account percentage under this paragraph or section 59B(e) of the Internal Revenue Code of 1986 which have not been credited into such Account).

"(3) In the case of months in a year after 1993, the prescription drug monthly premium shall be determined under rules similar to the rules of paragraph (2); except that—

"(A) in determining the prescription drug monthly premium for any month in a year before 1998, the following percentages shall be substituted for 20 percent in paragraph (2)(D)(iii)(I):

"In the case of year:	The percentage is:
1994	75
1995	50
1996	25
1997	25;

"(B) no adjustment by reason of the outlay-premium percentage shall be made for any calendar year before 1998;

"(C) any reference to the Medicare Catastrophic Coverage Account shall be treated as a reference to the Federal Catastrophic Drug Insurance Trust Fund; and

"(D) any reference to the catastrophic coverage monthly premium shall be treated as a reference to the prescription drug monthly premium.

"(4)(A) In the case of an individual who is a resident of Puerto Rico or who is a resident of another U.S. commonwealth or territory during a month, instead of the premium increase provided under Territories, U.S.

paragraph (1), subject to subsection (b), the monthly premium for each individual enrolled under this part otherwise determined, without regard to this subsection, shall be increased by the sum of—

"(i) the catastrophic coverage monthly premium determined under subparagraph (B) for such resident for the year, and

"(ii) the prescription drug monthly premium determined under subparagraph (C) for the resident for the year.

"(B) The catastrophic coverage monthly premium for months—

"(i) in 1989 is $1.30 for a resident of Puerto Rico and $2.10 for a resident of another U.S. commonwealth or territory;

"(ii) in 1990 is $3.56 for a resident of Puerto Rico and $5.78 for a resident of another U.S. commonwealth or territory; and

"(iii) in a subsequent year, with respect to a resident of Puerto Rico or a resident of another U.S. commonwealth or territory, is the catastrophic coverage monthly premium established under this subparagraph for the preceding year with respect to such a resident increased by the same percentage (estimated by the Secretary in September of that preceding year) by which—

"(I) the per capita catastrophic outlays for the year, will exceed

"(II) the per capita catastrophic outlays for that preceding year.

"(C) The prescription drug monthly premium for months—

"(i) in 1990 is $0.14 for a resident of Puerto Rico and $0.22 for a resident of another U.S. commonwealth or territory;

"(ii) in 1991 is $1.21 for a resident of Puerto Rico and $1.93 for a resident of another U.S. commonwealth or territory; and

"(iii) in a subsequent year, with respect to a resident of Puerto Rico or a resident of another U.S. commonwealth or territory, is the prescription drug monthly premium established under this subparagraph for the preceding year with respect to such a resident increased by the same percentage (estimated by the Secretary in September of that preceding year) by which—

"(I) the per capita prescription drug outlays for the year, will exceed

"(II) the per capita prescription drug outlays for that preceding year.

"(5)(A) In the case of a part B only individual (as defined in paragraph (8)(F)) during a month, instead of the premium increase provided under paragraph (1), subject to subsection (b), the monthly premium otherwise determined, without regard to this subsection, shall be increased by the sum of—

"(i) the catastrophic coverage monthly premium determined under subparagraph (B) for the year, and

"(ii) the prescription drug monthly premium determined under subparagraph (C) for the year.

"(B) The catastrophic coverage monthly premium for months—

"(i) in 1990 is $8.57, and

"(ii) in a subsequent year is 1/12th of the average actuarial expenses that the Secretary estimates (during September before the year) will be incurred during the year for benefits and administration costs (other than benefits and costs attributable to part A) for which outlays may be made from the Medicare Catastrophic Coverage Account.

"(C) The prescription drug monthly premium for months—

"(i) in 1990 is $0.53,

"(ii) in 1991 is $4.61, and

"(iii) a subsequent year is 1/12th of the average actuarial expenses that the Secretary estimates (during September before the year) will be incurred during the year for benefits and administration costs for which outlays may be made from the Federal Catastrophic Drug Insurance Trust Fund.

"(6)(A) If any premium increase for a month under this subsection is not a multiple of 10 cents, the Secretary shall round the increase to the nearest multiple of 10 cents.

"(B) If the Secretary so rounds the premium increase, the amount of such increase shall be allocated between the catastrophic coverage monthly premium and the prescription drug monthly premium on the basis of the respective amounts of such premiums without regard to the application of subparagraph (A).

"(7)(A) The Secretary and the Secretary of the Treasury shall jointly—

Federal Register, publication. Regulations.

"(i) publish in the Federal Register by not later than July 1 of each year (beginning with 1993) a proposed regulation to establish premium increases under this subsection for months in the following year,

Reports.

"(ii) report to Congress, by not later than September 1 of such year, on the final premiums to be published under clause (iii), and

Federal Register, publication. Regulations.

"(iii) publish in the Federal Register, during the last 3 days of September of each such year, a final regulation establishing monthly premiums under this subsection for months in the following year.

Reports. Territories, U.S.

"(B) The Secretary shall report to Congress, in 1993, respecting the appropriateness of the level of premium increases established under paragraph (4) for residents of Puerto Rico and of other U.S. commonwealths and territories.

"(8) For purposes of this subsection:

"(A) The term 'per capita catastrophic outlays' means, with respect to any year, the amount (as determined by the Secretary) equal to—

"(i) the outlays during such year from the Medicare Catastrophic Coverage Account, divided by

"(ii) the average number of individuals entitled to receive benefits under part A during such year.

"(B) The term 'per capita prescription drug outlays' means, with respect to any year, the amount (as determined by the Secretary) equal to—

"(i) the outlays during such year from the Federal Catastrophic Drug Insurance Trust Fund, divided by

"(ii) the average number of individuals entitled to receive benefits under part A during such year.

"(C) The percentage increase in the CPI for any 12-month period shall be the percentage by which the Consumer Price Index (as defined in section 1(f)(5) of the Internal Revenue Code of 1986) for the last month of such period exceeds such Index for the last month of the preceding 12-month period.

"(D) The term 'Medicare Catastrophic Coverage Account' refers to such Account as created under section 1841B.

"(E) The term 'U.S. commonwealth or territory' means Puerto Rico, the United States Virgin Islands, Guam, American Samoa, or the Northern Mariana Islands.

"(F) The term 'part B only individual' means, with respect to a month, an individual who—

"(i) is not a resident of a U.S. commonwealth or territory (as defined in subparagraph (E)) during the month,

"(ii) is entitled to benefits under this part, and

"(iii) is not entitled to (or, on application without payment of an additional premium, would not be entitled to) benefits under part A or is entitled to benefits under such part only because of payment of a premium under section 1818.".

(b) EXTENSION OF HOLD-HARMLESS PROVISION.—Subsection (f) of section 1839 (42 U.S.C. 1395r) is amended to read as follows:

"(f) For any calendar year after 1988, if an individual is entitled to monthly benefits under section 202 or 223 or to a monthly annuity under section 3(a), 4(a), or 4(f) of the Railroad Retirement Act of 1974 for November and December of the preceding year, and if the monthly premium of the individual under this section for December and for January is deducted from those benefits under section 1840(a)(1) or section 1840(b)(1), the monthly premium otherwise determined under this section for an individual for that year shall not be increased, pursuant to this subsection, to the extent that such increase would reduce the amount of benefits payable to that individual for that January below the amount of benefits payable to that individual for that December (after the deduction of the premium under this section). For purposes of this subsection, retroactive adjustments or payments and deductions on account of work shall not be taken into account in determining the monthly benefits to which an individual is entitled under section 202 or 223 or under the Railroad Retirement Act of 1974.".

(c) CONFORMING AMENDMENTS.—

(1) Section 1839 (42 U.S.C. 1395r) is amended—

(A) in the second sentence of subsections (a)(1) and (a)(4), by inserting "(other than costs relating to the amendments made by the Medicare Catastrophic Coverage Act of 1988)" before the period;

(B) by inserting before the period at the end of the last sentence of subsections (a)(1) and (a)(4) the following: ", but shall not take into account any amounts in the Trust Fund that may be attributable to receipts or outlays relating to the Medicare Catastrophic Coverage Account";

(C) in subsection (a)(2), by striking "and (e)" and inserting ", (e), and (g)";

(D) in subsection (a)(3), by striking "subsection (e)" and inserting "subsections (e) and (g)";

(E) in subsection (b), by striking "determined under subsection (a) or (e)" and inserting "otherwise determined under this section (without regard to subsections (f) and (g)(6))"; and

(F) in subsection (e)(1), by inserting "except as provided in subsection (g)," after "subsection (a)".

(2) Section 1844(a) (42 U.S.C. 1395w(a)) is amended by adding at the end the following:

"In computing the amount of aggregate premiums and premiums per enrollee under paragraph (1), there shall not be taken into account premiums attributable to section 1839(g) or section 59B of the Internal Revenue Code of 1986.".

42 USC 1395mm.

(3) Section 1876(a)(5) (42 U.S.C. 1395ff(a)(5)) is amended—

(A) by striking "and the Federal Supplementary Medical Insurance Trust Fund" and inserting ", the Federal Supplementary Medical Insurance Trust Fund, and the Federal Catastrophic Drug Insurance Trust Fund", and

(B) by amending the second sentence to read as follows: "The portion of that payment to the organization for a month to be paid by each trust fund shall be determined as follows: Contracts.

"(A) In regard to expenditures by eligible organizations having risk-sharing contracts, the allocation shall be determined each year by the Secretary based on the relative weight that benefits from each fund contribute to the adjusted average per capita cost.

"(B) In regard to expenditures by eligible organizations operating under a reasonable cost reimbursement contract, the initial allocation shall be based on the plan's most recent budget, such allocation to be adjusted, as needed, after cost settlement to reflect the distribution of actual expenditures.".

(d) EFFECTIVE DATE.—The amendments made by this section shall apply (except as otherwise specified in such amendments) to monthly premiums for months beginning with January 1989. 42 USC 1395r note.

SEC. 212. ESTABLISHMENT OF FEDERAL CATASTROPHIC DRUG INSURANCE TRUST FUND; FUND TRANSFERS.

(a) IN GENERAL.—Part B of title XVIII is amended by inserting after section 1841 the following new section:

"FEDERAL CATASTROPHIC DRUG INSURANCE TRUST FUND

"SEC. 1841A. (a)(1) There is hereby created on the books of the Treasury of the United States a trust fund to be known as the 'Federal Catastrophic Drug Insurance Trust Fund' (in this section referred to as the 'Trust Fund'). The Trust Fund shall consist of such gifts and bequests as may be made as provided in section 201(i)(1) and amounts transferred to it in accordance with section 1841(j) or under paragraph (2). 42 USC 1395t-1.

"(2) There are hereby appropriated to the Trust Fund amounts equivalent to 100 percent of the supplemental premiums imposed by section 59B of the Internal Revenue Code of 1986 which are attributable to the prescription drug rate. The amounts appropriated by the preceding sentence shall be transferred from time to time (not less frequently than monthly) from the general fund in the Treasury to the Trust Fund, such amounts to be determined on the basis of estimates by the Secretary of the Treasury of the premiums, specified in the preceding sentence, paid to or deposited into the Treasury; and proper adjustments shall be made in amounts subsequently transferred to the extent prior estimates were in excess of or were less than the premiums specified in such sentence. At the close of each year, the transfers under this subsection shall reflect all premiums paid or deposited (as specified in this subsection) into the Treasury in the year.

"(b) The provisions of subsections (b) through (i) of section 1841 shall apply to the Trust Fund in the same manner as they apply to the Federal Supplementary Medical Insurance Trust Fund.

"(c) Notwithstanding any other provision of this title, all payments under this part on or after January 1, 1990, for benefits and administrative costs relating to covered outpatient drugs shall be made from the Trust Fund. Effective date.

Federal Register, publication.

"(d)(1) The Secretary of the Treasury, in consultation with the Board of Trustees of the Trust Fund, shall publish in the Federal Register—

"(A) not later than July 1 of each year (beginning with 1992), information on—

"(i) the outlays made from the Trust Fund in the preceding year, and

"(ii) the balance in the Trust Fund as of the close of the preceding year; and

"(B) during the last 3 days of September of each such year, the prescription drug monthly premiums to be established under section 1839(g) for months in the succeeding year.

Reports.

"(2) The Secretary shall report to Congress, not later than July 1 of each year (beginning with 1992), respecting the distribution of outlays from the Trust Fund in the previous year among major spending categories. The Comptroller General shall report, not later than September 1 of each year, to Congress concerning the completeness and accuracy of the Secretary's report under the previous sentence and of the premiums established under section 1839(g) and under section 59B of the Internal Revenue Code of 1986.

"(e) In this part, with respect to the Trust Fund and the Medicare Catastrophic Coverage Account, the terms 'outlays' and 'receipts' mean, with respect to a quarter or other period, gross outlays and receipts, as such terms are employed in the 'Monthly Treasury Statement of Receipts and Outlays of the United States Government (MTS)', as published by the Department of the Treasury, for months in such quarter or other period.".

(b) TRANSFERS OF CERTAIN PREMIUMS.—

(1) TRANSFER OF FLAT PRESCRIPTION DRUG PREMIUMS TO FEDERAL CATASTROPHIC DRUG INSURANCE TRUST FUND.—Section 1840 (42 U.S.C. 1395s) is amended by adding at the end the following new subsection:

"(i) Notwithstanding the previous provisions of this subsection, premiums collected under this part which are attributable to a prescription drug monthly premium established under section 1839(g) shall, instead of being transferred to (or being deposited to the credit of) the Federal Supplemental Medical Insurance Trust Fund, be transferred to (or deposited to the credit of) the Federal Catastrophic Drug Insurance Trust Fund.".

(2) TRANSFER OF SUPPLEMENTAL CATASTROPHIC COVERAGE PREMIUMS INTO THE SMI TRUST FUND.—Section 1841(a) (42 U.S.C. 1395t(a)) is amended by adding the following: "There are hereby appropriated to the Trust Fund amounts equivalent to 100 percent of the supplemental premiums imposed by section 59B of the Internal Revenue Code of 1986 which are attributable to the catastrophic coverage rate and which are not otherwise appropriated under section 1817A(a)(2) to the Federal Hospital Insurance Catastrophic Coverage Reserve Fund. The amounts appropriated by the preceding sentence shall be transferred from time to time (not less frequently than monthly) from the general fund in the Treasury to the Trust Fund, such amounts to be determined on the basis of estimates by the Secretary of the Treasury of the premiums, specified in the preceding sentence, paid to or deposited into the Treasury; and proper adjustments shall be made in amounts subsequently transferred to the extent prior estimates were in excess of or were less than the premiums specified in such sentence. At the close of each

year, the transfers under this subsection shall reflect all premiums under section 59B of the Internal Revenue Code of 1986 paid or deposited into the Treasury in the year.".

(c) CONFORMING AMENDMENTS.—

(1)(A) Section 201(g)(1)(A) (42 U.S.C. 401(g)(1)(A)) is amended by striking "and the Federal Supplementary Medical Insurance Trust Fund" and inserting ", Federal Supplementary Medical Insurance Trust Fund, and the Federal Catastrophic Drug Insurance Trust Fund".

(B) Section 201(i)(1) (42 U.S.C. 401(i)(1)) is amended by striking "and the Federal Supplementary Medical Insurance Trust Fund" and inserting ", Federal Hospital Insurance Catastrophic Coverage Reserve Fund, Federal Supplementary Medical Insurance Trust Fund, and the Federal Catastrophic Drug Insurance Trust Fund".

(2) Section 1833(a) (42 U.S.C. 1395l(a)) is amended, in the matter before paragraph (1), by inserting "or, as provided in section 1841A(c), from the Federal Catastrophic Drug Insurance Trust Fund" after "Medical Insurance Trust Fund".

(3) Section 1817(b) (42 U.S.C. 1395i(b)) is amended by inserting after the sixth sentence the following: "Such report shall also identify (and treat separately) those outlays from the Trust Fund which are also outlays from the Medicare Catastrophic Coverage Account created under section 1841B and those outlays for which there are amounts transferred into the Federal Hospital Insurance Catastrophic Coverage Reserve Fund.".

(4) Section 1841(b) (42 U.S.C. 1395t(b)) is amended by inserting after the sixth sentence the following: "Such report shall also identify (and treat separately) those receipts and outlays in the Trust Fund which are also receipts and outlays in the Medicare Catastrophic Coverage Account created under section 1841B.".

SEC. 213. CREATION OF MEDICARE CATASTROPHIC COVERAGE ACCOUNT.

(a) IN GENERAL.—Part B of title XVIII is amended by inserting after section 1841A, as inserted by section 212, the following new section:

"MEDICARE CATASTROPHIC COVERAGE ACCOUNT

"SEC. 1841B. (a) For purposes of carrying out certain provisions of this title, and section 59B of the Internal Revenue Code of 1986, there is hereby created on the books of the Treasury of the United States an account to be known as the 'Medicare Catastrophic Coverage Account' (in this section referred to as the 'Account'), to be maintained by the Secretary of the Treasury in consultation with the Boards of Trustees of the Federal Hospital Insurance Trust Fund and the Federal Supplementary Medical Insurance Trust Fund. No funds shall actually be transferred into or paid out of the Account, but, for other purposes of this part and for purposes of section 59B of the Internal Revenue Code of 1986, amounts credited to the Account shall be considered receipts of the Account and amounts debited to the Account shall be considered outlays from the Account. 42 USC 1395t-2.

"(b)(1) The Account shall be—

"(A) credited for receipts of the Federal Supplementary Medical Insurance Trust Fund attributable to the portion of supplemental premiums under section 59B of the Internal Revenue Code of 1986, and the premiums under section 1839(g), attributable to the catastrophic coverage premium rate or catastrophic coverage monthly premium,

"(B) credited for receipts of the Federal Hospital Insurance Catastrophic Coverage Reserve Fund, and

"(C) debited for outlays made under this title that are attributable to the amendments made by the Medicare Catastrophic Coverage Act of 1988 (other than outlays relating to covered outpatient drugs and related administrative costs).

"(2) In addition, the Account shall be—

"(A) credited with interest (at the rate used for purposes of the Federal Supplementary Medical Insurance Trust Fund) on any positive average balance maintained in the Account in a calendar quarter, and

"(B) debited with interest (at the rate used for purposes of the Federal Supplementary Medical Insurance Trust Fund) on any negative average balance maintained in the Account in a calendar quarter.

"(3) Credits and debits under this subsection shall be made as of the last date of each month based upon receipts and outlays occurring during the month, as estimated by the Secretary and the Secretary of the Treasury.

"(4) The Account shall also identify (and treat separately) those credits and debits in the Account which are also receipts and outlays in the Federal Supplementary Medical Insurance Trust Fund, those receipts which are also receipts of the Federal Hospital Insurance Catastrophic Coverage Reserve Fund, and those outlays that are also outlays from the Federal Hospital Insurance Trust Fund.

Federal Register, publication.

"(c)(1) The Secretary of the Treasury shall publish in the Federal Register—

"(A) not later than July 1 of each year (beginning with 1990), information on—

"(i) the outlays made from the Account in the preceding year, and

"(ii) the balance in the Account as of the close of the preceding year; and

"(B) during the last 3 days of September of each such year, the catastrophic coverage monthly premiums to be established under section 1839(g) for months in the succeeding year.

Reports.

"(2) The Secretary shall report to Congress, not later than July 1 of each year (beginning with 1990), respecting the distribution of outlays from the Account in the previous year among major spending categories. The Comptroller General shall report, not later than September 1 of each year, to Congress concerning the completeness and accuracy of the Secretary's report under the previous sentence and of the premiums established under section 1839(g) and under section 59B of the Internal Revenue Code of 1986.

Reports.

"(d) The Secretary of the Treasury shall report to Congress in April of each year on the status of the Account created under this section.".

Subtitle C—Miscellaneous Provisions

SEC. 221. VOLUNTARY CERTIFICATION OF MEDICARE SUPPLEMENTAL HEALTH INSURANCE POLICIES.

(a) Free-Look Period.—Section 1882 (42 U.S.C. 1395ss) is amended—

(1) in subsection (b)(1)(B), by striking "and (3)" and inserting "through (4)", and

(2) in subsection (c)—

(A) by striking "and" at the end of paragraph (2),

(B) by striking the period at the end of paragraph (3) and inserting "; and", and

(C) by adding at the end thereof the following:

"(4) may, during a period of not less than 30 days after the policy is issued, be returned for a full refund of any premiums paid (without regard to the manner in which the purchase of the policy was solicited).".

(b) Reporting of Information Relating to Loss Ratios.—Section 1882(b)(1), as amended by subsection (a), is further amended—

(1) in subparagraph (C), by striking "(A) and (B)" and inserting "(A), (B), and (C)",

(2) by redesignating subparagraphs (C) and (D) as subparagraphs (D) and (E), respectively, and

(3) by inserting after subparagraph (B) the following new subparagraph:

"(C) provides that—

"(i) information with respect to the actual ratio of benefits provided to premiums collected under such policies will be reported to the State on forms conforming to those developed by the National Association of Insurance Commissioners for such purpose, or

"(ii) such ratios will be monitored under the program in an alternative manner approved by the Secretary;".

(c) Consumer Information.—Section 1882(e) is amended— 42 USC 1395ss.

(1) by inserting "(1)" after "(e)", and

(2) by adding at the end thereof the following:

"(2) The Secretary shall—

"(A) inform all individuals entitled to benefits under this title (and, to the extent feasible, individuals about to become so entitled) of—

"(i) the actions and practices that are subject to sanctions under subsection (d), and

"(ii) the manner in which they may report any such action or practice to an appropriate official of the Department of Health and Human Services (or to an appropriate State official), and

"(B) publish the toll-free telephone number for individuals to report suspected violations of the provisions of such subsection. Law enforcement and crime.

"(3) The Secretary shall provide individuals entitled to benefits under this title (and, to the extent feasible, individuals about to become so entitled) with a listing of the addresses and telephone numbers of State and Federal agencies and offices that provide information and assistance to individuals with respect to the selection of medicare supplemental policies.".

(d) Revision of Model Standards; Transition.—Section 1882 is further amended—

(1) in the third sentence of subsection (a), by striking "Such certification" and inserting "Subject to subsection (k)(3), such certification";

(2) in subsection (b), by striking "(for so long as" and inserting "(subject to subsection (k)(3), for so long as"; and

(3) by adding at the end thereof the following new subsections:

State and local governments. Effective date.

"(k)(1)(A) If, within the 90-day period beginning on the date of the enactment of this subsection, the National Association of Insurance Commissioners (in this subsection referred to as the 'Association') amends the NAIC Model Regulation adopted on June 6, 1979 (as it relates to medicare supplemental policies), with respect to matters such as minimum benefit standards, loss ratios, disclosure requirements, and replacement requirements and provisions otherwise necessary to reflect the changes in law made by the Medicare Catastrophic Coverage Act of 1988, subsection (g)(2)(A) shall be applied in a State, effective on and after the date specified in subparagraph (B), as if the reference to the Model Regulation adopted on June 6, 1979, were a reference to the Model Regulation as amended by the Association in accordance with this paragraph (in this subsection and subsection (l) referred to as the 'amended NAIC Model Regulation').

"(B) The date specified in this subparagraph for a State is the earlier of the date the State adopts standards equal to or more stringent than the amended NAIC Model Regulation or 1 year after the date the Association first adopts such amended Regulation.

Effective date.

"(2)(A) If the Association does not amend the NAIC Model Regulation within the 90-day period specified in paragraph (1)(A), the Secretary shall promulgate, not later than 60 days after the end of such period, Federal model standards (in this subsection and subsection (l) referred to as 'Federal model standards') for medicare supplemental policies to reflect the changes in law made by the Medicare Catastrophic Coverage Act of 1988, and subsection (g)(2)(A) shall be applied in a State, effective on and after the date specified in subparagraph (B), as if the reference to the Model Regulation adopted on June 6, 1979, were a reference to Federal model standards.

"(B) The date specified in this subparagraph for a State is the earlier of the date the State adopts standards equal to or more stringent than the Federal model standards or 1 year after the date the Secretary first promulgates such standards.

"(3) Notwithstanding any other provision of this section (except as provided in subsection (l))—

"(A) no medicare supplemental policy may be certified by the Secretary pursuant to subsection (a),

"(B) no certification made pursuant to subsection (a) shall remain in effect, and

"(C) no State regulatory program shall be found to meet (or to continue to meet) the requirements of subsection (b)(1)(A),

unless such policy meets (or such program provides for the application of standards equal to or more stringent than) the standards set forth in the amended NAIC Model Regulation or the Federal model standards (as the case may be) by the date specified in paragraph (1)(B) or (2)(B) (as the case may be).

State and local governments.

"(l)(1) Until the date specified in paragraph (3), in the case of a qualifying medicare supplemental policy described in paragraph (2) issued—

"(A) before January 1, 1989, the policy is deemed to remain in compliance with this section if the insurer issuing the policy complies with the NAIC Model Transition Regulation (including giving notices to subscribers and filing for premium adjustments with the State as described in section 5.B. of such Regulation) by January 1, 1989; or

"(B) on or after January 1, 1989, the policy is deemed to be in compliance with this section if the insurer issuing the policy complies with the NAIC Model Transition Regulation before the date of the sale of the policy.

"(2) In paragraph (1), the term 'qualifying medicare supplemental policy' means a medicare supplemental policy—

"(A) issued in a State which—

"(i) has not adopted standards equal to or more stringent than the NAIC Model Transition Regulation by January 1, 1989, and

"(ii) has not adopted standards equal to or more stringent than the amended NAIC Model Regulation (or Federal model standards) by January 1, 1989; and

"(B) which has been issued in compliance with this section (as in effect on June 1, 1988).

"(3)(A) The date specified in this paragraph is the earlier of—

"(i) the first date a State adopts, after January 1, 1989, standards equal to or more stringent than the NAIC Model Transition Regulation or equal to or more stringent than the amended NAIC Model Regulation (or Federal model standards), as the case may be, or

"(ii) the later of (I) the date specified in subsection (k)(1)(B) or (k)(2)(B) (as the case may be), or (II) the date specified in subparagraph (B).

"(B) In the case of a State which the Secretary identifies as—

"(i) requiring State legislation (other than legislation appropriating funds) in order for medicare supplemental policies to meet standards described in subparagraph (A)(i), but

"(ii) having a legislature which is not scheduled to meet in 1989 in a legislative session in which such legislation may be considered,

the date specified in this subparagraph is the first day of the first calendar quarter beginning after the close of the first legislative session of the State legislature that begins on or after January 1, 1989, and in which legislation described in clause (i) may be considered. For purposes of the previous sentence, in the case of a State that has a 2-year legislative session, each year of such session shall be deemed to be a separate regular session of the State legislature.

"(4) In the case of a medicare supplemental policy in effect on January 1, 1989, and offered in a State which, as of such date—

"(A) has adopted standards equal to or more stringent than the amended NAIC Model Regulation (or Federal model standards), but

"(B) does not have in effect standards equal to or more stringent than the NAIC Model Transition Regulation (or otherwise requiring notice substantially the same as the notice required in section 5.B. of such Regulation),

the policy shall not be deemed to meet the standards in subsection (c) unless each individual who is entitled to benefits under this title and is a policyholder under such policy on January 1, 1989, is sent such a notice in any appropriate form by not later than January 31, 1989, that explains—

"(A) the improved benefits under this title contained in the Medicare Catastrophic Coverage Act of 1988, and

"(B) how these improvements affect the benefits contained in the policies and the premium for the policy.

"(5) In this subsection, the term 'NAIC Model Transition Regulation' refers to the standards contained in the 'Model Regulation to Implement Transitional Requirements for the Conversion of Medicare Supplement Insurance Benefits and Premiums to Conform to Medicare Program Revisions' (as adopted by the National Association of Insurance Commissioners in September 1987).

Reports.

"(6) The Secretary shall report to the Congress in March 1989 and in July 1990 on actions States have taken in adopting standards equal to or more stringent than the NAIC Model Transition Regulation or the amended NAIC Model Regulation (or Federal model standards).".

42 USC 1395ss.

(e) REQUIRED SUBMISSION OF ADVERTISING.—Section 1882(b) is further amended by adding at the end the following new paragraph:

State and local governments.

"(3) Notwithstanding paragraph (1), a medicare supplemental policy offered in a State shall not be deemed to meet the standards and requirements set forth in subsection (c), with respect to an advertisement (whether through written, radio, or television medium) used (or, at a State's option, to be used) for the policy in the State, unless the entity issuing the policy provides a copy of each advertisement to the Commissioner of Insurance (or comparable officer identified by the Secretary) of that State for review or approval to the extent it may be required under State law.".

(f) APPOINTMENT OF SUPPLEMENTAL HEALTH INSURANCE PANEL MEMBERS.—Section 1882(b)(2)(A) is amended by striking "appointed by the President" and inserting "appointed by the Secretary".

42 USC 1395ss note.

(g) EFFECTIVE DATES.—

(1) Except as provided in paragraphs (2) and (3), the amendments made by this section shall take effect on the date of the enactment of this Act.

(2) The amendments made by subsections (a) and (b) shall become effective on the date specified in subsection (k)(1)(B) or (k)(2)(B) of section 1882 of the Social Security Act (as added by subsection (c) of this section).

(3) The amendment made by subsection (f) shall apply to medicare supplemental policies as of January 1, 1989, with respect to advertising used on or after such date.

(4) The Secretary of Health and Human Services shall provide for the reappointment of members to the Supplemental Health Insurance Panel (under section 1882(b)(2) of the Social Security Act) by not later than 90 days after the date of the enactment of this Act.

42 USC 1395mm note.

SEC. 222. ADJUSTMENT OF CONTRACTS WITH PREPAID HEALTH PLANS.

The Secretary of Health and Human Services shall—

(1) modify contracts under sections 1833(a)(1)(A) and 1876 of the Social Security Act, for portions of contract years occurring after December 31, 1988, to take into account the amendments made by this Act; and

(2) require such organizations to make appropriate adjustments (including adjustments in premiums and benefits) in the terms of their agreements with medicare beneficiaries to take into account such amendments.

The Secretary shall also provide for appropriate modifications of contracts with health maintenance organizations under section 1876(i)(2)(A) of the Social Security Act (as in effect before February 1, 1985), under section 402(a) of the Social Security Amendments of 1967, or under section 222(a) of the Social Security Amendments of

1972, for portions of contract years occurring after December 31, 1988, so as to apply to such organizations and contracts the requirements imposed by the amendments made by this Act upon an organization with a risk-sharing contract under section 1876 of the Social Security Act.

SEC. 223. MAILING OF NOTICE OF MEDICARE BENEFITS AND INFORMATION DESCRIBING PARTICIPATING PHYSICIAN PROGRAM.

(a) DISTRIBUTION OF NOTICES.—Title XVIII is amended by inserting after section 1803 the following new section:

"NOTICE OF MEDICARE BENEFITS

"SEC. 1804. The Secretary shall prepare (in consultation with groups representing the elderly and with health insurers) and provide for distribution of a notice containing— 42 USC 1395b-2.

"(1) a clear, simple explanation of the benefits available under this title and the major categories of health care for which benefits are not available under this title,

"(2) the limitations on payment (including deductibles and coinsurance amounts) that are imposed under this title, and

"(3) a description of the limited benefits for long-term care services available under this title and generally available under State plans approved under title XIX.

Such notice shall be mailed annually to individuals entitled to benefits under part A or part B of this title and when an individual applies for benefits under part A or enrolls under part B.".

(b) DISTRIBUTION OF INFORMATION DESCRIBING PARTICIPATING PHYSICIAN PROGRAM.—Section 1842(h)(5) (42 U.S.C. 1395u(h)(5)) is amended—

(1) by inserting "through an annual mailing" after "under this part",

(2) by striking the last sentence,

(3) by inserting "(A)" after "(5)", and

(4) by adding at the end the following new subparagraph:

"(B) The annual notice provided under subparagraph (A) shall include—

"(i) a description of the participation program,

"(ii) an explanation of the advantages to beneficiaries of obtaining covered services through a participating physician or supplier,

"(iii) an explanation of the assistance offered by carriers in obtaining the names of participating physicians and suppliers, and

"(iv) the toll-free telephone number under paragraph (2)(A) for inquiries concerning the program and for requests for free copies of appropriate directories.".

(c) REVISION OF EXPLANATION OF MEDICARE BENEFITS.—Section 1842(h)(7) (42 U.S.C. 1395u(h)(7)) is amended—

(1) in subparagraph (A)—

(A) by inserting "prominent" before "reminder", and

(B) by striking "), and" and inserting "and a clear statement of any amounts charged for the particular items or services on the claim involved above the amount recognized under this part),";

(2) in subparagraph (B), by striking the period at the end and inserting ", and"; and

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(3) by adding at the end the following new subparagraph:

"(C) shall include (i) an offer of assistance to such an individual in obtaining the names of participating physicians of appropriate specialty and (ii) an offer to provide a free copy of the appropriate participating physician directory.".

(d) EFFECTIVE DATES.—

42 USC 1395b-2 note.

(1) The Secretary of Health and Human Services shall first distribute the notice required by the amendment made by subsection (a) not later than January 31, 1989.

42 USC 1395u note.

(2) The amendments made by subsection (b) shall apply to annual notices beginning with 1989.

42 USC 1395u note.

(3) The amendments made by subsection (c) shall first apply to explanations of benefits provided for items and services furnished on or after January 1, 1989.

SEC. 224. CHANGES IN CIVIL MONEY PENALTIES FOR CERTAIN PRACTICES OF HEALTH MAINTENANCE ORGANIZATIONS AND COMPETITIVE MEDICAL PLANS.

Section 1876(i)(6)(B)(i) (42 U.S.C. 1395mm(i)(6)(B)(i)) is amended by adding at the end the following: "plus, with respect to a determination under subparagraph (A)(ii), double the excess amount charged in violation of such subparagraph (and the excess amount charged shall be deducted from the penalty and returned to the individual concerned), and plus, with respect to a determination under subparagraph (A)(iv), $15,000 for each individual not enrolled as a result of the practice involved,".

TITLE III—PROVISIONS RELATING TO THE MEDICAID PROGRAM

SEC. 301. REQUIRING MEDICAID BUY-IN OF PREMIUMS AND COST-SHARING FOR INDIGENT MEDICARE BENEFICIARIES.

(a) REQUIREMENT.—

(1) Section 1902(a)(10)(E) (42 U.S.C. 1396a(a)(10)(E)) is amended by striking "at the option of a State, but".

(2) Section 1905(p)(1)(B) (42 U.S.C. 1396d(p)(1)(B)) is amended by striking "and the election of the State".

(b) PHASING-IN REQUIRED INCOME STANDARD TO 100 PERCENT OF POVERTY LEVEL.—Section 1905(p)(2)(A) (42 U.S.C. 1396d(p)(2)(A)) is amended—

(1) by striking "may not exceed a percentage (not more than 100 percent)" and inserting "shall be at least the percent provided under clause (ii) (but not more than 100 percent)",

(2) by inserting "(i)" after "(2)(A)", and

(3) by adding at the end the following new clause:

"(ii) Except as provided in clause (iii), the percent provided under this clause, with respect to eligibility for medical assistance on or after—

"(I) January 1, 1989, is 85 percent,

"(II) January 1, 1990, is 90 percent,

"(III) January 1, 1991, is 95 percent, and

"(IV) January 1, 1992, is 100 percent.

"(iii) In the case of a State which has elected treatment under section 1902(f) and which, as of January 1, 1987, used an income standard for individuals age 65 or older which was more restrictive than the income standard established under the supplemental security income program under title XVI, the percent provided under clause (ii), with respect to eligibility for medical assistance on or after—

"(I) January 1, 1989, is 80 percent,

"(II) January 1, 1990, is 85 percent,

"(III) January 1, 1991, is 90 percent,

"(IV) January 1, 1992, is 95 percent, and

"(V) January 1, 1993, is 100 percent.".

(c) RESOURCE STANDARD.—Section 1905(p) (42 U.S.C. 1396d(p)) is amended—

(1) in paragraph (1)(C), by striking "(2)(A)" and inserting "(2)";

(2) in paragraph (1)(D), by striking "(except as provided in paragraph (2)(B))" and inserting "twice"; and

(3) in paragraph (2)—

(A) in subparagraph (A), by striking "(2)(A)" and inserting "(2)", and

(B) by striking subparagraph (B).

(d) MEDICARE COVERAGE.—Section 1905(p) (42 U.S.C. 1396d(p)) is amended—

(1) in paragraph (3)(A), by striking "under part B and (if applicable) under section 1818" and inserting "under title XVIII (including under part B and, if applicable, under section 1818)";

(2) by amending subparagraphs (B) and (C) of paragraph (3) to read as follows:

"(B) Coinsurance under title XVIII (including coinsurance described in section 1813).

"(C) Subject to paragraph (4), deductibles established under title XVIII (including those described in section 1813, 1833(b), and section 1834(c)(1)).''; and

(3) by adding at the end the following new paragraph:

State and local governments. Prescription drugs.

"(4) In a State which provides medical assistance for prescribed drugs under section 1905(a)(12), instead of providing to qualified medicare beneficiaries, under paragraph (3)(C), medicare cost-sharing with respect to the annual deductible for covered outpatient drugs under section 1834(c)(1), the State may provide to such beneficiaries, before charges for covered outpatient drugs for a year reach such deductible amount, benefits for prescribed drugs in the same amount, duration, and scope as the benefits made available under the State plan for individuals described in section 1902(a)(10)(A)(i).".

(e) CONFORMING AMENDMENTS.—

(1) Section 1843 (42 U.S.C. 1395v) is amended by inserting "or after 1988" in subsections (a), (g)(1), and (h)(1) after "during 1981".

(2) Section 1902 (42 U.S.C. 1396a) is amended—

(A) in subsection (a)(10)(A)(ii)(X), by striking "subject to subsection (m)(3),",

(B) in subsection (a)(10)(E), by striking "subject to subsection (m)(3),";

(C) in subsection (a)(17), by striking "(m)(4), and (m)(5)" and inserting "(m)(3), and (m)(4)", and

(D) in subsection (m), by striking paragraph (3) and by redesignating paragraphs (4) and (5) as paragraphs (3) and (4), respectively.

Effective dates. 42 USC 1395v note.

(3) The amendment made by paragraph (1) shall take effect on January 1, 1989, and the amendments made by paragraph (2) shall take effect on July 1, 1989.

Effective date.

(f) TECHNICAL AMENDMENT.—Effective as though included in the enactment of the Omnibus Budget Reconciliation Act of 1986, paragraph (2) of section 9403(g) of such Act is amended to read as follows:

"(2) PAYMENT OF MEDICARE COST-SHARING.—Section 1903(a)(1) (42 U.S.C. 1396b(a)(1)) is amended by inserting 'including expenditures for medicare cost-sharing and' before 'including expenditures'.".

42 USC 1396a note.

(g) TREATMENT OF CERTAIN STATES.—

(1) STATES OPERATING UNDER DEMONSTRATION PROJECTS.—In the case of any State which is providing medical assistance to its residents under a waiver granted under section 1115(a) of the Social Security Act, the Secretary of Health and Human Services shall require the State to meet the requirement of section 1902(a)(10)(E) of the Social Security Act in the same manner as the State would be required to meet such requirement if the State had in effect a plan approved under title XIX of such Act.

(2) COMMONWEALTHS AND TERRITORIES.—Section 1905(p) (42 U.S.C. 1396d(p)), as amended by subsection (d)(3), is further amended by adding at the end the following new paragraph:

"(5) Notwithstanding any other provision of this title, in the case of a State (other than the 50 States and the District of Columbia)—

"(A) the requirement stated in section 1902(a)(10)(E) shall be optional, and

"(B) for purposes of paragraph (2)(A), the State may substitute for the percent provided under clause (ii) of such paragraph any percent.".

42 USC 1396a note.

(h) EFFECTIVE DATE.—(1) The amendments made by this section apply (except as provided in subsections (e) and (f) and under paragraph (2)) to payments under title XIX of the Social Security Act for calendar quarters beginning on or after January 1, 1989, without regard to whether or not final regulations to carry out such amendments have been promulgated by such date, with respect to medical assistance for—

(A) monthly premiums under title XVIII of such Act for months beginning with January 1989, and

(B) items and services furnished on and after January 1, 1989.

State and local governments.

(2) In the case of a State plan for medical assistance under title XIX of the Social Security Act which the Secretary of Health and Human Services determines requires State legislation (other than legislation appropriating funds) in order for the plan to meet the additional requirements imposed by the amendments made by this section, the State plan shall not be regarded as failing to comply with the requirements of such title solely on the basis of its failure to meet these additional requirements before the first day of the first session of the State legislature that begins after the date of the enactment of this Act. For purposes of the previous sentence, in the case of a State that has a 2-year legislative session, each year of such session shall be deemed to be a separate regular session of the State legislature.

State and local governments.

SEC. 302. COVERAGE AND PAYMENT FOR PREGNANT WOMEN AND INFANTS WITH INCOMES BELOW POVERTY LINE.

(a) PREGNANT WOMEN AND INFANTS UNDER AGE 1.—

(1) REQUIRING COVERAGE.—Section 1902(a)(10) (42 U.S.C. 1396a(a)(10)) is amended—

(A) in subparagraph (A)(i), by striking "or" at the end of subclause (II), by striking the semicolon in subclause (III) and inserting ", or", and by adding at the end the following new subclause:

"(IV) who are described in subparagraph (A) or (B) of subsection (l)(1) and whose family income does not exceed the minimum income level the State is required to establish under subsection (l)(2)(A) for such a family;";

(B) by amending subclause (IX) of subparagraph (A)(ii) to read as follows:

"(IX) who are described in subsection (l)(1) and are not described in clause (i)(IV);"; and

(C) in clause (VII) in the matter after and below subparagraph (E), by inserting "(A)(i)(IV) or" before "(A)(ii)(IX)".

(2) DESCRIPTION OF INDIVIDUALS REQUIRED TO BE COVERED.—Section 1902(l) (42 U.S.C. 1396a(l)) is amended—

(A) in paragraph (1)(C)—

(i) by inserting "at the option of the State," after "(C)", and

(ii) by striking "and" after "1983,"; and

(B) in paragraph (2)(A)—

(i) by striking "not more than 185 percent)" and inserting "(not less than the percentage provided under clause (ii) and not more than 185 percent)";

(ii) by inserting "(i)" after "(2)(A)"; and

(iii) by adding at the end the following new clause:

"(ii) Subject to clause (iii), the percentage provided under this clause, with respect to eligibility for medical assistance on or after—

"(I) July 1, 1989, is 75 percent, and

"(II) July 1, 1990, is 100 percent.

"(iii) In the case of a State which, as of the date of the enactment of this clause, has elected to provide, and provides, medical assistance to individuals described in this subsection or has enacted legislation authorizing, or appropriating funds, to provide such assistance to such individuals before July 1, 1989, the percentage provided under clause (ii) shall not be less than—

"(I) the percentage specified by the State in an amendment to its State plan (whether approved or not) as of the date of the enactment of this clause, or

"(II) if no such percentage is specified as of the date of the enactment of this clause, the percentage established under the State's authorizing legislation or provided for under the State's appropriations;

but in no case shall this clause require the percentage provided under clause (ii) to exceed 100 percent.".

(b) COVERAGE OF MEDICALLY NECESSARY SERVICES FOR INFANTS AND ASSURING ADEQUATE PAYMENT FOR INPATIENT HOSPITAL SERVICES FOR INFANTS IN DISPROPORTIONATE SHARE HOSPITALS.—

(1) COVERAGE OF MEDICALLY NECESSARY SERVICES FOR INFANTS.—Section 1902(a)(10) (42 U.S.C. 1396a(a)(10)) is amended, in the matter after and below subparagraph (E)—

(A) by striking "and" before "(IX)", and

(B) by inserting before the semicolon at the end the following: ", and (X) if the plan provides for any fixed durational limit on medical assistance for inpatient hospital services (whether or not such a limit varies by medical condition or diagnosis), the plan must establish exceptions to such a limit for medically necessary inpatient hospital services furnished with respect to individuals under one year of age in a hospital defined under the State plan, pursuant to section 1923(a)(1)(A), as a disproportionate share hospital and subparagraph (B) (relating to comparability) shall not be construed as requiring such an exception for other individuals, services, or hospitals".

(2) ASSURING ADEQUATE PAYMENT FOR INPATIENT HOSPITAL SERVICES FOR INFANTS IN DISPROPORTIONATE SHARE HOSPITALS.—Section 1923(a)(2), as redesignated pursuant to the amendment made by section 411(k)(6)(B) of this Act, is amended by adding at the end the following new subparagraph:

42 USC 1396r-4.

"(C) If a State plan under this title provides for payments for inpatient hospital services on a prospective basis (whether per diem, per case, or otherwise), in order for the plan to be considered to have met such requirement of section 1902(a)(13)(A) as of July 1, 1989, the State must submit to the Secretary by not later than April 1, 1989, a State plan amendment that provides, in the case of hospitals defined by the State as disproportionate share hospitals under paragraph (1)(A), for an outlier adjustment in payment amounts for medically necessary inpatient hospital services provided on or after July 1, 1989, involving exceptionally high costs or exceptionally long lengths of stay for individuals under one year of age.".

(c) CERTAIN STATE PLAN REQUIREMENTS.—

(1) IN GENERAL.—Subsection (c) of section 1902 (42 U.S.C. 1396a) is amended to read as follows:

"(c) Notwithstanding subsection (b), the Secretary shall not approve any State plan for medical assistance if—

"(1) the State has in effect, under its plan established under part A of title IV, payment levels that are less than the payment levels in effect under such plan on May 1, 1988; or

"(2) the State requires individuals described in subsection (l)(1) to apply for benefits under such part as a condition of applying for, or receiving, medical assistance under this title.".

(2) ELIMINATING DUPLICATE REQUIREMENT.—Section 1902(l) (42 U.S.C. 1396a(l)) is amended by striking paragraph (4).

(3) MAINTENANCE OF EFFORT TO RECEIVE MEDICAL ASSISTANCE FOR OPTIONAL COVERAGE OF PREGNANT WOMEN AND CHILDREN.—Section 1903(i) (42 U.S.C. 1396b(i)) is amended—

(A) by striking the period at the end of paragraph (8) and inserting "; or", and

(B) by inserting after paragraph (8) the following new paragraph:

"(9) with respect to any amount of medical assistance for pregnant women and children described in section 1902(a)(10)(A)(ii)(IX), if the State has in effect, under its plan established under part A of title IV, payment levels that are less than the payment levels in effect under such plan on July 1, 1987.".

(d) TREATMENT OF CERTAIN STATES AND TERRITORIES.—Section 1902(l) (42 U.S.C. 1396a(l)) is amended by adding at the end the following new paragraph:

"(4)(A) In the case of any State which is providing medical assistance to its residents under a waiver granted under section 1115, the

Secretary shall require the State to provide medical assistance for pregnant women and infants under age 1 described in subsection (a)(10)(A)(i)(IV) in the same manner as the State would be required to provide such assistance for such individuals if the State had in effect a plan approved under this title.

"(B) In the case of a State which is not one of the 50 States or the District of Columbia, the State need not meet the requirement of subsection (a)(10)(A)(i)(IV) and, for purposes of paragraph (2)(A), the State may substitute for the percentage provided under clause (ii) of such paragraph any percentage.".

(e) CONFORMING AMENDMENTS.—

(1) Section 1902(e)(6) (42 U.S.C. 1396a(e)(6)) is amended to read as follows:

"(6) At the option of a State, in the case of a pregnant woman described in subsection (a)(10) who, because of a change in income of the family of which she is a member, would not otherwise continue to be described in such subsection, the State plan may nonetheless treat the woman as being an individual described in subsection (a)(10)(A)(i)(IV) and subsection (l)(1)(A) without regard to such change of income through the end of the month in which the 60-day period (beginning on the last day of her pregnancy) ends.".

(2) Section 1902(e)(7) (42 U.S.C. 1396a(e)(7)) is amended—

(A) by striking "If a State plan provides medical assistance for individuals under subsection (a)(10)(A)(ii)(IX), in" and inserting "In",

(B) by inserting "or paragraph (2) of section 1905(n)" after "subsection (l)(1)" the first place it appears, and

(C) by striking "subsection (a)(10)(A)(ii)(IX) and subsection (l)(1)" and inserting "such respective provision".

(3) Section 1902(l) (42 U.S.C. 1396a(l)) is amended—

(A) in the matter after and below subparagraph (C) of paragraph (1), by inserting "any of subclauses (I) through (III) of" after "who are not described in", and

(B) in paragraph (3), in the matter before subparagraph (A), by inserting "(a)(10)(A)(i)(IV) or" before "(a)(10)(A)(ii)(IX)".

(4) Section 1903(f)(4) (42 U.S.C. 1396b(f)(4)) is amended, in the matter before subparagraph (A), by inserting "1902(a)(10)(A)(i)(IV)," before "1902(a)(10)(A)(ii)(IX)".

(f) EFFECTIVE DATE.— 42 USC 1396a note.

(1) IN GENERAL.—The amendments made by this section apply (except as provided in this subsection) to payments under title XIX of the Social Security Act for calendar quarters beginning on or after July 1, 1989, with respect to eligibility for medical assistance on or after such date, without regard to whether or not final regulations to carry out such amendments have been promulgated by such date.

(2) PAYMENT ADJUSTMENT.—The amendments made by subsection (b)(2) shall take effect on the date of the enactment of this Act.

(3) DELAY FOR STATE LEGISLATION.—In the case of a State plan for medical assistance under title XIX of the Social Security Act which the Secretary of Health and Human Services determines requires State legislation (other than legislation appropriating funds) in order for the plan to meet the additional requirements imposed by the amendments made by this section (other than subsection (b)(2)), the State plan shall not be regarded as failing

to comply with the requirements of such title solely on the basis of its failure to meet these additional requirements before the first day of the first calendar quarter beginning after the close of the first regular session of the State legislature that begins after the date of the enactment of this Act. For purposes of the previous sentence, in the case of a State that has a regular legislative session of 2 years, each year of such session shall be deemed to be a separate regular session of the State legislature.

SEC. 303. PROTECTION OF INCOME AND RESOURCES OF COUPLE FOR MAINTENANCE OF COMMUNITY SPOUSE.

(a) IN GENERAL.—

(1) Title XIX, as amended by the amendment made by section 411(k)(6)(B) of this Act, is amended—

42 USC 1396s. (A) by redesignating section 1924 as section 1925, and

(B) by inserting after section 1923 the following new section:

"TREATMENT OF INCOME AND RESOURCES FOR CERTAIN INSTITUTIONALIZED SPOUSES

42 USC 1396r-5. "SEC. 1924. (a) SPECIAL TREATMENT FOR INSTITUTIONALIZED SPOUSES.—

"(1) SUPERSEDES OTHER PROVISIONS.—In determining the eligibility for medical assistance of an institutionalized spouse (as defined in subsection (h)(1)), the provisions of this section supersede any other provision of this title (including sections 1902(a)(17) and 1902(f)) which is inconsistent with them.

"(2) NO COMPARABLE TREATMENT REQUIRED.—Any different treatment provided under this section for institutionalized spouses shall not, by reason of paragraph (10) or (17) of section 1902(a), require such treatment for other individuals.

"(3) DOES NOT AFFECT CERTAIN DETERMINATIONS.—Except as this section specifically provides, this section does not apply to—

"(A) the determination of what constitutes income or resources, or

"(B) the methodology and standards for determining and evaluating income and resources.

"(4) APPLICATION IN CERTAIN STATES AND TERRITORIES.—

"(A) APPLICATION IN STATES OPERATING UNDER DEMONSTRATION PROJECTS.—In the case of any State which is providing medical assistance to its residents under a waiver granted under section 1115, the Secretary shall require the State to meet the requirements of this section in the same manner as the State would be required to meet such requirement if the State had in effect a plan approved under this title.

"(B) NO APPLICATION IN COMMONWEALTHS AND TERRITORIES.—This section shall only apply to a State that is one of the 50 States or the District of Columbia.

"(b) RULES FOR TREATMENT OF INCOME.—

"(1) SEPARATE TREATMENT OF INCOME.—During any month in which an institutionalized spouse is in the institution, except as provided in paragraph (2), no income of the community spouse shall be deemed available to the institutionalized spouse.

"(2) ATTRIBUTION OF INCOME.—In determining the income of an institutionalized spouse or community spouse, after the institutionalized spouse has been determined to be eligible for medical assistance, except as otherwise provided in this section and regardless of any State laws relating to community property or the division of marital property, the following rules apply:

"(A) NON-TRUST PROPERTY.—Subject to subparagraphs (C) and (D), in the case of income not from a trust, unless the instrument providing the income otherwise specifically provides—

"(i) if payment of income is made solely in the name of the institutionalized spouse or the community spouse, the income shall be considered available only to that respective spouse;

"(ii) if payment of income is made in the names of the institutionalized spouse and the community spouse, one-half of the income shall be considered available to each of them; and

"(iii) if payment of income is made in the names of the institutionalized spouse or the community spouse, or both, and to another person or persons, the income shall be considered available to each spouse in proportion to the spouse's interest (or, if payment is made with respect to both spouses and no such interest is specified, one-half of the joint interest shall be considered available to each spouse).

"(B) TRUST PROPERTY.—In the case of a trust—

"(i) except as provided in clause (ii), income shall be attributed in accordance with the provisions of this title (including sections 1902(a)(17) and 1902(k)), and

"(ii) income shall be considered available to each spouse as provided in the trust, or, in the absence of a specific provision in the trust—

"(I) if payment of income is made solely to the institutionalized spouse or the community spouse, the income shall be considered available only to that respective spouse;

"(II) if payment of income is made to both the institutionalized spouse and the community spouse, one-half of the income shall be considered available to each of them; and

"(III) if payment of income is made to the institutionalized spouse or the community spouse, or both, and to another person or persons, the income shall be considered available to each spouse in proportion to the spouse's interest (or, if payment is made with respect to both spouses and no such interest is specified, one-half of the joint interest shall be considered available to each spouse).

"(C) PROPERTY WITH NO INSTRUMENT.—In the case of income not from a trust in which there is no instrument establishing ownership, subject to subparagraph (D), one-half of the income shall be considered to be available to the institutionalized spouse and one-half to the community spouse.

"(D) REBUTTING OWNERSHIP.—The rules of subparagraphs (A) and (C) are superseded to the extent that an institutionalized spouse can establish, by a preponderance of the evidence, that the ownership interests in income are other than as provided under such subparagraphs.

"(c) RULES FOR TREATMENT OF RESOURCES.—

"(1) COMPUTATION OF SPOUSAL SHARE AT TIME OF INSTITUTIONALIZATION.—

"(A) TOTAL JOINT RESOURCES.—There shall be computed (as of the beginning of a continuous period of institutionalization of the institutionalized spouse)—

"(i) the total value of the resources to the extent either the institutionalized spouse or the community spouse has an ownership interest, and

"(ii) a spousal share which is equal to ½ of such total value.

State and local governments. Records.

"(B) ASSESSMENT.—At the request of an institutionalized spouse or community spouse, at the beginning of a continuous period of institutionalization of the institutionalized spouse and upon the receipt of relevant documentation of resources, the State shall promptly assess and document the total value described in subparagraph (A)(i) and shall provide a copy of such assessment and documentation to each spouse and shall retain a copy of the assessment for use under this section. If the request is not part of an application for medical assistance under this title, the State may, at its option as a condition of providing the assessment, require payment of a fee not exceeding the reasonable expenses of providing and documenting the assessment. At the time of providing the copy of the assessment, the State shall include a notice indicating that the spouse has right to a fair hearing under subsection (e)(2)(E) with respect to the determination of the community spouse resource allowance, to provide for an allowance adequate to raise the spouse's income to the minimum monthly maintenance needs allowance.

"(2) ATTRIBUTION OF RESOURCES AT TIME OF INITIAL ELIGIBILITY DETERMINATION.—In determining the resources of an institutionalized spouse at the time of application for benefits under this title, regardless of any State laws relating to community property or the division of marital property—

"(A) except as provided in subparagraph (B), all the resources held by either the institutionalized spouse, community spouse, or both, shall be considered to be available to the institutionalized spouse, and

"(B) resources shall not be considered to be available to an institutionalized spouse, to the extent that the amount of such resources does not exceed the amount computed under subsection (f)(2)(A) (as of the time of application for benefits).

"(3) ASSIGNMENT OF SUPPORT RIGHTS.—The institutionalized spouse shall not be ineligible by reason of resources determined under paragraph (2) to be available for the cost of care where—

"(A) the institutionalized spouse has assigned to the State any rights to support from the community spouse;

"(B) the institutionalized spouse lacks the ability to execute an assignment due to physical or mental impairment but the State has the right to bring a support proceeding against a community spouse without such assignment; or

"(C) the State determines that denial of eligibility would work an undue hardship.

"(4) SEPARATE TREATMENT OF RESOURCES AFTER ELIGIBILITY FOR BENEFITS ESTABLISHED.—During the continuous period in which an institutionalized spouse is in an institution and after the month in which an institutionalized spouse is determined to be eligible for benefits under this title, no resources of the community spouse shall be deemed available to the institutionalized spouse.

"(5) RESOURCES DEFINED.—In this section, the term 'resources' does not include—

"(A) resources excluded under subsection (a) or (d) of section 1613, and

"(B) resources that would be excluded under section 1613(a)(2)(A) but for the limitation on total value described in such section.

"(d) PROTECTING INCOME FOR COMMUNITY SPOUSE.—

"(1) ALLOWANCES TO BE OFFSET FROM INCOME OF INSTITUTIONALIZED SPOUSE.—After an institutionalized spouse is determined to be eligible for medical assistance, in determining the amount of the spouse's income that is to be applied monthly to payment for the costs of care in the institution, there shall be deducted from the spouse's monthly income the following amounts in the following order:

"(A) A personal needs allowance (described in section 1902(q)(1)), in an amount not less than the amount specified in section 1902(q)(2).

"(B) A community spouse monthly income allowance (as defined in paragraph (2)), but only to the extent income of the institutionalized spouse is made available to (or for the benefit of) the community spouse.

"(C) A family allowance, for each family member, equal to at least ⅓ of the amount by which the amount described in paragraph (3)(A)(i) exceeds the amount of the monthly income of that family member.

"(D) Amounts for incurred expenses for medical or remedial care for the institutionalized spouse (as provided under section 1902(r)).

In subparagraph (C), the term 'family member' only includes minor or dependent children, dependent parents, or dependent siblings of the institutionalized or community spouse who are residing with the community spouse.

"(2) COMMUNITY SPOUSE MONTHLY INCOME ALLOWANCE DEFINED.—In this section (except as provided in paragraph (5)), the 'community spouse monthly income allowance' for a community spouse is an amount by which—

"(A) except as provided in subsection (e), the minimum monthly maintenance needs allowance (established under and in accordance with paragraph (3)) for the spouse, exceeds

"(B) the amount of monthly income otherwise available to the community spouse (determined without regard to such an allowance).

"(3) ESTABLISHMENT OF MINIMUM MONTHLY MAINTENANCE NEEDS ALLOWANCE.—

"(A) IN GENERAL.—Each State shall establish a minimum monthly maintenance needs allowance for each community State and local governments.

spouse which, subject to subparagraph (C), is equal to or exceeds—

"(i) the applicable percent (described in subparagraph (B)) of 1/12 of the nonfarm income official poverty line (defined by the Office of Management and Budget and revised annually in accordance with sections 652 and 673(2) of the Omnibus Budget Reconciliation Act of 1981) for a family unit of 2 members; plus

"(ii) an excess shelter allowance (as defined in paragraph (4)).

A revision of the official poverty line referred to in clause (i) shall apply to medical assistance furnished during and after the second calendar quarter that begins after the date of publication of the revision.

"(B) APPLICABLE PERCENT.—For purposes of subparagraph (A)(i), the 'applicable percent' described in this paragraph, effective as of—

"(i) September 30, 1989, is 122 percent,

"(ii) July 1, 1991, is 133 percent, and

"(iii) July 1, 1992, is 150 percent.

"(C) CAP ON MINIMUM MONTHLY MAINTENANCE NEEDS ALLOWANCE.—The minimum monthly maintenance needs allowance established under subparagraph (A) may not exceed $1,500 (subject to adjustment under subsections (e) and (g)).

"(4) EXCESS SHELTER ALLOWANCE DEFINED.—In paragraph (3)(A)(ii), the term 'excess shelter allowance' means, for a community spouse, the amount by which the sum of—

"(A) the spouse's expenses for rent or mortgage payment (including principal and interest), taxes and insurance and, in the case of a condominium or cooperative, required maintenance charge, for the community spouse's principal residence, and

"(B) the standard utility allowance (used by the State under section 5(e) of the Food Stamp Act of 1977) or, if the State does not use such an allowance, the spouse's actual utility expenses,

exceeds 30 percent of the amount described in paragraph (3)(A)(i), except that, in the case of a condominium or cooperative, for which a maintenance charge is included under subparagraph (A), any allowance under subparagraph (C) shall be reduced to the extent the maintenance charge includes utility expenses.

"(5) COURT ORDERED SUPPORT.—If a court has entered an order against an institutionalized spouse for monthly income for the support of the community spouse, the community spouse monthly income allowance for the spouse shall be not less than the amount of the monthly income so ordered.

"(e) NOTICE AND FAIR HEARING.—

State and local governments.

"(1) NOTICE.—Upon—

"(A) a determination of eligibility for medical assistance of an institutionalized spouse, or

"(B) a request by either the institutionalized spouse, or the community spouse, or a representative acting on behalf of either spouse,

each State shall notify both spouses (in the case described in subparagraph (A)) or the spouse making the request (in the case described in subparagraph (B)) of the amount of the community spouse monthly income allowance (described in subsection (d)(1)(B)), of the amount of any family allowances (described in subsection (d)(1)(C)), of the method for computing the amount of the community spouse resources allowance permitted under subsection (f), and of the spouse's right to a fair hearing under this subsection respecting ownership or availability of income or resources, and the determination of the community spouse monthly income or resource allowance.

"(2) FAIR HEARING.—

"(A) IN GENERAL.—If either the institutionalized spouse or the community spouse is dissatisfied with a determination of—

"(i) the community spouse monthly income allowance;

"(ii) the amount of monthly income otherwise available to the community spouse (as applied under subsection (d)(2)(B));

"(iii) the computation of the spousal share of resources under subsection (c)(1);

"(iv) the attribution of resources under subsection (c)(2); or

"(v) the determination of the community spouse resource allowance (as defined in subsection (f)(2));

such spouse is entitled to a fair hearing described in section 1902(a)(3) with respect to such determination. Any such hearing respecting the determination of the community spouse resource allowance shall be held within 30 days of the date of the request for the hearing.

"(B) REVISION OF MINIMUM MONTHLY MAINTENANCE NEEDS ALLOWANCE.—If either such spouse establishes that the community spouse needs income, above the level otherwise provided by the minimum monthly maintenance needs allowance, due to exceptional circumstances resulting in significant financial duress, there shall be substituted, for the minimum monthly maintenance needs allowance in subsection (d)(2)(A), an amount adequate to provide such additional income as is necessary.

"(C) REVISION OF COMMUNITY SPOUSE RESOURCE ALLOWANCE.—If either such spouse establishes that the community spouse resource allowance (in relation to the amount of income generated by such an allowance) is inadequate to raise the community spouse's income to the minimum monthly maintenance needs allowance, there shall be substituted, for the community spouse resource allowance under subsection (f)(2), an amount adequate to provide such a minimum monthly maintenance needs allowance.

"(f) PERMITTING TRANSFER OF RESOURCES TO COMMUNITY SPOUSE.—

"(1) IN GENERAL.—An institutionalized spouse may, without regard to section 1917, transfer to the community spouse (or to another for the sole benefit of the community spouse) an amount equal to the community spouse resource allowance (as defined in paragraph (2)), but only to the extent the resources of the institutionalized spouse are transferred to (or for the sole benefit of) the community spouse. The transfer under the preceding sentence shall be made as soon as pacticable after the date of the initial determination of eligibility, taking into account such time as may be necessary to obtain a court order under paragraph (3).

"(2) COMMUNITY SPOUSE RESOURCE ALLOWANCE DEFINED.—In paragraph (1), the 'community spouse resource allowance' for a community spouse is an amount (if any) by which—

"(A) the greatest of—

"(i) $12,000 (subject to adjustment under subsection (g)), or, if greater (but not to exceed the amount specified in clause (ii)(II)) an amount specified under the State plan,

"(ii) the lesser of (I) the spousal share computed under subsection (c)(1), or (II) $60,000 (subject to adjustment under subsection (g)),

"(iii) the amount established under subsection (e)(2); or

"(iv) the amount transferred under a court order under paragraph (3);

exceeds

"(B) the amount of the resources otherwise available to the community spouse (determined without regard to such an allowance).

"(3) TRANSFERS UNDER COURT ORDERS.—If a court has entered an order against an institutionalized spouse for the support of the community spouse, section 1917 shall not apply to amounts of resources transferred pursuant to such order for the support of the spouse of a family member (as defined in subsection (d)(1)).

"(g) INDEXING DOLLAR AMOUNTS.—For services furnished during a calendar year after 1989, the dollar amounts specified in subsections (d)(3)(C), (f)(2)(A)(i), and (f)(2)(A)(ii)(II) shall be increased by the same percentage as the percentage increase in the consumer price index for all urban consumers (all items; U.S. city average) between September 1988 and the September before the calendar year involved.

"(h) DEFINITIONS.—In this section:

"(1) The term 'institutionalized spouse' means an individual who—

"(A) is in a medical institution or nursing facility or who (at the option of the State) is described in section 1902(a)(10)(A)(ii)(VI), and

"(B) is married to a spouse who is not in a medical institution or nursing facility;

but does not include any such individual who is not likely to meet the requirements of subparagraph (A) for at least 30 consecutive days.

"(2) The term 'community spouse' means the spouse of an institutionalized spouse.".

(2) Section 1919(c)(1)(B)(i) (42 U.S.C. 1396r(c)(1)(B)(i)) is amended by inserting "and of the requirements and procedures for establishing eligibility for medical assistance under this title, including the right to request an assessment under section 1924(c)(1)(B)" before the semicolon.

(b) TAKING INTO ACCOUNT CERTAIN TRANSFERS OF ASSETS.—Subsection (c) of section 1917 (42 U.S.C. 1396p) is amended to read as follows:

State and local governments.

"(c)(1) In order to meet the requirements of this subsection (for purposes of section 1902(a)(51)(B)), the State plan must provide for a period of ineligibility in the case of an institutionalized individual (as defined in paragraph (3)) who, at any time during the 30-month period immediately before the individual's application for medical assistance under the State plan, disposed of resources for less than fair market value. The period of ineligibility shall begin with the month in which such resources were transferred and the number of months in such period shall be equal to the lesser of—

"(A) 30 months, or

"(B)(i) the total uncompensated value of the resources so transferred, divided by (ii) the average cost, to a private patient at the time of the application, of nursing facility services in the State or, at State option, in the community in which the individual is institutionalized.

"(2) An individual shall not be ineligible for medical assistance by reason of paragraph (1) to the extent that—

"(A) the resources transferred were a home and title to the home was transferred to— Real property.

"(i) the spouse of such individual;

"(ii) a child of such individual who is under age 21, or (with respect to States eligible to participate in the State program established under title XVI) is blind or permanently and totally disabled, or (with respect to States which are not eligible to participate in such program) is blind or disabled as defined in section 1614; Children and youth. Blind persons. Handicapped persons.

"(iii) a sibling of such individual who has an equity interest in such home and who was residing in such individual's home for a period of at least one year immediately before the date of the individual's admission to the medical institution or nursing facility; or

"(iv) a son or daughter of such individual (other than a child described in clause (ii)) who was residing in such individual's home for a period of at least two years immediately before the date of such individual's admission to the medical institution or nursing facility, and who (as determined by the State) provided care to such individual which permitted such individual to reside at home rather than in such an institution or facility;

"(B) the resources were transferred to (or to another for the sole benefit of) the community spouse, as defined in section 1924(h)(2), or the individual's child who is blind or permanently and totally disabled; Children and youth. Blind persons. Handicapped persons.

"(C) a satisfactory showing is made to the State (in accordance with any regulations promulgated by the Secretary) that (i) the individual intended to dispose of the resources either at fair market value, or for other valuable consideration, or (ii) the resources were transferred exclusively for a purpose other than to qualify for medical assistance; or

"(D) the State determines that denial of eligibility would work an undue hardship.

"(3) In this subsection, the term 'institutionalized individual' means an individual who is an inpatient in a medical institution or nursing facility.

"(4) A State (including a State which has elected treatment under section 1902(f)) may not provide for any period of ineligibility for an individual due to transfer of resources for less than fair market value except in accordance with this subsection.".

(c) New SSI Policy Regarding Disposal of Resources for Less Than Fair Market Value.—

(1) Elimination of SSI penalty; notification of medicaid policy limiting eligibility of institutionalized individuals for benefits based on such disposal of resources.—Subsection (c) of section 1613 (42 U.S.C. 1382b) is amended to read as follows:

"Notification of Medicaid Policy Restricting Eligibility of Institutionalized Individuals for Benefits Based on Disposal of Resources for Less Than Fair Market Value

"(c)(1) At the time an individual (and the individual's eligible spouse, if any) applies for benefits under this title, and at the time the eligibility of an individual (and such spouse, if any) for such benefits is redetermined, the Secretary shall—

"(A) inform such individual of the provisions of section 1917(c) providing for a period of ineligibility for benefits under title XIX for individuals who make certain dispositions of resources for less than fair market value, and inform such individual that information obtained pursuant to subparagraph (B) will be made available to the State agency administering a State plan under title XIX (as provided in paragraph (2)); and

"(B) obtain from such individual information which may be used by the State agency in determining whether or not a period of ineligibility for such benefits would be required by reason of section 1917(c) if such individual (or such spouse, if any) enters a medical institution or nursing facility.

State and local governments.

"(2) The Secretary shall make the information obtained under paragraph (1)(B) available, on request, to any State agency administering a State plan approved under title XIX.".

(2) Conforming amendment.—Subparagraph (B) of section 1611(e)(1) (42 U.S.C. 1382(e)(1)) is amended by adding after and below clause (iii) the following new sentence:

"For purposes of this subsection, a hospital, extended care facility, nursing home, or intermediate care facility which is a 'medical institution or nursing facility' within the meaning of section 1917(c) shall be considered to be receiving payments with respect to an individual under a State plan approved under title XIX during any period of ineligibility of such individual provided for under the State plan pursuant to section 1917(c).".

(d) Disregarding Payments for Certain Medical Expenses by Institutionalized Individuals.—Section 1902 (42 U.S.C. 1396), as amended by the amendment made by section 411(n)(3) of this Act, is amended by adding at the end the following new subsection:

42 USC 1396a

"(r) For purposes of sections 1902(a)(17) and 1924(d)(1)(D) and for purposes of a waiver under section 1915, with respect to the post-eligibility treatment of income of individuals who are institutionalized or receiving home or community-based services under such a waiver, there shall be taken into account amounts for incurred expenses for medical or remedial care that are not subject to payment by a third party, including—

"(A) medicare and other health insurance premiums, deductibles, or coinsurance, and

"(B) necessary medical or remedial care recognized under State law but not covered under the State plan under this title, subject to reasonable limits the State may establish on the amount of these expenses.".

(e) CONFORMING AMENDMENT.—Section 1902 (42 U.S.C. 1396a), as amended by the amendment made by section 411(n)(3) of this Act, is amended—

(1) in subsection (a)(10)(C)(i)(III), by striking "the same" each place it appears and inserting "no more restrictive than the";

(2) by striking "and" at the end of subsection (a)(49);

(3) by striking the period at the end of subsection (a)(50) and inserting "; and";

(4) by inserting after paragraph (50) of subsection (a) the following new paragraph:

"(51)(A) meet the requirements of section 1924 (relating to protection of community spouses), and (B) meet the requirement of section 1917(c) (relating to transfer of assets)."; and

(5) in subsection (r), as added by subsection (d)—

(A) by redesignating subparagraphs (A) and (B) as clauses (i) and (ii), respectively,

(B) by inserting "(1)" after "(r)", and

(C) by adding at the end the following new paragraph:

"(2)(A) The methodology to be employed in determining income and resource eligibility for individuals under subsection (a)(10)(A)(i)(III), (a)(10)(A)(i)(IV), (a)(10)(A)(ii), (a)(10)(C)(i)(III), or under subsection (f) may be less restrictive, and shall be no more restrictive, than the methodology—

"(i) in the case of groups consisting of aged, blind, or disabled individuals, under the supplemental security income program under title XVI, or

Blind persons. Handicapped persons.

"(ii) in the case of other groups, under the State plan most closely categorically related.

"(B) For purposes of this subsection and subsection (a)(10), methodology is considered to be 'no more restrictive' if, using the methodology, additional individuals may be eligible for medical assistance and no individuals who are otherwise eligible are made ineligible for such assistance.".

(f) TREATMENT OF HOMESTEAD EXEMPTION IN MISSOURI.—The State medical assistance plan of Missouri shall not be in compliance with the requirements of title XIX of the Social Security Act as of October 1, 1989, unless such plan is amended to provide that, in determining the resources of any aged, blind, or disabled individual in the State who applies for medical assistance under such plan on or after such date, the State will not consider the home of the individual as a resource, regardless of the value of the home.

Blind persons. Handicapped persons.

(g) EFFECTIVE DATE.—

42 USC 1396r-5 note.

(1)(A) The amendments made by this section apply (except as provided in this subsection) to payments under title XIX of the Social Security Act for calendar quarters beginning on or after September 30, 1989, without regard to whether or not final regulations to carry out such amendments have been promulgated by such date.

(B) Section 1924 of the Social Security Act (as inserted by subsection (a)) shall only apply to institutionalized individuals who begin continuous periods of institutionalization on or after September 30, 1989, except that subsections (b) and (d) of such section (and so much of subsection (e) of such section as relates to such other subsections) shall apply as of such date to individuals institutionalized on or after such date.

(2)(A) The amendment made by subsection (b) and section 1902(a)(51)(B) of the Social Security Act, apply (except as provided in paragraph (5)) to payments under title XIX of the Social Security Act for calendar quarters beginning on or after July 1, 1988, or the date of the enactment of this Act, without regard to whether or not final regulations to carry out such amendments have been promulgated by such date.

(B) Section 1917(c) of the Social Security Act, as amended by subsection (b) of this section, shall apply to resources disposed of on or after July 1, 1988.

State and local governments.

(C) Notwithstanding subparagraphs (A) and (B), a State may continue to apply the policies contained in the State plan as of June 30, 1988, with respect to resources disposed of before July 1, 1988.

(3) The amendments made by subsection (c) shall apply to transfers occurring on or after July 1, 1988, without regard to whether or not final regulations to carry out such amendments have been promulgated by such date.

(4) The amendment made by subsection (d) is effective on and after April 8, 1988. The final rule of the Health Care Financing Administration published on February 8, 1988 (53 Federal Register 3586) is superseded to the extent inconsistent with the amendment made by subsection (d).

State and local governments.

(5) In the case of a State plan for medical assistance under title XIX of the Social Security Act which the Secretary of Health and Human Services determines requires State legislation (other than legislation appropriating funds) in order for the plan to meet the additional requirements imposed by the amendments made by this section (other than subsection (e)), the State plan shall not be regarded as failing to comply with the requirements of such title solely on the basis of its failure to meet these additional requirements before the first day of the first calendar quarter beginning after the close of the first regular session of the State legislature that begins after the date of the enactment of this Act. For purposes of the previous sentence, in the case of a State that has a 2-year legislative session, each year of such session shall be deemed to be a separate regular session of the State legislature.

(6) The amendments made by paragraphs (1) and (5) of subsection (e) shall apply to medical assistance furnished on or after October 1, 1982.

TITLE IV—UNITED STATES BIPARTISAN COMMISSION ON COMPREHENSIVE HEALTH CARE, OBRA TECHNICAL CORRECTIONS, AND MISCELLANEOUS PROVISIONS

Subtitle A—United States Bipartisan Commission on Comprehensive Health Care

SEC. 401. ESTABLISHMENT.

42 USC 1395b note.

There is established a commission to be known as the United States Bipartisan Commission on Comprehensive Health Care (in this title referred to as the "Commission").

SEC. 402. DUTIES.

42 USC 1395b note.

(a) IN GENERAL.—The Commission shall—

(1) examine shortcomings in the current health care delivery and financing mechanisms that limit or prevent access of all individuals in the United States to comprehensive health care, and

(2) make specific recommendations to the Congress respecting Federal programs, policies, and financing needed to assure the availability of—

(A) comprehensive long-term care services for the elderly and disabled,

(B) comprehensive health care services for the elderly and disabled, and

(C) comprehensive health care services for all individuals in the United States.

(b) CONSIDERATIONS IN RECOMMENDATIONS.—In making its recommendations, the Commission shall consider—

(1) the amount and sources (consistent with principles of social insurance) of Federal funds to finance the needed services, including reallocations of existing Federal program funds, and

(2) the most efficient and effective manner of administering such programs.

(c) DEFINITIONS.—In this title:

(1) The term "comprehensive health care services" includes—

(A) inpatient hospital services (including mental health services);

(B) skilled nursing facility services, intermediate care facility services, home health services, and other long-term health care services;

(C) physician services and other outpatient health care services (including mental health services);

(D) periodic general physical examinations, eye examinations, hearing examinations, dental examinations, foot examinations, and other preventive health care services; and

(E) prescription drugs, eyeglasses, hearing aids, orthopedic equipment, and dentures (both complete and partial).

(2) The term "comprehensive long-term care services" includes custodial and noncustodial services in facilities, as well as home and community-based services.

42 USC 1395b note.

SEC. 403. MEMBERSHIP.

(a) APPOINTMENT.—The Commission shall be composed of 15 members appointed as follows:

President of U.S.

(1) The President shall appoint 3 members.

(2) The President pro tempore of the Senate shall appoint, after consultation with the minority leader of the Senate, 6 members of the Senate, of whom not more than 4 may be of the same political party.

(3) The Speaker of the House of Representatives shall appoint, after consultation with the minority leader of the House of Representatives, 6 members of the House, of whom not more than 4 may be of the same political party.

(b) CHAIRMAN AND VICE CHAIRMAN.—The Commission shall elect a chairman and vice chairman from among its members.

(c) VACANCIES.—Any vacancy in the membership of the Commission shall be filled in the manner in which the original appointment was made and shall not affect the power of the remaining members to execute the duties of the Commission.

(d) QUORUM.—A quorum shall consist of 8 members of the Commission, except that 4 members may conduct a hearing under section 405(a).

(e) MEETINGS.—The Commission shall meet at the call of its chairman or a majority of its members.

(f) COMPENSATION AND REIMBURSEMENT OF EXPENSES.—Members of the Commission are not entitled to receive compensation for service on the Commission. Members may be reimbursed for travel, subsistence, and other necessary expenses incurred in carrying out the duties of the Commission.

42 USC 1395b note.

SEC. 404. STAFF AND CONSULTANTS.

(a) STAFF.—The Commission may appoint and determine the compensation of such staff as may be necessary to carry out the duties of the Commission. Such appointments and compensation may be made without regard to the provisions of title 5, United States Code, that govern appointments in the competitive services, and the provisions of chapter 51 and subchapter III of chapter 53 of such title that relate to classifications and the General Schedule pay rates.

(b) CONSULTANTS.—The Commission may procure such temporary and intermittent services of consultants under section 3109(b) of title 5, United States Code, as the Commission determines to be necessary to carry out the duties of the Commission.

42 USC 1395b note.

SEC. 405. POWERS.

(a) HEARINGS AND OTHER ACTIVITIES.—For the purpose of carrying out its duties, the Commission may hold such hearings and undertake such other activities as the Commission determines to be necessary to carry out its duties.

(b) STUDIES BY GENERAL ACCOUNTING OFFICE.—Upon the request of the Commission, the Comptroller General shall conduct such studies or investigations as the Commission determines to be necessary to carry out its duties.

(c) COST ESTIMATES BY CONGRESSIONAL BUDGET OFFICE.—

(1) Upon the request of the Commission, the Director of the Congressional Budget Office shall provide to the Commission such cost estimates as the Commission determines to be necessary to carry out its duties.

(2) The Commission shall reimburse the Director of the Congressional Budget Office for expenses relating to the employment in the office of the Director of such additional staff as may be necessary for the Director to comply with requests by the Commission under paragraph (1).

(d) DETAIL OF FEDERAL EMPLOYEES.—Upon the request of the Commission, the head of any Federal agency is authorized to detail, without reimbursement, any of the personnel of such agency to the Commission to assist the Commission in carrying out its duties. Any such detail shall not interrupt or otherwise affect the civil service status or privileges of the Federal employee.

(e) TECHNICAL ASSISTANCE.—Upon the request of the Commission, the head of a Federal agency shall provide such technical assistance to the Commission as the Commission determines to be necessary to carry out its duties.

(f) USE OF MAILS.—The Commission may use the United States mails in the same manner and under the same conditions as Federal agencies.

(g) OBTAINING INFORMATION.—The Commission may secure directly from any Federal agency information necessary to enable it to carry out its duties, if the information may be disclosed under section 552 of title 5, United States Code. Upon request of the Chairman of the Commission, the head of such agency shall furnish such information to the Commission.

(h) ADMINISTRATIVE SUPPORT SERVICES.—Upon the request of the Commission, the Administrator of General Services shall provide to the Commission on a reimbursable basis such administrative support services as the Commission may request.

(i) ACCEPTANCE OF DONATIONS.—The Commission may accept, use, and dispose of gifts or donations of services or property.

SEC. 406. REPORT.

42 USC 1395b note.

(a) REPORT ON COMPREHENSIVE LONG-TERM CARE SERVICES FOR THE ELDERLY AND DISABLED.—The Commission shall submit to Congress a report, not later than 6 months after the date of the enactment of this Act, containing its findings and recommendations regarding comprehensive long-term care services for the elderly and disabled. The report shall include detailed recommendations for appropriate legislative initiatives respecting such services.

(b) REPORT ON COMPREHENSIVE HEALTH CARE SERVICES.—The Commission shall submit to Congress a report, not later than 1 year after the date of the enactment of this Act, containing its findings and recommendations regarding comprehensive health care services for the elderly and disabled and comprehensive health care services for all individuals in the United States. The report shall include detailed recommendations for appropriate legislative initiatives respecting such services.

SEC. 407. TERMINATION.

42 USC 1395b note.

The Commission shall terminate 30 days after the date of submission of the report required in section 406(b).

42 USC 1395b note.

SEC. 408. AUTHORIZATION OF APPROPRIATIONS.

There are authorized to be appropriated $1,500,000 to carry out this title.

Subtitle B—OBRA Technical Corrections

SEC. 411. TECHNICAL CORRECTIONS TO CERTAIN HEALTH CARE PROVISIONS IN THE OMNIBUS BUDGET RECONCILIATION ACT OF 1987.

1 USC 106 note.

(a) REFERENCE TO OBRA AND EFFECTIVE DATES.—

(1) REFERENCE.—In this section, the term "OBRA" refers to the Omnibus Budget Reconciliation Act of 1987 (Public Law 100-203).

(2) EFFECTIVE DATE.—Except as specifically provided in this section, the amendments made by this section, as they relate to a provision in OBRA, shall be effective as if they were included in the enactment of that provision in OBRA.

(3) RATIFICATION OF ENROLLMENT CORRECTIONS AND PRINTED ENROLLMENT.—

(A) IN GENERAL.—Except as provided in subparagraph (B), the enrollment corrections noted in footnotes numbered 9 through 72 of OBRA are hereby ratified and shall be considered to have been enacted as part of OBRA. The printed enrollment of title IV of OBRA, as prepared and printed under section 8004 of OBRA (including the footnote corrections described in subparagraph (B) and as incorporating the clarifications described in subparagraph (C)), shall be deemed to constitute title IV of OBRA as enacted.

42 USC 1320a-7b.

(B) FOOTNOTE CORRECTIONS.—(i) With respect to the reference to which footnote 28 relates (101 Stat. 1330-81), the reference shall be deemed to have read "1320a-7b)".

42 USC 1395m.

(ii) With respect to the word to which footnote 30 relates (101 Stat. 1330-91), the word shall be deemed to have read "the".

42 USC 1396b.

(iii) With respect to the designation to which footnote 52 relates (101 Stat. 1330-151), the designation shall be deemed to have read "(F)".

42 USC 1395u.

(C) CLARIFICATIONS OF ILLEGIBLE MATTER.—(i) Section 1842(n)(1)(A) of the Social Security Act, as added by section 4051(a) of OBRA (101 Stat. 1330-93), is deemed to have the phrase "the supplier's reasonable charge to individuals enrolled under this part for the test" immediately after "or, if lower, the".

42 USC 1395m.

(ii) Section 1834(a)(7)(B)(i) of the Social Security Act, as inserted by section 4062(b) of OBRA (101 Stat. 1330-103), is deemed to have a reference to "1987" immediately after "December".

(b) CORRECTIONS RELATING TO PART 1 OF SUBTITLE A OF TITLE IV (PART A OF THE MEDICARE PROGRAM).—

42 USC 1395ww.

(1) SECTION 4002.—(A) Subclauses (III) and (IV) of section 1886(b)(3)(B)(i) of the Social Security Act, as amended by section 4002(a) of OBRA, are amended by striking "other hospitals" and inserting "for hospitals located in other urban areas".

(B) Section 1886(b)(3)(B)(i)(IV) of the Social Security Act, as amended by section 4002(a) of OBRA, is amended by striking "percent" each place it appears and inserting "percentage points".

(C) Section 1886(b)(3)(B)(i)(V) of the Social Security Act, as amended by section 4002(a) of OBRA, is amended by inserting "increase" after "market basket percentage". 42 USC 1395ww.

(D) The second sentence of section 1886(d)(2)(D) of the Social Security Act, as amended by section 4002(b) of OBRA, is amended by striking "the publication described in subsection (e)(5)(B)" and inserting "the publications described in subsection (e)(5)".

(E) Section 4002(c)(1)(B)(iii) of OBRA is amended, in the matter stricken, by striking the comma after "available". 42 USC 1395ww.

(F) Section 1886(d)(3)(A)(ii) of the Social Security Act, as amended by section 4002(c)(1)(C) of OBRA, is amended by striking "in urban areas" and inserting "in other urban areas". Urban areas.

(G) Section 1886(d)(1)(A)(iii) of the Social Security Act, as amended by section 4002(d) of OBRA, is amended by striking "if greater" and inserting "if the average standardized amount (described in clause (i)(I) or clause (ii)(I) of paragraph (3)(D)) for hospitals within the region of, and in the same rural, large urban, or other urban area as, the hospital is greater than the average standardized amount (described in the respective clause) for hospitals within the United States in that type of area". Urban areas. Rural areas.

(H)(i) Section 1886(d)(2)(D) of the Social Security Act is amended by striking the last sentence (added by section 4002(f)(1)(A) of OBRA).

(ii) Section 4002(f) of OBRA is amended by adding at the end the following new paragraph:

"(3) The second sentence of section 1813(b)(1) of the Social Security Act (42 U.S.C. 1395e(b)(1)) is amended by striking 'applicable percentage increase' and all that follows through 'is applied' and inserting 'Secretary's best estimate of the payment-weighted average of the applicable percentage increases (as defined in section 1886(b)(3)(B)) which are applied'.".

(iii) The amendment made by clause (ii) shall apply to the inpatient hospital deductible for years beginning with 1989. Effective date. 42 USC 1395e note.

(I) Section 4002(g) of OBRA is amended— 42 USC 1395ww note.

(i) in paragraph (1)(A), by striking "1886(a)(1)(A)(iii)" and inserting "1886(d)(1)(A)(iii)",

(ii) in paragraphs (1)(B) and (2)(B), by striking "1886(d)(3)(B)" and inserting "1886(b)(3)(B)", and

(iii) in paragraph (6), by striking "1886(d)(10)(B)" and inserting "1886(d)(1)(B)".

(2) SECTION 4003.—Section 4003(d) of OBRA is amended— 101 Stat. 1330-46.

(A) in paragraph (2)—

(i) by inserting "(other than under section 1886(d)(5)(F) of such Act)" after "receives payments", and

(ii) by inserting "of such services" after "reasonable costs"; and

(B) in the matter following paragraph (2), by inserting "the" after "facilities of".

(3) SECTION 4004.—Section 4004(a) of OBRA is amended by inserting "(1)" after "SURVEY.—" and by adding at the end the following new paragraph: 42 USC 1395ww.

"(2) Section 1886(d)(9)(C)(iv) of such Act is amended by adding at the end the following new sentence: 'The second and third sentences Puerto Rico.

of paragraph (3)(E) shall apply to subsection (d) Puerto Rico hospitals under this clause in the same manner as they apply to subsection (d) hospitals under such paragraph and, for purposes of this clause, any reference in such paragraph to a subsection (d) hospital is deemed a reference to a subsection (d) Puerto Rico hospital.'.".

(4) SECTION 4005.—(A) Section 1886(d)(8)(B) of the Social Security Act, as added by section 4005(a)(1)(D) of OBRA, is amended— 42 USC 1395ww.

(i) by striking "The Secretary" and inserting "For purposes of this subsection, the Secretary", and

(ii) by striking all that follows "if" and inserting the following: "the rural county would otherwise be considered part of an urban area, under the standards for designating Metropolitan Statistical Areas (and for designating New England County Metropolitan Areas) published in the Federal Register on January 3, 1980, if the commuting rates used in determining outlying counties (or, for New England, similar recognized areas) were determined on the basis of the aggregate number of resident workers who commute to (and, if applicable under the standards, from) the central county or counties of all contiguous Metropolitan Statistical Areas (or New England County Metropolitan Areas).". Rural areas.

(B) Section 1886(d)(8)(C) of the Social Security Act, as added by section 4005(a)(1)(D) of OBRA, is amended by striking "standardized amount" and inserting "standardized amounts".

101 Stat. 1330-47. (C) Section 4005(a) of OBRA is amended—

(i) in paragraph (1)(D), by striking "subparagraph" and inserting "subparagraphs", and

42 USC 1395ww note. (ii) in paragraph (3), by striking "This section, and the amendments made by paragraph (1)," and inserting "This subsection".

(D) Section 1883(d)(3) of the Social Security Act, as added by section 4005(b)(2)(B) of OBRA, is amended by inserting before the period at the end the following: ", except that such payment shall continue to be made in the period for those patients who are receiving extended care services at the time the hospital reaches the limit specified in this paragraph". 42 USC 1395tt.

(5) SECTION 4006.—(A) Section 1886(g)(3)(A)(iv) of the Social Security Act, as amended by section 4006(a) of OBRA, is amended by inserting "for payments attributable" after "15 percent".

42 USC 1395ww. (B) Section 4006(a) of OBRA is amended—

(i) by adding "and" at the end of subparagraph (A), and

(ii) by redesignating subparagraphs (A) and (B) as paragraphs (1) and (2), respectively.

42 USC 1395ww note. (6) SECTION 4007.—Section 4007 of OBRA is amended—

(A) in the second sentence of subsection (a), by striking "updata" and inserting "updated";

(B) by amending subsection (b) to read as follows:

"(b) REQUIRING REPORTING OF STANDARDIZED COST REPORT ELECTRONICALLY.—

"(1) IN GENERAL.—Section 1886(f)(1) of the Social Security Act (42 U.S.C. 1395ww(f)(1)) is amended—

"(A) by striking ', for a period ending not earlier than September 30, 1988,',

"(B) by inserting '(A)' after '(f)(1)', and

"(C) by adding at the end the following new subparagraph:

" '(B)(i) Subject to clause (ii), the Secretary shall place into effect a standardized electronic cost reporting format for hospitals under this title.

" '(ii) The Secretary may delay or waive the implementation of such format in particular instances where such implementation would result in financial hardship (in particular with respect to hospitals with a small percentage of inpatients entitled to benefits under this title).'.

"(2) EFFECTIVE DATE.—The amendment made by paragraph (1)(C) shall apply to hospital cost reporting periods beginning on or after October 1, 1989."; and 42 USC 1395ww note.

(C) in subsection (c)— 42 USC 1395ww note.

(i) in paragraph (1)—

(I) by striking "3-year", and

(II) by striking "contracting" and inserting "conducting";

(ii) in paragraph (2), by striking "by category of service and" in subparagraphs (A) and (B);

(iii) in paragraph (2)(C), by striking "(by category of service)";

(iv) in paragraph (2), by striking subparagraph (D) and redesignating subparagraphs (E) through (L) as subparagraphs (D) through (K), respectively;

(v) by amending subparagraph (I), as so redesignated, to read as follows:

"(I) Bad debt and charity care.";

(vi) in paragraph (2), by adding at the end the following:

"The Secretary shall develop a definition of 'outpatient visit' for purposes of reporting hospital information.";

(vii) in paragraph (5), by striking "paragraph (3)" and inserting "paragraph (2)";

(viii) in paragraph (5)(A), by striking "The terms" and all that follows through "as" and inserting "The term 'bad debt and charity care' has such meaning as";

(ix) in paragraph (5)(B)—

(I) by inserting "at least" after "to payors",

(II) by striking "title VIII" and inserting "title XVIII", and

(III) by striking "self-paying individuals" and inserting "and other persons (including self-paying individuals)"; and

(x) in paragraph (6)—

(I) by striking "$1,000,000 for each of" and inserting "a total of $3,000,000 for",

(II) by inserting "or from operation funds" after "research funds",

(III) by striking ", and at least" and all that follows through "operations funds" and inserting "and", and

(IV) by striking "over 3 years".

(7) SECTION 4008.—Section 4008(d)(1)(B) of OBRA is amended by striking "1886" and inserting "1886(d)". 42 USC 1395ww note.

(8) SECTION 4009.—(A) Section 4009(a) of OBRA is amended— 42 USC 1395dd.

(i) by striking paragraphs (1) and (2) and inserting the following:

"(1) INCREASE IN CIVIL MONETARY PENALTY AND EXCLUSION OF RESPONSIBLE PHYSICIAN VIOLATORS.—Section 1867(d)(2) of the Social Security Act (42 U.S.C. 1395dd(d)(2)) is amended—

"(A) in the second sentence—

"(i) by redesignating such sentence as subparagraph (C),

"(ii) by striking 'previous sentence' and inserting 'this paragraph', and

"(iii) by redesignating subparagraphs (A) and (B) as clauses (i) and (ii), respectively; and

"(B) by striking the first sentence and inserting the following: '(A) A participating hospital that knowingly violates a requirement of this section is subject to a civil money penalty of not more than $50,000 for each such violation. The provisions of section 1128A (other than subsections (a) and (b)) shall apply to a civil money penalty under this subparagraph in the same manner as such provisions apply with respect to a penalty or proceeding under section 1128A(a).

"'(B) The responsible physician in a participating hospital with respect to the hospital's violation of a requirement of this subsection is subject to the sanctions described in section 1842(j)(2), except that, for purposes of this subparagraph, the civil money penalty with respect to each violation may not exceed $50,000, rather than $2,000.'"; and

42 USC 1395dd note. (ii) by redesignating paragraph (3) as paragraph (2).

42 USC 1395ww. (B) Section 4009(d)(1)(A) of OBRA is amended, in the matter inserted by such section, by striking the comma after "representatives".

42 USC 1395ww note. (C) Section 4009(i) of OBRA is amended by striking "New England county metropolitan areas" and "4001(b)" and inserting "urban areas in New England" and "4002(b)", respectively.

(D) Section 4009(j) of OBRA is amended by adding at the end the following new paragraphs:

"(9) Section 1818(c) of the Social Security Act (42 U.S.C. 1395i-2(c)) is amended by striking paragraph (4) and redesignating paragraphs (5) through (7) as paragraphs (4) through (6), respectively.

100 Stat. 1988. "(10) Section 9305(d) of the Omnibus Budget Reconciliation Act of 1986 is amended by striking '2 years after the date of the enactment of this Act' and inserting 'January 1, 1990'.".

(c) CORRECTIONS RELATING TO SUBPART A OF PART 2 OF SUBTITLE A OF TITLE IV (HEALTH MAINTENANCE ORGANIZATION REFORMS).—

42 USC 1395mm. (1) SECTION 4011.—Subparagraph (F) of section 1876(c)(3) of the Social Security Act, as added by the amendment made by section 4011(a)(1) of OBRA, is amended by moving its indentation 4 ems to the left so its left margin is aligned with the left margin of subparagraph (G) of that section, as added by section 4011(b)(1) of OBRA.

Contracts. 42 USC 1395cc. (2) SECTION 4012.—(A)(i) Section 1866(a)(1)(O) of the Social Security Act, as inserted by section 4012(a) of OBRA, is amended by striking "with a risk-sharing contract under section 1876" and inserting "(i) with a risk-sharing contract under section 1876, under section 1876(i)(2)(A) (as in effect before

February 1, 1985), under section 402(a) of the Social Security Amendments of 1967, or under section 222(a) of the Social Security Amendments of 1972, and (ii) which does not have a contract establishing payment amounts for services furnished to members of the organization".

(ii) The amendment made by clause (i) shall apply to admissions occurring on or after the first day of the fourth month beginning after the date of the enactment of this Act. Effective date. 42 USC 1395cc note.

(B) Section 4012(c) of OBRA is amended by striking "paragraph (2)" and inserting "subsection (a)". 42 USC 1395mm note.

(3) SECTION 4013.—Section 4013 of OBRA is amended by striking "(a) IN GENERAL" and all that follows through the end and inserting the following: 42 USC 1395mm.

"Section 2350(b)(3) of the Deficit Reduction Act of 1984 is amended by striking 'four years after the date of the enactment of this Act' and inserting 'September 30, 1990'.". 42 USC 1395mm note.

(4) SECTION 4014.—Section 1876(i)(6) of the Social Security Act, as amended by section 4014 of OBRA, is amended— 42 USC 1395mm.

(A) in subparagraph (A), by inserting ", in addition to any other remedies authorized by law," after "the Secretary may provide", and

(B) in the last sentence of subparagraph (B), by striking "under that section" and inserting "or proceeding under section 1128A(a)".

(5) SECTION 4018.—Section 1876(f)(3)(A) of the Social Security Act, as inserted by section 4018(a) of OBRA, is amended—

(A) by inserting "enrollment and residency requirements under this section and for" after "for purposes of", and

(B) by striking "of the subdivision" and inserting "described in subparagraph (B)(iii) who receive services through the subdivision".

(d) CORRECTIONS RELATING TO SUBPART B OF PART 2 OF SUBTITLE A OF TITLE IV (HOME HEALTH QUALITY).—

(1) SECTION 4021.—(A) Section 1891(a) of the Social Security Act, as added by section 4021(b) of OBRA, is amended— 42 USC 1395bbb.

(i) in paragraph (3)(A), by striking "who is not a licensed health care professional (as defined in subparagraph (F))",

(ii) in paragraph (3)(F), by inserting "physical or occupational therapy assistant," after "occupational therapist,", and Health care professionals.

(iii) by striking paragraph (4) and by redesignating paragraphs (5) and (6) as paragraphs (4) and (5), respectively.

(B)(i) Section 1861(n) of the Social Security Act (42 U.S.C. 1395x(n)) is amended by inserting before the period at the end the following: "; except that such term does not include such equipment furnished by a supplier who has used, for the demonstration and use of specific equipment, an individual who has not met such minimum training standards as the Secretary may establish with respect to the demonstration and use of such specific equipment".

(ii) The amendment made by clause (i) shall apply to equipment furnished on or after the effective date provided in section 4021(c) of OBRA. Effective date.

(2) SECTION 4022.—(A) The third sentence of section 1891(c)(1) of the Social Security Act, as added by section 4022(a) of OBRA, is amended by inserting "(other than subsections (a) and (b))" after "1128A".

42 USC 1395bbb. (B) Section 1891(d)(2)(A) of the Social Security Act, as added by section 4022(a) of OBRA, is amended by striking "1991" and inserting "1992".

42 USC 1395bbb. (3) SECTION 4023.—(A) Section 4023 of OBRA is amended by inserting "(a) IN GENERAL.—" before "Section 1891".

(B) Section 1891(f)(2)(A) of the Social Security Act, as added by section 4023 of OBRA, is amended—

(i) by moving the indentation of clauses (i) through (iii) (and the sentence following clause (iii)) 2 ems to the left,

(ii) in clause (i), by striking "for each day of noncompliance" and inserting "in an amount not to exceed $10,000 for each day of noncompliance", and

(iii) by inserting after and below clause (iii), the following: "The provisions of section 1128A (other than subsections (a) and (b)) shall apply to a civil money penalty under clause (i) in the same manner as such provisions apply to a penalty or proceeding under section 1128A(a).".

(C) Section 4023(b) of OBRA is amended by inserting before the period at the end the following: ", and no intermediate sanction described in section 1891(f)(2)(A) of such Act shall be imposed for violations occurring before such effective date".

42 USC 1395aa. (4) SECTION 4025.—(A) Section 1864(a) of the Social Security Act is amended—

(i) in the first sentence added by section 4025(a) of OBRA, by striking "most recent accreditation survey conducted with respect to the agency," and inserting "most recent accreditation survey conducted by a State agency or private accreditation agency under section 1865 with respect to the home health agency,", and

(ii) in the second sentence so added—

(I) by inserting "such State or local" before "agency" the first place it appears, and

(II) by striking "section 1864" and inserting "section 1865".

42 USC 1395aa note. (B) Section 4025 of OBRA is amended—

(i) in subsection (b), by striking "subsection (a)" and inserting "this section" and by redesignating such subsection as subsection (c), and

(ii) by inserting after subsection (a) the following new subsection:

"(b) CONFORMING AMENDMENT.—The last sentence of section 1865(a) of such Act (42 U.S.C. 1395bb(a)) is amended by inserting '(other than a survey with respect to a home health agency' after 'any accreditation survey'.".

42 USC 1395x. (5) SECTION 4026.—(A) Section 1861(v)(1)(L)(iii) of the Social Security Act, as added by section 4026(a)(1) of OBRA, is amended—

(i) by striking "audited" each place it appears and inserting "verified", and

(ii) by adding at the end the following:

Wages. "In the case of a home health agency that refuses to provide data, or deliberately provides false data, respecting wages for purposes of this clause upon the request of the Secretary, the Secretary may withhold up to 5 percent of the amount of the payments otherwise payable to the agency under this title until such date as the Secretary determines that such data has been satisfactorily provided.".

(B) Section 4026(a)(2) of OBRA is amended by striking "July 1, 1988" and inserting "July 1, 1989". 42 USC 1395x note.

(C) Section 4026(b) of OBRA is amended by striking "June 1, 1988" and inserting "June 1, 1989".

(6) SECTION 4027.—Section 4027(a) of OBRA is amended by striking "July 1, 1988" and inserting "April 1, 1989". 42 USC 1395n note.

(e) CORRECTIONS RELATING TO SUBPART C OF PART 2 OF SUBTITLE A OF TITLE IV (OTHER MEDICARE PART A AND B PROVISIONS).—

(1) SECTION 4032.—(A) Section 4032 of OBRA is amended by striking "AND PHYSICIAN REVIEW" in the heading of subsection (a) and by striking "AND CARRIERS" in the heading of subsection (b). 42 USC 1395h.

(B) Section 1816(j)(2) of the Social Security Act, as added by section 4032(a) of OBRA, is amended— 42 USC 1395h.

(i) by inserting "in the case of a request for reconsideration of a denial," after "(2)", and

(ii) by inserting "the" before "disposition".

(C) Section 4032(c)(1)(B) of OBRA is amended by striking "claims filed" and inserting "reconsiderations requested". 42 USC 1395h note.

(2) SECTION 4033.—Section 4033 of OBRA is amended—

(A) by striking "(a) IN GENERAL.—"; 42 USC 426.

(B) by redesignating paragraphs (1) and (2) (and subparagraphs (A) and (B) of paragraph (2)) as subsections (a) and (b) (and paragraphs (1) and (2) of subsection (b)), respectively; and 42 USC 426 note.

(C) by aligning the left margins of the matter in such section flush left.

(3) SECTION 4039.—Section 4039 of OBRA is amended by adding at the end the following new subsection:

"(h) TECHNICAL CORRECTIONS.—

"(1) Section 1128A(b) of the Social Security Act (42 U.S.C. 1320a-7a(b)) is amended—

"(A) in paragraph (1)(A), by striking 'XVII' and inserting 'XVIII', and

"(B) in paragraph (2) by inserting 'each' after '$2,000 for'.

"(2) Section 1138(a)(1)(B) of such Act (42 U.S.C. 1320b-8(a)(1)(B)) is amended by striking 'In' and inserting 'in'.

"(3) Section 1154(a)(4) of such Act (42 U.S.C. 1320c-3(a)(4)) is amended—

"(A) by indenting subparagraphs (B) and (C) (and clauses (i) through (iii) of subparagraph (C)) two additional ems;

"(B) in subparagraph (B), by inserting 'risk-sharing' before 'contract under section 1876'; and

"(C) in subparagraph (C)(i), by adding before the comma at the end the following: '(other than the ability to perform review functions under this section that are not described in subparagraph (B))'.

"(4) Section 1154(d) of such Act (42 U.S.C. 1320c-3(d)) is amended by striking '1164(b)(4)' and inserting '1164'.

"(5) Section 1156(b) of such Act (42 U.S.C. 1320c-5(b)) is amended—

"(A) in the second sentence of paragraph (1), by striking 'such services on a reimbursable basis.' and inserting 'services under this Act on a reimbursable basis.', and

"(B) in paragraph (2), by striking 'at such time' and all that follows through 'and shall remain' and inserting 'on the same date and in the same manner as an exclusion from participation under the programs under this Act becomes effective under section 1128(c), and shall remain'.

"(6) Section 1160 of such Act (42 U.S.C. 1320c-9) is amended by adding at the end the following new subsection:

" '(e) For purposes of this section and section 1157, the term "organization with a contract with the Secretary under this part" includes an entity with a contract with the Secretary under section 1154(a)(4)(C).'.

"(7) The heading of section 1870 of such Act (42 U.S.C. 1395gg) is amended to read as follows:

'OVERPAYMENT ON BEHALF OF INDIVIDUALS AND SETTLEMENT OF CLAIMS FOR BENEFITS ON BEHALF OF DECEASED INDIVIDUALS'.

"(8) Section 1876(i)(7) of such Act (42 U.S.C. 1395mm(i)(7)) is amended—

"(A) in subparagraph (A), by striking 'Except as provided under section 1154(a)(4)(C), each' and inserting 'Each';

"(B) in subparagraph (A), by inserting 'or with an entity selected by the Secretary under section 1154(a)(4)(C)' after 'located)'; and

"(C) by striking 'peer' in subparagraph (B) and the second place it appears in subparagraph (A).

"(9) Section 9353 of the Omnibus Budget Reconciliation Act of 1986 is amended—

42 USC 1320c-3 note. Contracts.

"(A) in subsection (a)(6)(A)(i), by striking 'paragraphs (1) and (2)(D) shall apply to contracts as of' and inserting 'paragraph (1) shall apply to contracts entered into or renewed on or after';

"(B) in subsection (a)(6)(B), by striking 'amendment made by paragraph (2)(B)' and inserting 'amendments made by paragraphs (2)(B) and (2)(D)'; and

42 USC 1395mm note. Contracts.

"(C) in subsection (e)(3)(B), by adding at the end the following: 'The provisions of section 1876(i)(7) of the Social Security Act (added by such amendment) shall apply to health maintenance organizations with contracts in effect under section 1876 of such Act (as in effect before the date of the enactment of Public Law 97-248) in the same manner as it applies to eligible organizations with risk-sharing contracts in effect under section 1876 of such Act (as in effect on the date of the enactment of this Act).'.".

(f) CORRECTIONS RELATING TO SUBPART A OF PART 3 OF SUBTITLE A OF TITLE IV (PAYMENTS FOR PHYSICIANS' SERVICES).—

42 USC 1395u.

(1) SECTION 4041.—(A) Section 4041(a)(1)(B) of OBRA is amended—

(i) by inserting "as amended retroactively by section 4085(i)(7)(C)," after "(j)(1)(C),", and

(ii) by redesignating the clause added by such section as clause (viii).

42 USC 1395u.

(B) The last sentence of section 1842(b)(2) of the Social Security Act, as added by section 4041(a)(3)(A) of OBRA, is amended by striking "and subsection (h)" and inserting ", subsection (h), and section 1845(f)(2)".

42 USC 1395u note.

(C) Subclause (II) of section 4041(a)(3)(B)(iii) of OBRA is amended to read as follows:

"(II) by striking 'April 1' and inserting 'September 30', and".

(2) SECTION 4042.—(A) Section 1842(b)(4)(F)(iii) of the Social Security Act, as added by section 4042(a) of OBRA, is amended— 42 USC 1395u.

(i) in subclause (I), by striking the semicolon and inserting a comma, and

(ii) in subclause (II), by striking "physician's" and inserting "physicians' ".

(B) Section 1842(b)(4)(F)(ii)(I) of the Social Security Act, as added by section 4042(a) of OBRA, is amended by striking "subparagraph (E)(iii)" and inserting "subsection (i)(4)".

(C) Section 4042(b) of OBRA is amended by striking "Section" and all that follows up to "The term" and inserting the following:

"(1) Section 1842 of such Act (42 U.S.C. 1395u) is amended—

"(A) in subsection (h)(7), by striking ', described in paragraph (8)';

"(B) in paragraph (8) of subsection (h)—

"(i) by striking '(8) For purposes of this title, a' and inserting '(1) A',

"(ii) by indenting such paragraph 2 ems, and

"(iii) by inserting before such paragraph the following:

" '(i) For purposes of this title:';

"(C) in subsection (b)(4)(E)—

"(i) by striking '(E) In this section:',

"(ii) by redesignating clauses (i) and (ii), as paragraphs (2) and (3), respectively, and

"(iii) by transferring and inserting such paragraphs, as redesignated, before subsection (j);

"(D) in subsection (b)(4), by redesignating subparagraphs (F) and (G) of subsection (b)(4), as subparagraphs (E) and (F), respectively; and

"(E) by inserting, after the paragraphs transferred and inserted by subparagraph (C)(iii), the following new paragraph:

" '(4)".

(D) Section 4042(b) of OBRA is further amended by adding at the end the following: 42 USC 1395u.

"(2)(A) Section 1842(b)(4)(A)(vii) of such Act, as redesignated by sections 4041(a)(1)(A)(i) and 4044(a), is amended by striking 'subparagraph (E)(ii)' and inserting 'subsection (i)(3)'.

"(B) Section 1833(l)(2) of such Act (42 U.S.C. 1395l(l)(2)) is amended by striking '1842(b)(4)(E)(ii)' and inserting '1842(i)(3)'.".

(E) The last sentence of section 1842(b)(4)(A)(iv)(II) of the Social Security Act, as added by section 4042(c)(2) of OBRA, is amended by striking "January 1, 1988" and inserting "January 1, 1989".

(F) Section 4042(c) of OBRA is amended—

(i) by striking "Section" and all that follows up to "In the previous sentence" and inserting the following:

"(1) The first sentence of clause (iv) of section 1842(b)(4)(A) of such Act (42 U.S.C. 139u(b)(4)(A)) is amended to read as follows: 'The reasonable charge for physicians' services furnished on or after January 1, 1987, by a nonparticipating physician shall be no greater than the applicable percent of the prevailing charge levels established under the third and fourth sentences of paragraph (3) (or under any other applicable provision of law affecting the prevailing charge level).'.", and Effective date. Health care professionals.

(ii) by adding at the end the following:

Health care professionals. 42 USC 1395u.

"(2) Subclauses (I) and (II) of section 1842(j)(1)(C)(i) of such Act are amended by striking 'prevailing charge for the year involved for such service furnished by nonparticipating physicians' and inserting 'applicable percent (as defined in subsection (b)(4)(A)(iv)) of the prevailing charge for the year and service involved'.".

101 Stat. 1330-86.

(3) SECTION 4044.—(A) Section 4044(a) of OBRA is amended by striking "INCREASE IN PREVAILING CHARGES" and inserting "PREVAILING CHARGE FLOOR".

42 USC 1395u.

(B) Section 1842(b)(4)(A)(vi) of the Social Security Act, as inserted by section 4044(a) of OBRA, is amended—

(i) by striking "subparagraph (E)(iii)" and inserting "subsection (i)(4)",

(ii) by striking "the average of the prevailing charge levels" and inserting "the estimated average prevailing charge levels based on the best available data", and

(iii) by striking "for participating physicians".

(4) SECTION 4045.—(A) Section 1842(b)(10) of the Social Security Act, as amended by section 4045(a) of OBRA, is amended—

(i) in subparagraph (A)(i)—

(I) by striking "under paragraph (3)",

(II) by striking "subparagraph (C)" and inserting "subparagraph (B)", and

(III) by striking "for participating and nonparticipating physicians";

(ii) in subparagraph (A)(iii), by striking "clause (i)(II)" and inserting "clause (i)(I)";

(iii) in subparagraph (B) by inserting "(including subsequent insertion of an intraocular lens)" after "cataract surgery"; and

(iv) in subparagraph (D), by inserting "under" after "review".

42 USC 1395u.

(B) Section 4045(c)(2) of OBRA is amended—

(i) in subparagraph (B), by inserting before the period at the end the following: "and by striking the second sentence", and

(ii) by adding at the end the following new subparagraph:

"(D) The fourth sentence of section 1842(b)(3) of the Social Security Act (42 U.S.C. 1395u(b)(3)) is amended by inserting '(or under any other provision of law affecting the prevailing charge level)' after 'the level determined under this sentence'.".

(C) Section 1842(j)(1)(D)(iv) of the Social Security Act, as added by section 4045(c)(1)(B) of OBRA, is amended by striking "imposes a charge" and inserting "bills".

(D)(i) Section 1862(a)(15) of the Social Security Act (42 U.S.C. 1395y(a)(15)) is amended by inserting "(including subsequent insertion of an intraocular lens)" after "operation".

Effective date. 42 USC 1395y note.

(ii) The amendment made by clause (i) shall apply to operations performed on or after 60 days after the date of the enactment of this Act.

(5) SECTION 4046.—(A) Section 1842(b)(11)(C)(i) of the Social Security Act, as inserted by section 4046(a)(1)(C) of OBRA and as designated by section 4063(a)(1)(A), is amended by striking "implantation" and inserting "insertion".

(B) Section 1842(j)(1)(D)(ii)(IV) of the Social Security Act, as inserted by section 4046(a)(2)(A) of OBRA, is amended by striking "is". 42 USC 1395u.

(6) SECTION 4047.—(A) The heading of section 4047 of OBRA is amended by striking "**PRIMARY CARE**" and inserting "**CERTAIN**".

(B) Section 1842(b)(4)(G) of the Social Security Act, as added by section 4047(a) of OBRA, is amended—

(i) by inserting "than" after "(other", and

(ii) by striking "(as determined under the third and fourth sentences of paragraph (3) and under paragraph (4))".

(C) Section 4047(b) of OBRA is amended by inserting "on or" after "medicare beneficiaries". 42 USC 1395u note.

(D) The item in the table of contents of title IV of OBRA relating to section 4047 is amended to read as follows:

"Sec. 4047. Customary charges for certain services of new physicians.".

(7) SECTION 4048.—(A) Paragraph (14) of section 1842(b) of the Social Security Act, as added by section 4048(a) of OBRA, is redesignated as paragraph (13).

(B) Section 4048 of OBRA is amended by adding at the end the following new subsection: 101 Stat.1330-89.

"(e) CONFORMING AMENDMENT TO MAXMIMUM ALLOWABLE ACTUAL CHARGE.—Section 1842(j)(1)(C) of the Social Security Act (42 U.S.C. 1395u(j)(1)(C)), as amended by sections 4085(i)(7)(C) and 4041(a)(1)(B) of this title, is amended by adding at the end the following new clause:

" '(ix) If there is a reduction under subsection (b)(13) in the reasonable charge for medical direction furnished by a nonparticipating physician, the maximum allowable actual charge otherwise permitted under this subsection for such services shall be reduced in the same manner and in the same percentage as the reduction in such reasonable charge.'.". Health care professionals.

(8) SECTION 4049.—(A) Section 1834(b)(6) of the Social Security Act, as added by section 4049(a)(2) of OBRA, is amended by striking "radiologic" each place it appears and inserting "radiology". 42 USC 1395m.

(B) Section 4049(a) of OBRA is amended—

(i) in paragraph (1), by striking "4062(c)(3)" and inserting "4062(d)(3)", and 42 USC 1395*l*.

(ii) in paragraph (2), by striking "4062(a)" and inserting "4062(b)". 42 USC 1395n.

(C) Section 1833(a)(1) of the Social Security Act, as amended by section 4049(a)(1) of OBRA, is amended in the clause added by that section by striking "1834(b)(5)" and inserting "1834(b)(6)". 42 USC 1395*l*.

(D) Section 1834(b) of the Social Security Act, as added by section 4049(a)(2) of OBRA, is amended—

(i) in the headings of paragraphs (4)(D) and (5), by inserting "AND SUPPLIERS" after "PHYSICIANS";

(ii) in paragraph (5)(C), by striking "imposes a charge" and inserting "bills";

(iii) in paragraph (5)(C), by inserting "in the same manner as such sanctions may apply to a physician" after "1842(j)(2)";

(iv) in paragraph (6), by striking ", section 1833(a)(1)(I), and section 1842(h)(1)(B)" and inserting "and section 1833(a)(1)(J)"; and

(v) in paragraph (6)(B), by striking "billings" and inserting "the total amount of charges".

42 USC 1395m note. (E) Section 4049(b) of OBRA is amended by striking "establish" and inserting "propose".

(9) SECTION 4051.—Section 1842(n) of the Social Security Act, 42 USC 1395u. as added by section 4051(a) of OBRA, is amended—

(A) in paragraph (1) in the matter before subparagraph (A)—

(i) by striking "to a patient",

(ii) by inserting "the bill or request for" after "for which",

(iii) by striking "his" and inserting "a", and

(iv) by striking "supervised the test" and inserting "supervised the performance of the test";

(B) in paragraph (1)(A), by striking "to individuals enrolled under this part";

(C) in paragraph (2)(A), by inserting "the payment amount specified in paragraph (1)(A) and" after "other than"; and

(D) in paragraph (3), by striking "or supplier".

(10) FIRST SECTION 4052.—(A) Section 1892(a) of the Social 42 USC 1395ccc. Security Act, as added by the first section 4052(a) of OBRA, is amended—

(i) in paragraphs (2)(C)(ii) and (3)(B), by striking "paragraph (3)" and inserting "paragraph (4)",

(ii) in paragraph (4), by striking "bar" and inserting "exclude", and

(iii) in paragraph (4), by inserting before the period at the end the following: "if a State requests that the physician not be excluded".

(B) The first section 4052(b) of OBRA (relating to conforming 42 USC 254o. reference) is amended by striking "338E(b)(1)" and "254o(b)(1)" and inserting "338E(b)(1)(B)(i)" and "254o(b)(1)(B)(i)", respectively.

(C)(i) Section 1892 of the Social Security Act, as added by the first section 4052(a) of OBRA, is amended—

(I) in the heading, by striking "PHYSICIANS" and "SCHOLARSHIP" and inserting "INDIVIDUALS" and "SCHOLARSHIP AND LOAN", respectively;

(II) by striking "physician" each place it appears (other than the third place it appears in subsection (a)(4)) and inserting "individual";

(III) by striking "physician" the third place it appears in subsection (a)(4) and inserting "practitioner";

(IV) in paragraph (1)(A), by inserting ", the Physician Shortage Area Scholarship Program, or the Health Education Assistance Loan Program," after "Scholarship Program";

(V) in subsection (b), by striking ", and (2)" and all that follows through "Act" and inserting "or under subpart III of part F of title VII of such Act (as in effect before October 1, 1976) and which has not been paid by the deadline established by the Secretary pursuant to such respective section"; and

(VI) in subsection (b), by striking the period at the end and inserting "; or" and by adding at the end the following:

"(2) owed by an individual to the United States by reason of a loan covered by Federal loan insurance under subpart I of part C of title VII of the Public Health Service Act and payment for which has not been cancelled, waived, or suspended by the Secretary under such subpart.". Loans.

(ii) Section 733(f) of the Public Health Service Act (42 U.S.C. 294f(f)) is amended by adding at the end the following: "Procedures for reduction of payments under the medicare program are provided under section 1892 of the Social Security Act.".

(iii) The amendments made by this subparagraph shall be effective 30 days after the date of the enactment of this Act. Effective date. 42 USC 294f note.

(11) SECOND SECTION 4052.—(A) The second section 4052(a) of OBRA is amended by striking "is amended" and all that follows through the end and inserting the following: "is amended by inserting before the period at the end of the next-to-last sentence the following: ', and shall remain at such prevailing charge level until the prevailing charge for a year (as adjusted by economic index data) equals or exceeds such prevailing charge level'.". 42 USC 1395u.

(B) The second section 4052(b) of OBRA is amended by striking "January" and inserting "April". 42 USC 1395u note.

(12) SECTION 4054.—(A) Section 4054 of OBRA is amended to read as follows: 42 USC 1395*l* note.

"SEC. 4054. APPLYING COPAYMENT AND DEDUCTIBLE TO CERTAIN OUTPATIENT PHYSICIANS' SERVICES.

"(a) IN GENERAL.—Section 1833 of the Social Security Act (42 U.S.C. 1395l) is amended—

"(1) in subsection (a)(1), by striking clause (F),

"(2) in subsection (b), by striking paragraph (3) and by redesignating paragraphs (4) and (5) as paragraphs (3) and (4), respectively, and

"(3) in subsection (i), by striking paragraph (4).

"(b) EFFECTIVE DATE.—The amendments made by subsection (a) shall apply to services furnished on or after April 1, 1988.".

(B) The item relating to section 4054 in the table of contents of title IV of OBRA is amended to read as follows:

"Sec. 4054. Applying copayment and deductible to certain outpatient physicians' services.".

(13) SECTION 4055.—Section 4055 of OBRA is amended—

(A) in subsection (a)(2), by striking "such list" and inserting "such definitions", and 42 USC 1395u note.

(B) in subsection (b)(1), by striking "dermatology,". 42 USC 1395w-1 note.

(14) REDESIGNATION.—The second section 4052 of OBRA and sections 4053, 4054, and 4055 of OBRA are redesignated as sections 4053 through 4056, respectively. 42 USC 1395u, 1395u notes, 1395*l*, 1395*l* notes, 1395w-1 note.

(g) CORRECTIONS RELATING TO SUBPART B OF PART 3 OF SUBTITLE A OF TITLE IV (PAYMENTS FOR OTHER PART B SERVICES).—

(1) SECTION 4062.—(A) The heading of section 1834 of the Social Security Act, as inserted by section 4062(b) of OBRA, is amended by inserting "ITEMS AND" after "PARTICULAR". 42 USC 1395m.

(B) Subsection (a) of section 1834 of the Social Security Act, as so inserted, is amended—

(i) in paragraph (1)(C), by inserting "or under part A to a home health agency" after "under this part";

(ii) in the second sentence of paragraph (2)(A), by striking "rental" before "payments";

(iii) in paragraph (2)(B)(i), by striking "allowed" and inserting "reasonable", and in paragraphs (3)(B)(i) and (8)(A)(i)(I), by striking "allowable" and inserting "reasonable";

(iv) in paragraph (3)(A), by striking the extra space after "ventilators";

(v) in paragraph (4), by inserting after "individual patient" the following: ", and for that reason cannot be grouped with similar items for purposes of payment under this title,";

(vi) in paragraph (4), by inserting "(A)" after "in a lump-sum amount" and by inserting "(B)" after "for that item, and";

(vii) in paragraph (4), by striking "maintenance and service" each place it appears and inserting "maintenance and servicing", in paragraph (7)(A)(iii), by striking "service and maintenance" and inserting "maintenance and servicing", and in paragraphs (7)(A)(ii) and (11)(A), by striking "servicing" and inserting "maintenance and servicing";

(viii) in paragraph (7)(A)(iii)(I), by striking "fee established by the carrier" and inserting "fee or fees established by the Secretary ";

(ix) in paragraph (9)(A)(ii)(I), by striking "12-month period" and inserting "6-month period";

(x) in paragraph (9)(A)(ii)(II), by striking "and to 1991" and inserting ", 1991, and 1992";

(xi) in paragraphs (9)(B)(i) and (10)(B)(i), by striking the comma after "1991";

(xii) in paragraph (9)(C)(i), by striking "subparagraph (A)(ii)(I)" and inserting "subparagraph (A)(ii)";

(xiii) in paragraph (10)(B), by inserting before the period the following: "and payments under this subsection as such provisions apply to physicians' services and physicians and a reasonable charge under section 1842(b)";

(xiv) in the last sentence of paragraph (11)(A), by striking "under subsection (j)(2)" and inserting "under section 1842(j)(2)";

(xv) in paragraph (12), by striking "(as defined in section 1886(d)(2)(D))"; and

(xvi) by striking paragraph (14).

42 USC 1395m note.

(C) Section 4062(c)(4) of OBRA is amended—

(i) by inserting "and payment of a reasonable copying fee which the Secretary may establish" after "upon written request", and

(ii) by inserting before the period at the end the following: ", but only in a form which does not permit identification of individual suppliers".

42 USC 1395cc.

(D) The last sentence of section 1866(a)(2)(A) of the Social Security Act, as added by section 4062(d)(4) of OBRA, is amended by striking "section 1834(a)(2)" and inserting "section 1834(a)(1)(B)".

42 USC 1395*l*.

(E) The matter added by section 4062(d)(3)(A)(ii) of OBRA is amended by striking "and" before "(I)".

(2) SECTION 4063.—(A) Section 1842(b)(11)(C)(ii) of the Social Security Act, as amended by section 4063(a)(1)(A) of OBRA, is amended— 42 USC 1395u.

(i) by striking "implanted" and inserting "inserted", and

(ii) by inserting "or subsequent to" after "during".

(B) Subclause (IV) of section 1842(j)(1)(D)(ii) of the Social Security Act, as inserted by section 4063(a)(2)(A) of OBRA, is redesignated as subclause (V) and is amended by striking "is".

(C) Section 4063(a)(2)(B) of OBRA is amended by striking clause (ii) and by redesignating clauses (iii) and (iv) as clauses (ii) and (iii), respectively. 42 USC 1395*l*.

(D) Section 1833(i)(2)(A)(iii) of the Social Security Act, as inserted by section 4063(b)(3) of OBRA, is amended— 42 USC 1395*l*.

(i) by striking "implantation" and inserting "insertion", and

(ii) by inserting "or subsequent to" after "during".

(E) Section 4063 of OBRA is amended by adding at the end the following new subsection:

"(e) PREVENTION OF ADDITIONAL BILLINGS FOR IOLs.—

"(1) Section 1833(i) of the Social Security Act (42 U.S.C. 1395l(i)) is amended by adding at the end the following new paragraph:

" '(6) Any person, other than a facility having an agreement under section 1832(a)(2)(F)(i), who knowingly and willfully presents, or causes to be presented, a bill or request for payment, for an intraocular lens inserted during or subsequent to cataract surgery for which payment may be made under paragraph (2)(A)(iii), is subject to a civil money penalty of not to exceed $2,000. The provisions of section 1128A (other than subsections (a) and (b)) shall apply to a civil money penalty under the previous sentence in the same manner as such provisions apply to a penalty or proceeding under section 1128A(a).'. Contracts. Claims. Law enforcement and crime.

"(2) Section 1832(a)(2)(F)(i) of such Act (42 U.S.C. 1395k(a)(2)(F)(i)) is amended by inserting '(including intraocular lens in cases described in section 1833(i)(2)(A)(iii))' after 'services' each place it appears.".

(3) SECTION 4064.—(A) Section 4064(a) of OBRA is amended by striking all that follows the first dash and inserting the following: "Paragraph (2) of section 1833(h) of the Social Security Act (42 U.S.C. 1395l(h)) is amended— 42 USC 1395*l* note.

"(1) by inserting '(A)(i)' after '(2)';

"(2) in the second sentence—

"(A) by redesignating clauses (A) and (B) as clauses (i) and (ii), respectively, and

"(B) by designating such sentence as subparagraph (B); and

"(3) by adding at the end of subparagraph (A)(i), as designated under paragraph (1), the following new clause:

" '(ii) Notwithstanding any other provision of this subsection—

" '(I) any change in the fee schedules which would have become effective under this subsection for tests furnished on or after January 1, 1988, shall not be effective for tests furnished during the 3-month period beginning on January 1, 1988, and

" '(II) the Secretary shall not adjust the fee schedules under clause (i) to take into account any increase in the consumer price index for 1988.'.".

(B) Section 4064(b)(1) of OBRA is amended—

(i) by striking "1833(h)(2) of the Social Security Act (42 U.S.C. 1395l(h)(2))" and inserting "1833(h)(2)(A) of the Social Security Act (42 U.S.C. 1395l(h)(2)(A)), as amended by subsection (a),";

(ii) by striking "the following: 'In establishing fee schedules under the first sentence of this paragraph with respect to" and inserting "the following new clause:

" '(iii) In establishing fee schedules under clause (i) with respect to"; and

(iii) by moving the indentation of all the matter added following "with respect to" 2 ems to the left.

42 USC 1395*l*.

(C) The clause added by section 4064(b)(1) of OBRA, as amended by subparagraph (A), is amended by inserting before the period at the end the following: ", and such reduced fee schedules shall serve as the base for 1989 and subsequent years".

42 USC 1395*l*.

(D) Section 1833(h)(4)(B)(ii) of the Social Security Act, as amended by section 4064(b)(2)(B) of OBRA, is amended by inserting "after" before "March".

(E) Section 4064(c) of OBRA is amended by striking all that follows the dash and inserting the following: "Section 1833(h)(1)(D) of such Act is amended by inserting ', in a sole community hospital (as defined in the last sentence of section 1886(d)(5)(C)(ii)),' after 'a hospital laboratory'.".

(F) Section 4064(c) of OBRA is amended by inserting "(1)" after the dash and by adding at the end the following new paragraph:

Effective date. 42 USC 1395*l* note.

"(2) The amendment made by paragraph (1) shall apply with respect to diagnostic laboratory tests furnished on or after April 1, 1988.".

42 USC 1395w-2.

(G) Section 1846 of the Social Security Act, as added by section 4064(d)(1) of OBRA, is amended—

(i) in subsection (a)—

(I) by striking "certified" and "certification" and inserting "approved" and "approval", respectively,

(II) by inserting "or for coverage" after "conditions of participation", and

(III) by striking "cancelling immediately the certification of the provider or clinical laboratory" and inserting "terminating immediately the provider agreement or cancelling immediately approval of the clinical laboratory";

(ii) in subsections (b)(1)(A) and (b)(2)(A)(iv), by striking "certified";

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(iii) in subsection (b)(2)(A)(ii), by striking "civil fines and penalties" and inserting "civil money penalties in an amount not to exceed $10,000 for each day of substantial noncompliance";

(iv) in subsection (b)(2)(A), by adding at the end the following new sentence:

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"The provisions of section 1128A (other than subsections (a) and (b)) shall apply to a civil money penalty under clause (ii) in the same manner as such provisions apply to a penalty or proceeding under section 1128A(a).";

(v) in subsection (b)(2)(A)(iii), by striking "certification";

(vi) in subsection (b)(2)(A)(iv), by striking "provided on or after the date in" and inserting "furnished on or after the date on"; and

(vii) in subsection (b)(3), by striking "fines" and inserting "penalties" each place it appears.

(H) The matter inserted in section 1861(s) of the Social Security Act by section 4064(e)(1) of OBRA is amended by inserting a comma after "year". 42 USC 1395x.

(4) SECTION 4066.—(A) The heading of section 4066 of OBRA is amended by inserting "AND OTHER DIAGNOSTIC TESTS" after "RADIOLOGY".

(B) The item relating to section 4066 in the table of contents of title IV of OBRA is amended to read as follows:

"Sec. 4066. Payments to hospital outpatient departments for radiology and other diagnostic tests.".

(C) Section 1833(n) of the Social Security Act, as added by section 4066(a)(2) of OBRA, is amended— 42 USC 1395l.

(i) in paragraph (1)(A), by striking "beginning on or after October 1, 1988, under this part for services described in subsection (a)(2)(E)" and inserting "for services described in subsection (a)(2)(E)(i) furnished under this part on or after October 1, 1988, and for services described in subsection (a)(2)(E)(ii) furnished under this part on or after October 1, 1989,";

(ii) in paragraph (1)(B)(i)(II), by inserting "or (for services described in subsection (a)(2)(E)(i) furnished on or after January 1, 1989) the fee schedule amount established" after "the prevailing charge"; and

(iii) by amending subclauses (I) and (II) of paragraph (1)(B)(ii) to read as follows:

"(I) The term 'cost proportion' means 50 percent, except that such term means 65 percent in the case of outpatient radiology services for portions of cost reporting periods which occur in fiscal year 1989 and in the case of diagnostic procedures described in subsection (a)(2)(E)(ii) for portions of cost reporting periods which occur in fiscal year 1990.

"(II) The term 'charge proportion' means 100 percent minus the cost proportion.".

(5) SECTION 4067.—Section 1833(f) of the Social Security Act, as inserted by section 4067(a) of OBRA, is amended by striking "medicare economic index (referred to in the fourth sentence of section 1842(b)(3)) applicable to physicians' services" and inserting "MEI (as defined in section 1842(i)(3)) applicable to primary care services (as defined in section 1842(i)(4))".

(6) SECTION 4068.—The last sentence of section 1135(d)(3) of the Social Security Act, as added by section 4068(b)(1) of OBRA, is amended by striking "speciality" and inserting "specialty". 42 USC 1320b-5.

(h) CORRECTIONS RELATING TO SUBPART B OF PART 3 OF SUBTITLE A OF TITLE IV (PART B ELIGIBILITY AND BENEFITS CHANGES).—

(1) SECTION 4070.—(A) The last sentence of section 1833(c) of the Social Security Act, as added by section 4070(a)(2) of OBRA, is amended by striking "prescribing or monitoring prescription drugs" and inserting "monitoring or changing drug prescriptions". Prescription drugs.

(B) Section 1861(ff) of the Social Security Act, as added by section 4070(b)(2) of OBRA, is amended—

(i) by inserting before such subsection the following heading:

"Partial Hospitalization Services", and

(ii) in paragraph (3), by striking "hospital-based or hospital-affiliated (as defined by the Secretary)" and inserting "furnished by a hospital to its outpatients".

(2) SECTION 4071.—Section 1861(s)(10)(A) of the Social Security Act, as amended by section 4071(a) of OBRA, is amended by inserting ", subject to section 4071(b) of the Omnibus Budget Reconciliation Act of 1987," before "influenza vaccine". 42 USC 1395x.

(3) SECTION 4072.—(A) Section 1861(s)(12) of the Social Security Act, as amended by section 4072(a) of OBRA, is amended by inserting "subject to section 4072(e) of the Omnibus Budget Reconciliation Act of 1987," after "(12)".

42 USC 1395*l*. (B) Section 4072(b) of OBRA is amended—

(i) by striking "by inserting after subsection (e)" and inserting "by adding at the end, as previously amended,", and

(ii) by redesignating the subsection added by such section as subsection (o).

(4) SECTION 4073.—Section 4073 of OBRA is amended—

42 USC 1395k. (A) by striking paragraph (1) of subsection (b);

42 USC 1395*l*. (B) in paragraph (2) of subsection (b)—

(i) by redesignating such paragraph as paragraph (1);

(ii) by inserting "and" at the end of subparagraph (A);

(iii) by striking subparagraph (B);

(iv) in the matter added by subparagraph (C)—

(I) by striking "and (I)" and inserting "(K)",

(II) by inserting "80 percent of the lesser of the actual charge for the services or" after "amounts paid shall be",

(III) by striking "but in no event more than" and inserting "but in no event shall such fee schedule exceed", and

(IV) by striking the semicolon and inserting a comma; and

(v) by redesignating subparagraph (C) as subparagraph (B);

(C) in paragraph (3) of subsection (b)—

(i) by inserting ", as previously amended," after "at the end",

(ii) by redesignating such paragraph as paragraph (2),

(iii) by redesignating the subsection added by such paragraph as subsection (p), and

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(iv) by adding at the end of the subsection added by such paragraph the following: "Except for deductible and coinsurance amounts applicable under section 1833, whoever knowingly and willfully presents, or causes to be presented, to an individual enrolled under this part a bill or request for payment for services described in the previous sentence, is subject to a civil money penalty of not to exceed $2,000 for each such bill or request. The provisions of section 1128A (other than subsections (a) and (b)) shall apply to a civil money penalty under the previous sentence in the same manner as such provisions apply to a penalty or proceeding under section 1128A(a).";

(D) in the subsection added by subsection (c)— 42 USC 1395x.

(i) by redesignating such subsection as subsection (gg), and

(ii) in paragraph (1), by striking "his" and inserting "the nurse-midwife's" and by striking "physician's" and inserting "physicians' "; and

(E) in the matter inserted by subsection (d)(1), by striking "section 1861(ff)" and inserting "section 1861(gg)". 42 USC 1396d.

(5) SECTION 4074.—Section 4074 of OBRA is amended— 42 USC 1395x.

(A) in the matter inserted by subsection (a)(1), by striking "(ff)" and inserting "(hh)", and

(B) by redesignating the subsection added by subsection (b) as subsection (hh).

(6) SECTION 4076.—Subsection (a) of section 4076 of OBRA is amended to read as follows:

"(a) SERVICES COVERED.—Section 1861(s)(2)(K) of the Social Security Act (42 U.S.C. 1395x(s)(2)(K)) is amended by inserting '(I)' before 'in a hospital' and by striking 'or as an assistant at surgery' and inserting ', (II) as an assistant at surgery, or (III) in a rural area (as defined in section 1886(d)(2)(D)) that is designated, under section 332(a)(1)(A) of the Public Health Service Act, as a health manpower shortage area,'.". Rural areas.

(7) SECTION 4077.—Section 4077(b) of OBRA is amended—

(A) in paragraph (1), by inserting "by section 4073(a) of this title" after "as amended"; 42 USC 1395x.

(B) by striking paragraph (2); 42 USC 1395k.

(C) in paragraph (3)— 42 USC 1395*l*.

(i) by striking "1395k(a)(1))" and inserting "1395l(a)(1)),

(ii) by striking subparagraphs (A) and (B),

(iii) in subparagraph (C), by striking "(I)" and inserting "(K)" and by redesignating such subparagraph as subparagraph (A),

(iv) in subparagraph (D), by striking "subparagraph:" and inserting "clause:" and by redesignating such subparagraph as subparagraph (B), and

(v) in the matter added by subparagraph (B), as so redesignated—

(I) by striking "(J)" and inserting "(L)", and

(II) by inserting "80 percent of the lesser of the actual charge for the services or" after "amounts paid shall be";

(D) in paragraph (4), by striking "section 4073(b)(3)" and inserting "4073(b)(2)"; 42 USC 1395*l*.

(E) in paragraph (5), by redesignating the subsection (gg) added by such paragraph as subsection (ii); and 42 USC 1395x.

(F) by redesignating paragraphs (3) through (6) as paragraphs (2) through (5), respectively. 42 USC 1395*l*, 1395x, 1395k note.

(8) SECTION 4079.—Section 4079(c)(1) of OBRA is amended by striking "subsection (d)" and inserting "subsection (e)". 42 USC 1395mm note.

(i) PROVISIONS RELATING TO SUBPART D OF PART 3 OF SUBTITLE A OF TITLE IV (OTHER PART B PROVISIONS).—

(1) SECTION 4081.—(A) Section 1842(h)(3)(B) of the Social Security Act, as added by section 4081(a) of OBRA, is amended— 42 USC 1395u.

(i) in the second sentence—

(I) by striking "claims" and inserting "payment", and

(II) by striking "including such information as the Secretary determines is generally provided" and inserting "shall include an explanation of benefits and any additional information that the Secretary may determine to be appropriate in order";

(ii) in the third sentence, by striking "arrangements" and inserting "agreements"; and

(iii) in the fourth sentence—

(I) by inserting "by a carrier" after "under this subparagraph", and

(II) by inserting before the period at the end the following: ", and such user fees shall be collected and retained by the carrier".

42 USC 1395ss.

(B) Section 4081(b)(2) of OBRA is amended by redesignating subparagraphs (A) through (C) as subparagraphs (B) through (D), respectively, and by inserting before subparagraph (B), as so redesignated, the following:

"(A) in the matter before paragraph (1), by inserting '(or, with respect to paragraph (3), the issuer of the policy)' after 'he finds that such policy',".

42 USC 1395ss.

(C) Section 1882(c)(3) of the Social Security Act, as inserted by section 4081(b)(2)(C) of OBRA, is amended—

(i) in subparagraph (A), by striking "claims form" each place it appears and inserting "claim form" in the first 2 places and "notice" in the third place,

(ii) in subparagraph (B)(i), by inserting "under the policy" after "payment determination", and

(iii) in subparagraph (B)(ii), by striking "appropriate payment" and inserting "payment covered by such policy".

42 USC 1395ss note.

(D) Section 4081(c)(2)(B)(i) of OBRA is amended by striking "medical" and inserting "medicare".

(E) Section 4081(c)(2)(B)(ii) of OBRA is amended by inserting "or which has not enacted such legislation before July 1, 1988," after "in which such legislation may be considered".

42 USC 1395u.

(2) SECTION 4082.—Section 4082(c) of OBRA is amended—

(A) by striking "1842(b)(5) of such Act (42 U.S.C. 1395u(b)(5)" and inserting "1842(b)(2) of such Act (42 U.S.C. 1395u(b)(2))", and

(B) in paragraph (1), by striking "(5)" and inserting "(2)".

(3) SECTION 4084.—Section 4084 of OBRA is amended by adding at the end the following new subsection:

"(c) ADDITIONAL TECHNICAL CORRECTIONS.—

"(1) Section 1861(bb)(2) of the Social Security Act (42 U.S.C. 1395x(bb)(2)) is amended by adding at the end the following: 'Such term also includes, as prescribed by the Secretary, an anesthesiologist assistant.'.

"(2) Section 1833(a)(1)(H) of such Act (42 U.S.C. 1395l(a)(1)(H)) is amended by striking 'lesser of the actual charge' and inserting 'least of the actual charge, the prevailing charge that would be recognized if the services had been performed by an anesthesiologist,'.

Effective date. 42 USC 1395l note.

"(3) The amendments made by this subsection shall apply to services furnished after December 31, 1988.".

42 USC 1395w-1.

(4) SECTION 4085.—(A) Section 1845(f) of the Social Security Act, as added by section 4085(a) of OBRA, is amended—

(i) in paragraph (1), by striking "October 1st" and inserting "December 31st", and

(ii) in paragraph (2), by striking "July 1st of the following year" and inserting "the later of (A) July 1st of the following year, or (B) 45 days after the date of a reasonable charge update".

(B) Subparagraph (D) of section 1833(h)(5) of the Social Security Act, as added by section 4085(b)(1) of OBRA, is amended— 42 USC 1395*l*.

(i) by striking "If a person" and all that follows through "under subparagraph (C)" and inserting the following: "A person may not bill for a clinical diagnostic laboratory test performed by a laboratory, other than a rural health clinic, other than on an assignment-related basis. If a person knowingly and willfully and on a repeated basis bills for a clinical diagnostic laboratory test in violation of the previous sentence", and

(ii) by striking "section 1842(j)(2)" and inserting "paragraphs (2) and (3) of section 1842(j) in the same manner such paragraphs apply with respect to a physician".

(C) Section 4085(i) of OBRA is amended—

(i) in the matter inserted by paragraph (1)(A), by inserting a comma after "assignment-related basis"; 42 USC 1395*l*.

(ii) in paragraph (1), by striking subparagraph (B);

(iii) in paragraph (11), by striking "9367(a)" and inserting "4072(a)"; 42 USC 1395x.

(iv) in paragraph (21)(D)(i), by inserting "by" after "(i)"; 42 USC 1395*l*.

(v) in paragraph (21)(D)(ii), by striking "and by" and all that follows up to the semicolon; and 42 USC 1395*l* note.

(vi) by adding at the end the following:

"(22)(A) Section 1832(a)(2)(F)(ii) of the Social Security Act (42 U.S.C. 1395k(a)(2)(F)(ii)) is amended by striking 'an assignment described in section 1842(b)(3)(B)(ii)' and inserting 'payment on an assignment-related basis'.

"(B) Section 1833(h)(5) of such Act (42 U.S.C. 1395l(h)(5)) is amended, in each of subparagraphs (A) and (C), by striking 'on the basis of an assignment' and all that follows through '1870(f)(1),' and inserting 'on an assignment-related basis'.

"(C) Section 1842(b)(7)(B)(iii) of such Act (42 U.S.C. 1395u(b)(7)(B)(ii)) is amended by striking 'the basis of' and all that follows through '1870(f)(1)' and inserting 'an assignment-related basis'.

"(23) Section 1833(l)(5)(B)(ii) of such Act (42 U.S.C. 1395k(l)(5)(B)(ii)) is amended— 42 USC 1395*l*.

"(A) in the first sentence by striking 'monetary' and inserting 'money', and

"(B) by amending the second sentence to read as follows: 'The provisions of section 1128A (other than subsections (a) and (b)) shall apply to a civil money penalty under the previous sentence in the same manner as such provisions apply to a penalty or proceeding under section 1128A(a).'.

"(24) The fourth sentence of section 1842(b)(3) of such Act (42 U.S.C. 1395u(b)(3)) is amended by striking 'physician services' and 'physicians services' and inserting 'physicians' services' in both places.

"(25) Section 1842(b)(12)(C) of such Act (42 U.S.C. 1395u(b)(12)(C)) is amended—

"(A) in the first sentence by striking 'monetary' and inserting 'money', and

"(B) by amending the second sentence to read as follows: 'The provisions of section 1128A (other than subsections (a) and (b)) shall apply to a civil money penalty under the previous sentence in the same manner as such provisions apply to a penalty or proceeding under section 1128A(a).'.

"(26) Section 1842(j)(2) of such Act (42 U.S.C. 1395u(j)(2)(B)) is amended—

"(A) by striking 'title' each place it appears and inserting 'Act', and

"(B) in subparagraph (B)—

"(i) by striking 'the imposition of',

"(ii) by inserting 'and assessments' after 'such penalties', and

"(iii) by amending the second sentence to read as follows: 'The provisions of section 1128A (other than the first 2 sentences of subsection (a) and other than subsection (b)) shall apply to a civil money penalty and assessment under subparagraph (B) in the same manner as such provisions apply to a penalty, assessment, or proceeding under section 1128A(a), except to the extent such provisions are inconsistent with subparagraph (A) or paragraph (3).'.

"(27) Section 1842(l)(1)(C)(i) of such Act (42 U.S.C. 1395u(l)(1)(C)(i)) is amended by inserting 'the physician establishes that' after '(i)'.

"(28) Section 1866(g) of such Act (42 U.S.C. 1395cc(g)) is amended—

"(A) in the first sentence by striking 'monetary' and inserting 'money', and

"(B) by amending the second sentence to read as follows: 'The provisions of section 1128A (other than subsections (a) and (b)) shall apply to a civil money penalty under the previous sentence in the same manner as such provisions apply to a penalty or proceeding under section 1128A(a).'.".

(D)(i) Section 1862(e) of the Social Security Act (42 U.S.C. 1395y(e)) is amended—

(I) by striking "or section 1128A" and inserting ", 1128A, 1156, 1842(j)(2), or 1867(d)",

(II) by redesignating paragraphs (1) and (2) as subparagraphs (A) and (B), and

(III) by inserting "(1)" after "(e)".

(ii) Section 1890 of the Social Security Act, as added by section 10 of Public Law 100-93, is amended— 42 USC 1395aaa.

(I) by striking its heading;

(II) by striking "Sec. 1890" and inserting "(2)";

(III) by inserting "1842(j)(2)," before "1862(d),";

(IV) by striking "or 1866" and inserting "1866, or 1867(d)"; and

(V) by transferring and adding such provision at the end of section 1862(e) of such Act. 42 USC 1395y.

(j) Corrections to Part 4 of Subtitle A of Title IV (Relating to Peer Review Organizations).—

42 USC 1320c-2 note.

(1) Section 4091.—Section 4091(a)(1)(B) of OBRA is amended by striking "renewals occurring" and inserting "contracts expiring".

(2) SECTION 4093.—Section 1154(a)(3) of the Social Security Act, as amended by section 4093(a) of OBRA, is amended by amending the last sentence to read as follows: 42 USC 1320c-3. Health care professionals.

"(C) The discussion and review conducted under subparagraph (B)(ii) shall not affect the rights of a practitioner or provider to a formal reconsideration of a determination under this part (as provided under section 1155).".

(3) SECTION 4094.—(A) Section 4094(a) of OBRA is amended by striking "subparagraph (B)" and inserting "subparagraph (A)". 42 USC 1320c-3.

(B) Section 1154(a)(15) of the Social Security Act, as added by section 4094(b) of OBRA, is amended by striking "at at" and inserting "in at".

(4) SECTION 4096.—(A) Section 4096(a)(1)(A) of OBRA is amended by striking "(b)(3)(ii)" and inserting "(b)(3)(B)(ii)". 42 USC 1395u.

(B) Section 1870(f) of the Social Security Act, as amended by section 4096(a)(2) of OBRA, is amended by striking "specified in subclauses (I) and (II) of " and inserting "of assignment specified in". 42 USC 1395gg.

(C) Sections 1154(e)(3)(A)(i) and 1154(e)(3)(B) (42 U.S.C. 1320c-3(e)(3)(A)(i), 1320c-3(e)(2)(B)), as amended by section 4096(c) of OBRA, are each amended by striking "or (2)" before "paragraph (2)".

(5) SECTION 4097.—Section 4097(b) of OBRA is amended by striking "1866(a)(4)(C)(ii) of such Act (42 U.S.C. 1395cc(a)(4)(C)(ii))" and inserting "1866(a)(3)(C)(ii) of such Act (42 U.S.C. 1395cc(a)(3)(C)(ii))". 42 USC 1395cc.

(k) CORRECTIONS TO SUBTITLE B OF TITLE IV (RELATING TO MEDICAID).—

(1) TABLE OF CONTENTS.—The table of contents of title IV of OBRA is amended by striking the item relating to section 4105 and by redesignating the items relating to sections 4106 and 4107 as relating to sections 4105 and 4106, respectively.

(2) SECTION 4101.—Section 1916(c)(1) of the Social Security Act, as inserted by section 4101(d)(1)(C) of OBRA, is amended by striking "nonfarm". 42 USC 1396o.

(3) SECTION 4102.—(A) Section 1915(d)(5)(B) of the Social Security Act, as amended by section 4102(a)(1)(B) of OBRA, is amended— 42 USC 1396n.

(i) in clause (iii)(III), by striking "75" and inserting "65", and

(ii) by inserting before "Effective on" the following: "The Secretary shall develop (by not later than October 1, 1989) a method for projecting, on a State-specific basis, the percentage increase in the number of residents in each State who are over 75 years of age for any period.".

(B) Section 1915(d)(5)(C)(i) of the Social Security Act, as amended by section 4102(a)(1)(B) of OBRA, is amended—

(i) by striking "(4)(B)," and inserting "(4), and", and

(ii) by striking ", and services furnished" and all that follows through "subsection (c)".

(4) SECTION 4103.—Section 1905(a)(5)(B) of the Social Security Act, as inserted by section 4103(a) of OBRA, is amended by striking "subparagraph" and inserting "clause". 42 USC 1396d.

(5) SECTION 4104.—(A) Paragraph (1) of section 4104(1) of OBRA is amended to read as follows: 42 USC 1396a.

"(1) by striking ', or' at the end of subclause (IX) and inserting a semicolon and by inserting 'or' at the end of subclause (X); and".

42 USC 1396a.

(B) Section 1902(a)(10)(A)(ii)(XI) of the Social Security Act, as added by section 4104(2) of OBRA, is amended—

(i) by striking "are more restrictive" and inserting "may be more restrictive", and

(ii) by striking the period at the end and inserting a semicolon.

42 USC 1396a note.

(6) SECTION 4112.—(A) Section 4112 of OBRA is amended—

(i) in subsection (a)(2)(A)—

(I) by striking "such date" and inserting "April 1, 1989", and

Effective date.

(II) by inserting ", effective for inpatient hospital services provided on or after July 1, 1989" before the period;

(ii) in subsection (a)(2)(B)—

(I) by striking "such date" and inserting "April 1, 1990", and

Effective date.

(II) by inserting ", effective for inpatient hospital services provided on or after July 1, 1990" before the period;

(iii) the undesignated paragraph at the end of subsection (a) is amended—

State and local governments.

(I) by striking "June 30 of each year in which the State is required to submit" and inserting "90 days after the date a State submits",

(II) by indenting all of such paragraph 2 ems, and

(III) by designating the first two sentences thereof as paragraph (3) and the last sentence thereof as paragraph (4);

(iv) in subsection (b)(2), by striking "the State plan" and inserting "a State plan";

(v) in subsection (b)(3)(B)(i), by inserting ", less the portion of any cash subsidies described in clause (i)(II) in the period reasonably attributable to inpatient hospital services" after "charity care in a period";

(vi) in subsection (c)—

(I) by striking "paragraphs (2)(A) and (2)(B)" and inserting "paragraphs (1)(B) and (2)(A) of subsection (a)",

(II) by striking "paragraph (2)(A)" and "paragraph (2)(B)" and inserting "such paragraph (1)(B)" and "such paragraph (2)(A)", respectively,

(III) in paragraph (1), by inserting "at least" after "equal to",

(IV) in paragraph (2), by inserting "(without regard to the election made by a State under subsection (b)(1))" after "payment) and",

(V) in the matter after paragraph (2), by inserting "at least" before "one-third" and before "two-thirds", and

Children and youth.

(VI) by adding at the end the following new sentences: "In the case of a hospital described in subsection (d)(2)(A)(i) (relating to children's hospitals), in computing the hospital's disproportionate share adjustment percentage for purposes of paragraph (1)(B) of this subsection, the disproportionate patient percentage (defined in section 1886(d)(5)(F)(vi)) shall be computed by substituting for the fraction described in subclause (I) of such section the fraction described in subclause (II) of that section. If a State elects in a State plan amendment under subsection (a) to provide the payment adjustment described in paragraph (2), the State must include in the amendment a detailed description of the specific methodology to be used in determining the specified additional payment amount (or increased percentage payment) to be made to each hospital qualifying for such a payment adjustment and must publish at least annually the name of each hospital qualifying for such a payment adjustment and the amount of such payment adjustment made for each such hospital."; and

State and local governments.

(vii) in subsection (e)—

(I) by inserting "(1)" after "SPECIAL RULE.—",

(II) by inserting "based on a pooling arrangement involving a majority of the hospitals participating under the plan" after "payment adjustments", and

(III) by adding at the end the following new paragraph:

"(2) In the case of a State that used a health insuring organization before January 1, 1986, to administer a portion of its plan on a Statewide basis, during the 3-year period beginning on July 1, 1988—

State and local governments. Effective date.

"(A) the requirements of subsections (b) and (c) shall not apply if the aggregate amount of the payment adjustments under the plan for disproportionate share hospitals (as defined under the State plan) is not less than the aggregate amount of payment adjustments otherwise required to be made if such subsections applied, and

"(B) subsection (d)(2)(B) shall apply to hospitals located in urban areas, as well as in rural areas.".

Urban areas. Rural areas. 42 USC 1396a note.

(B) Section 4112 of OBRA is further amended—

(i) by striking "(a) IMPLEMENTATION OF REQUIREMENT.—" and inserting the following:

"(a) IN GENERAL.—Title XIX of the Social Security Act is amended—

"(1) by redesignating section 1923 as section 1924, and

42 USC 1396s.

"(2) by inserting after section 1922 the following new section:

" 'ADJUSTMENT IN PAYMENT FOR INPATIENT HOSPITAL SERVICES FURNISHED BY DISPROPORTIONATE SHARE HOSPITALS

" 'SEC. 1923. (a) IMPLEMENTATION OF REQUIREMENT.—";

42 USC 1396r-4.

(ii) in subsection (a)(1), by striking "A State's plan under title XIX of the Social Security Act" and inserting "A State plan under this title";

(iii) in subsection (a)(1), by striking "of such Act";

(iv) in subsection (a), by striking "of Health and Human Services" each place it appears;

(v) in the matter following paragraph (2)(B) of subsection (a), by striking "of the Social Security Act";

(vi) in subsections (b) and (c), by striking "under title XIX of the Social Security Act" each place it appears and inserting "under this title";

(vii) in subsection (d)(2)(B), by striking "of the Social Security Act";

(viii) in subsections (b)(2), (b)(3), and (d)(2)(B), by striking double quotation marks enclosing terms and inserting single quotation marks;

(ix) by placing opening double quotation marks at the beginning of any matter with an initial paragraph indentation (beginning with subsection (a)(1)) and closing double quotation marks at the end of subsection (e); and

(x) by adding at the end the following:

Disadvantaged persons.

"(b) CONFORMING AMENDMENT.—Section 1903(i)(3) of such Act (42 U.S.C. 1396b(i)(3)) is amended by inserting '(other than amounts attributable to the special situation of a hospital which serves a disproportionate number of low income patients with special needs)' before 'to the extent'.".

(7) SECTION 4113.—Section 4113 of OBRA is amended—

42 USC 1396b.

(A) in the matter inserted by subsection (a)(1)(B)—

(i) by moving the left margin of the matter 2 ems to the left, and

(ii) by striking "subparagraph (G)" and inserting "subparagraph (E) or (G)";

42 USC 1396a.

(B) in the matter inserted by subsection (a)(2), by striking "paragraph (2)(G) or (6)" and inserting "paragraph (2)(B)(iii), (2)(E), (2)(G), or (6)";

42 USC 1396a.

(C) in subsection (b)(2)(ii), by striking "such"; and

42 USC 1396a, 1396b.

(D) by striking subsection (d) and redesignating subsection (e) as subsection (d).

42 USC 1396d.

(8) SECTION 4114.—(A) Section 4114 of OBRA is amended in paragraph (1), by striking " '(1)' " and inserting " '(o)(1)' ".

42 USC 1396d.

(B) Section 1905(o)(1)(B) of the Social Security Act, as added by section 4114(3) of OBRA, is amended—

(i) by striking "only", and

(ii) by striking "immunodeficiency syndrome" and inserting "immune deficiency syndrome (AIDS)".

101 Stat. 1330–153.

(9) SECTION 4115.—(A) Section 4115 of OBRA is amended—

(A) in subsection (b)(4)(B), by striking "program" and inserting "Program",

(B) in subsection (c)—

(i) by inserting "under section 9121 of this Act" after "Upon approval", and

(ii) by striking "1916, and 1924" and inserting "1902(e)(1), and 1916", and

(C) by adding at the end the following:

"(d) EXTENSION OF TEXAS STATE WAIVER.—Section 9523(a) of the Consolidated Omnibus Budget Reconciliation Act of 1985 is amended by striking 'January 1, 1989' and inserting 'January 1, 1990'.".

100 Stat. 217.

(10) SECTION 4118.—(A) Section 1915(c)(10) of the Social Security Act, as added by section 4118(b) of OBRA, is amended—

42 USC 1396n.

(i) by striking "No waiver under this subsection shall limit by an amount less than 200" and inserting "The Secretary shall not limit to fewer than 200", and

(ii) by striking "under such waiver" and inserting "under a waiver under this subsection".

42 USC 1320a-7a note.

(B) Section 4118(e) of OBRA is amended—

(i) in paragraph (3), by striking "amendment" and inserting "amendments", and

(ii) in paragraph (1)—

(I) by inserting "(A)" after "(1)",
(II) by striking "1128A(a)(1)" and "1320a-7(a)(1))" and inserting "1128(a)" and "1320a-7(a))", respectively, and 42 USC 1320a-7a, 1320a-7.
(III) by adding at the end the following:
"(B) Section 1128A of such Act is amended by adding at the end the following new subsection: 42 USC 1320a-7a.
" '(l) A principal is liable under this section for the actions of the principal's agent acting within the scope of the agency.' ".
(C) Section 1128(d)(3)(B)(ii) of the Social Security Act, as added by section 4118(e)(2)(B) of OBRA, is amended by striking "under a program". 42 USC 1320a-7.
(D) Section 4118(e) of OBRA is amended by redesignating paragraph (3) as paragraph (14) and by inserting after paragraph (2) the following new paragraphs: 42 USC 1320a-7a note.
"(3) Section 1128(b)(8)(A)(i) of such Act is amended by inserting after '(A)(i)' the following: 'who has a direct or indirect ownership or control interest of 5 percent or more in the entity or'.
"(4) Section 1128(d) of such Act is amended—
"(A) in paragraph (1), by striking 'subsection (b)' and inserting 'this section and section 1128A', and
"(B) in paragraph (3)(A), by striking 'under a program'.
"(5) Section 1128(i) of such Act is amended—
"(A) in the matter before paragraph (1), by striking 'a physician or other individual' and inserting 'an individual or entity',
"(B) in paragraphs (1) through (4), by striking 'physician or other individual' each place it appears and inserting 'individual or entity', and
"(C) in paragraph (4), by striking 'first offender or other program' and inserting 'first offender, deferred adjudication, or other arrangement or program'.
"(6) Section 1128A(a)(1)(D) of such Act is amended— 42 USC 1320a-7a.
"(A) by striking 'excluded under' and inserting 'excluded from', and
"(B) by inserting 'or as a result of the application of the provisions of section 1842(j)(2) or section 1867(d)(2)' after 'or 1866(b)'.
"(7) The second sentence of section 1128A(c)(1) of such Act is amended—
"(A) by inserting ', request for payment, or other occurrence described in this section' after 'any claim', and
"(B) by inserting ', the request for payment was made, or the occurrence took place' after 'claim was presented'.
"(8) Section 1128A(i) of such Act is amended, in the matter before paragraph (1), by striking 'subsection' and inserting 'section'.
"(9) Section 1128A(i)(1) of such Act is amended by inserting 'or title XX' after 'title V'.
"(10) Section 1128A of such Act is further amended—
"(A) in the matter in subsection (a) before paragraph (1), by inserting ', but excluding a beneficiary, as defined in subsection (i)(5)' after 'other entity',
"(B) in subsection (i)(2), by striking 'submitted by' and all that follows through the end and inserting 'for payments for items and services under title V, XVIII, XIX, or XX of this Act.', and

"(C) by adding at the end the following new paragraph:

" '(5) The term "beneficiary" means an individual who is eligible to receive items or services for which payment may be made under title V, XVIII, XIX, or XX but does not include a provider, supplier, or practitioner.'.

"(11) Section 1903(i)(2) of such Act (42 U.S.C. 1396b(i)(2)) is amended—

"(A) in subparagraph (A), by striking 'in the State plan under this title pursuant to section 1128 or section 1128A' and inserting 'under title V, XVIII, or XX or under this title pursuant to section 1128, 1128A, 1156, 1842(j)(2), or 1867(d)(2)', and

"(B) in subparagraph (B), by striking 'pursuant to section 1128 or section 1128A from participation in the program under this title' and inserting 'from participation under title V, XVIII, or XX or under this title pursuant to section 1128, 1128A, 1156, 1842(j)(2), or 1867(d)(2)'.

"(12) Section 504(b)(6) of such Act (42 U.S.C. 704(b)(6)) is amended by striking 'pursuant to section 1128 or section 1128A from participation in the program under this title' each place it appears and inserting 'under this title or title XVIII, XIX, or XX pursuant to section 1128, 1128A, 1156, 1842(j)(2), or 1867(d)(2)'.

"(13) Section 2005(a)(9) of such Act (42 U.S.C. 1397d(a)(9)) is amended by striking 'pursuant to section 1128 or section 1128A from participation in the program under this title' each place it appears and inserting 'under this title or title V, XVIII, or XIX pursuant to section 1128, 1128A, 1156, 1842(j)(2), or 1867(d)(2)'.".

42 USC 1396j.

(E) Section 4118(f)(1) of OBRA is amended by striking "4111(g)(8)" and inserting "4211(h)(8)".

(F) Section 4118(g)(1)(B) of OBRA is amended by striking "insert" and inserting "inserting".

(G) Section 4118(h) of OBRA is amended—

(i) by inserting a dash after "Expenses.";

(ii) in paragraph (1), by striking "Section 1902(a)(17) of the Social Security Act (42 U.S.C. 1396a(a)(17)) is amended" and inserting "Sections 1902(a)(17) and 1903(f)(2) of the Social Security Act (42 U.S.C. 1396a(a)(17), 1396b(f)(2)) are each amended";

42 USC 1396a note.

(iii) in paragraph (2), by striking "(2) The amendment made by paragraph (1)" and inserting "(3) The amendments made by this subsection", and

(iv) by inserting after paragraph (1) the following new paragraph:

State and local governments.

"(2) The first sentence of section 1902(f) of such Act (42 U.S.C. 1396a(f)) is amended by inserting after 'as recognized under State law' the following: 'regardless of whether such expenses are reimbursed under another public program of the State or political subdivision thereof'.".

42 USC 1396n.

(H) Section 1915(c)(7)(B) of the Social Security Act, as added by section 4118(k) of OBRA, is amended by inserting before the period at the end the following: ", without regard to the availability of beds for such inpatients".

42 USC 1396n.

(I) Section 4118(l)(1) of OBRA is amended by inserting ", as redesignated by section 4102(a)," after "1396n(h))".

(J) Section 9414(b)(3) of the Omnibus Budget Reconciliation Act of 1986, as amended by section 4118(o)(1)(C) of OBRA, is amended by striking "nonfarm".

(K) Section 4118(o)(2)(A) of OBRA is amended by inserting "each place it appears" before "and inserting".

(L) Section 4118(p)(9) of OBRA is amended by striking "1925(a)" and "(4111(a))" and inserting "1923(a)" and "4211(a)", respectively. 42 USC 1396s.

(M) Section 4118(p) of OBRA is amended by adding at the end the following new paragraph:

"(11) Paragraph (5) of section 9432(c) of the Omnibus Budget Reconciliation Act of 1986 is amended to read as follows: 42 USC 1396a note.

" '(5) The Secretary shall submit an interim report on the results of the study, including an analysis of the geographic variations under paragraph (2), to the Congress not later than January 1, 1990, and shall report the final results of the study to the Congress not later than January 1, 1992.'.". Reports.

(11) OMITTED SECTION.—(A) Part 2 of subtitle B of title IV of OBRA is amended by adding at the end the following new section:

"SEC. 4119. STUDY OF MEANS OF RECOVERING COSTS OF NURSING FACILITY SERVICES FROM ESTATES OF BENEFICIARIES.

"The Secretary of Health and Human Services shall study the means of recovering amounts from estates of deceased medicaid beneficiaries (or the estates of the spouses of such deceased beneficiaries) to pay for the medical assistance for skilled nursing facility or intermediate care facility services furnished, under title XIX of the Social Security Act, to such medicaid beneficiaries. The Secretary shall report to Congress, not later than December 31, 1988, on such means, and include appropriate recommendations for changes in legislation.". Reports.

(B) The table of contents of title IV of OBRA is amended by inserting after the item relating to section 4118 the following new item:

"Sec. 4119. Study of means of recovering costs of nursing facility services from estates of beneficiaries.".

(12) MEDICAID CONFORMING AMENDMENT TO SECTION 4014 OF OBRA.—(A) Paragraph (5) of section 1903(m) of the Social Security Act (42 U.S.C. 1396b(m)) is amended to read as follows:

"(5)(A) If the Secretary determines that an entity with a contract under this subsection— Contracts.

"(i) fails substantially to provide medically necessary items and services that are required (under law or under the contract) to be provided to an individual covered under the contract, if the failure has adversely affected (or has substantial likelihood of adversely affecting) the individual;

"(ii) imposes premiums on individuals enrolled under this subsection in excess of the premiums permitted under this title;

"(iii) acts to discriminate among individuals in violation of the provision of paragraph (2)(A)(v), including expulsion or refusal to re-enroll an individual or engaging in any practice that would reasonably be expected to have the effect of denying or discouraging enrollment (except as permitted by this subsection) by eligible individuals with the organization whose medical condition or history indicates a need for substantial future medical services; or

"(iv) misrepresents or falsifies information that is furnished—

"(I) to the Secretary or the State under this subsection, or

"(II) to an individual or to any other entity under this subsection,

the Secretary may provide, in addition to any other remedies available under law, for any of the remedies described in subparagraph (B).

Law enforcement and crime.

"(B) The remedies described in this subparagraph are—

"(i) civil money penalties of not more than $25,000 for each determination under subparagraph (A), or, with respect to a determination under clause (iii) or (iv)(I) of such subparagraph, of not more than $100,000 for each such determination, plus, with respect to a determination under subparagraph (A)(ii), double the excess amount charged in violation of such subparagraph (and the excess amount charged shall be deducted from the penalty and returned to the individual concerned), and plus, with respect to a determination under subparagraph (A)(iii), $15,000 for each individual not enrolled as a result of a practice described in such subparagraph, or

State and local governments. Contracts.

"(ii) denial of payment to the State for medical assistance furnished under the contract under this subsection for individuals enrolled after the date the Secretary notifies the organization of a determination under subparagraph (A) and until the Secretary is satisfied that the basis for such determination has been corrected and is not likely to recur.

The provisions of section 1128A (other than subsections (a) and (b)) shall apply to a civil money penalty under clause (i) in the same manner as such provisions apply to a penalty or proceeding under section 1128A(a).".

Effective date. 42 USC 1396b note.

(B) The amendment made by subparagraph (A) shall apply to actions occurring on or after the date of the enactment of this Act.

(13) TREATMENT OF EDUCATIONALLY-RELATED SERVICES.—(A) Section 1903 of the Social Security Act (42 U.S.C. 1396b) is amended by inserting after subsection (b) the following new subsection:

Children and youth. Handicapped persons.

"(c) Nothing in this title shall be construed as prohibiting or restricting, or authorizing the Secretary to prohibit or restrict, payment under subsection (a) for medical assistance for covered services furnished to a handicapped child because such services are included in the child's individualized education program established pursuant to part B of the Education of the Handicapped Act or furnished to a handicapped infant or toddler because such services are included in the child's individualized family service plan adopted pursuant to part H of such Act.".

Effective date. 42 USC 1396b note.

(B) The amendment made by subparagraph (A) shall take effect on the date of the enactment of this Act.

(14) CLARIFICATION OF TERM "INSTITUTION FOR MENTAL DISEASES".—(A) Section 1905 of the Social Security Act (42 U.S.C. 1396d) is amended by inserting after subsection (h) the following new subsection:

"(i) The term 'institution for mental diseases' means a hospital, nursing facility, or other institution of more than 16 beds, that is primarily engaged in providing diagnosis, treatment, or care of persons with mental diseases, including medical attention, nursing care, and related services.".

(B) The amendment made by subparagraph (A) shall take effect on the date of the enactment of this Act. Effective date. 42 USC 1396d note.

(15) ELIGIBILITY VERIFICATION TECHNICAL CORRECTION.—(A) Section 1137 of the Social Security Act (42 U.S.C. 1320b-7) is amended by adding at the end the following new subsection:

"(f) Subsections (a)(1) and (d) shall not apply with respect to aliens seeking medical assistance for the treatment of an emergency medical condition under section 1903(v)(2).". Aliens.

(B) The amendment made by subparagraph (A) shall apply as if it were included in the enactment of section 9406 of the Omnibus Budget Reconciliation Act of 1986. Effective date. 42 USC 1320b-7 note.

(16) TECHNICAL CORRECTIONS RELATING TO PRESUMPTIVE ELIGIBILITY.—(A) Section 1920(d)(1)(B) of the Social Security Act (42 U.S.C. 1396r-1(d)(1)(B)) is amended by striking "by a qualified provider" and inserting "by a provider that is eligible for payments under the State plan".

(B) Section 1920(b)(2)(D) of such Act (42 U.S.C. 1396r-1(b)(2)(D)) is amended—

(i) in clause (i)—

(I) in subclause (I), by striking "or section 330" and inserting ", 330, or 340" and by striking "or" at the end,

(II) in subclause (II), by striking the semicolon at the end and inserting ", or", and

(III) by adding after subclause (II) the following new subclause:

"(III) title V of the Indian Health Care Improvement Act;";

(ii) in clause (ii), by striking "or" at the end; and

(iii) by adding at the end the following new clause:

"(iv) is the Indian Health Service or is a health program or facility operated by a tribe or tribal organization under the Indian Self-Determination Act (Public Law 93-638).". Indians.

(C) The amendments made by this paragraph shall be effective as if they were included in section 9407(b) of the Omnibus Budget Reconciliation Act of 1986. Effective date. 42 USC 1396r-1 note.

(17) WAIVER FOR CHILDREN INFECTED WITH AIDS OR DRUG DEPENDENT AT BIRTH.—(A) Section 1915 of the Social Security Act (42 U.S.C. 1396n) is amended—

(i) by redesignating subsection (f) as paragraph (2);

(ii) in subsection (e), by striking paragraph (2) and by redesignating such subsection as subsection (f);

(iii) by inserting after subsection (d) the following new subsection:

"(e)(1)(A) Subject to paragraph (2), the Secretary shall grant a waiver to provide that a State plan approved under this title shall include as 'medical assistance' under such plan payment for part or all of the cost of nursing care, respite care, physicians' services, prescribed drugs, medical devices and supplies, transportation services, and such other services requested by the State as the Secretary may approve which are provided pursuant to a written plan of care to a child described in subparagraph (B) with respect to whom there has been a determination that but for the provision of such services the infants would be likely to require the level of care provided in a State and local governments. Prescription drugs. Children and youth. Transportation.

hospital or nursing facility the cost of which could be reimbursed under the State plan.

"(B) Children described in this subparagraph are individuals under 5 years of age who—

AIDS.

"(i) at the time of birth were infected with (or tested positively for) the etiologic agent for acquired immune deficiency syndrome (AIDS),

"(ii) have such syndrome, or

Drugs and drug abuse.

"(iii) at the time of birth were dependent on heroin, cocaine, or phencyclidine,

and with respect to whom adoption or foster care assistance is (or will be) made available under part E of title IV.

State and local governments.
Public health and safety.

"(2) A waiver shall not be granted under this subsection unless the State provides assurances satisfactory to the Secretary that—

"(A) necessary safeguards (including adequate standards for provider participation) have been taken to protect the health and welfare of individuals provided services under the waiver and to assure financial accountability for funds expended with respect to such services;

"(B) under such waiver the average per capita expenditure estimated by the State in any fiscal year for medical assistance provided with respect to such individuals does not exceed 100 percent of the average per capita expenditure that the State reasonably estimates would have been made in that fiscal year for expenditures under the State plan for such individuals if the waiver had not been granted; and

"(C) the State will provide to the Secretary annually, consistent with a data collection plan designed by the Secretary, information on the impact of the waiver granted under this subsection on the type and amount of medical assistance provided under the State plan and on the health and welfare of recipients.

"(3) A waiver granted under this subsection may include a waiver of the requirements of section 1902(a)(1) (relating to statewideness) and section 1902(a)(10)(B) (relating to comparability). A waiver under this subsection shall be for an initial term of 3 years and, upon the request of a State, shall be extended for additional five-year periods unless the Secretary determines that for the previous waiver period the assurances provided under paragraph (2) have not been met.

"(4) The provisions of paragraph (6) of subsection (d) shall apply to this subsection in the same manner as it applies to subsection (d)."; and

(iv) in subsection (h), by striking "or (d)" and inserting "(d), or (e)".

(B) Section 1902(a)(10)(A)(ii)(VI) of such Act (42 U.S.C. 1396a(a)(10)(A)(ii)(VI)) is amended by striking "(c) or (d)" each place it appears and inserting "(c), (d), or (e)".

(l) CORRECTIONS RELATING TO SUBTITLE C OF TITLE IV (NURSING HOME REFORM).—

42 USC 1395i-3.

(1) SECTION 4201.—(A) Section 1819 of the Social Security Act, as added by section 4201(a)(3) of OBRA, is amended—

(i) in subsection (b)(3)(C)(i)(I), by striking "October 1, 1990" the second place it appears and inserting "January 1, 1991";

(ii) in subsection (b)(4)(C)(i)—

(I) by inserting "licensed" after "24-hour",

(II) by striking "employ" and inserting "use", and

(III) by striking "during the day tour of duty (of at least 8 hours a day)" and inserting "at least 8 consecutive hours a day,";

(iii) in subsection (b)(5)(A), by striking "October 1, 1989" and all that follows through "July 1, 1989)" and inserting "January 1, 1990";

(iv) in subsection (e)(1)(A), by striking "March 1, 1989" and inserting "January 1, 1989";

(v) in subsection (e)(1)(B), by striking "March 1, 1990" and inserting "January 1, 1990";

(vi) in subsection (e)(2)(A), by striking "March 1, 1989" and inserting "January 1, 1989";

(vii) in subsection (e)(3), by striking "October 1, 1990" and inserting "October 1, 1989";

(viii) in subsection (e)(5), by striking "July 1, 1989" and inserting "July 1, 1990";

(ix) in subsection (f)(3), by striking "October 1, 1989" and inserting "October 1, 1988";

(x) in subsection (f)(6)(A), by striking "July 1, 1989" and inserting "January 1, 1989"; and

(xi) in subsection (f)(6)(B), by striking "October 1, 1990" and inserting "April 1, 1990".

(B) Section 4201(d) of OBRA is amended— 42 USC 1395x.

(i) by striking "AMENDMENT.—" and inserting "AMENDMENTS.—(1)",

(ii) by striking "1919(a)(2)" and inserting "1819(a)(1)", and

(iii) by adding at the end the following new paragraph:

"(2) Section 1861(n) of such Act (42 U.S.C. 1395x(n)) is amended by striking 'or (j)(1) of this section' and inserting 'or of section 1819(a)(1)'.".

(2) SECTIONS 4201 AND 4211.—(A) Sections 1819(b)(3)(A)(iv) and 1919(b)(3)(A)(iv) of the Social Security Act, as added by section 4201(a)(3) and as inserted by section 4211(a)(3) of OBRA, respectively, are amended by striking "in the case of a resident eligible for benefits under part A of this title" and by striking "in the case of a resident eligible for benefits under part A of title XVIII", respectively. 42 USC 1395i-3, 1396r.

(B) Sections 1819(b)(3)(A)(iii) and 1919(b)(3)(A)(iii) of the Social Security Act, as added by section 4201(a)(3) and as inserted by section 4211(a)(3) of OBRA, respectively, are amended by striking "in the case of a resident eligible for benefits under title XIX," and "in the case of a resident eligible for benefits under this title,", respectively.

(C) Subclause (III) of each of sections 1819(b)(3)(B)(ii) and 1919(b)(3)(B)(ii) of the Social Security Act, as added by section 4201(a)(3) and as inserted by section 4211(a)(3) of OBRA, respectively, is amended to read as follows:

"(III) The provisions of section 1128A (other than subsections (a) and (b)) shall apply to a civil money penalty under this clause in the same manner as such provisions apply to a penalty or proceeding under section 1128A(a).".

(D) Sections 1819(b)(5) and 1919(b)(5) of the Social Security Act, as added by section 4201(a)(3) of OBRA and as inserted by section 4211(a)(3) of OBRA, respectively, are each amended—

(i) in subparagraph (A), by striking ", who is not a licensed health care professional (as defined in subparagraph (E)),",

(ii) in subparagraph (A)(ii), by striking "such services" and inserting "nursing or nursing-related services", and

(iii) in subparagraph (G), by inserting "physical or occupational therapy assistant," after "occupational therapist,".

Effective date. 42 USC 1395x note. 42 USC 1395x.

(E) Effective as of the date of the enactment of this Act and until the effective date of section 1819(c) of such Act, section 1861(j) of the Social Security Act is deemed to include the requirement described in section 1819(c)(3)(A) of such Act (as added by section 4201(a)(3) of OBRA).

42 USC 1395i-3, 1396r.

(F) Sections 1819(c)(2)(A)(v) and 1919(c)(2)(A)(v) of the Social Security Act, as added by section 4201(a)(3) and as inserted by section 4211(a)(3) of OBRA, respectively, are each amended by striking "an allowable charge" and all that follows through the semicolon and inserting "for a stay at the facility;".

(G) Sections 1819(c)(6) and 1919(c)(6) of the Social Security Act, as added by section 4201(a)(3) and as inserted by section 4211(a)(3) of OBRA, respectively, are each amended—

(i) in subparagraph (A)(ii), by striking "once the facility accepts" and inserting "upon", and

(ii) in subparagraph (B), by striking "a facility's acceptance of".

(H) Sections 1819(e)(2)(B) and 1919(e)(2)(B) of the Social Security Act, as added by section 4201(a)(3) and as inserted by section 4211(a)(3) of OBRA, respectively are each amended by inserting after the first sentence the following sentence: "The State shall make available to the public information in the registry.".

State and local governments. Public information. Records.

(I) Sections 1819(e)(3), 1819(f)(3), 1919(e)(3), and 1919(f)(3) of the Social Security Act, as added by section 4201(a)(3) and as inserted by section 4211(a)(3) of OBRA, are each amended—

(i) by inserting "AND DISCHARGES" after "TRANSFERS", and

(ii) by inserting "and discharges" after "transfers".

(J) Sections 1819(f)(2)(A)(i)(I) and 1919(f)(2)(A)(i)(I) of the Social Security Act, as added by section 4201(a)(3) and as inserted by section 4211(a)(3) of OBRA, respectively, are each amended by striking "cognitive, behavioral and social care" and inserting "recognition of mental health and social service needs".

(K) Sections 1819(f)(7) and 1919(f)(7) of the Social Security Act, as added by section 4201(a)(3) and as inserted by section 4211(a)(3) of OBRA, respectively, are each amended by striking "patients" and inserting "residents".

(L)(i) Section 1819(f)(7)(B) of the Social Security Act, as added by section 4201(a)(3), is amended by striking "shall not" and inserting "shall".

(ii) Section 1919(f)(7)(B) of the Social Security Act, as inserted by section 4211(a)(3) of OBRA, is amended by striking "do not".

(3) SECTION 4211.—(A) Section 1919(b)(4)(C) of the Social Security Act, as inserted by section 4211(a) of OBRA, is amended—

(i) by striking "registered nurse" each place it appears and inserting "registered professional nurse";

(ii) by striking "employ" and inserting "use";

(iii) by striking "(ii) FACILITY WAIVERS.—" and all that follows through "(i) WAIVER" and inserting "(ii) WAIVER";

(iv) by striking "and subject to clause (ii)" and inserting "and subject to clause (iii)";

(v) by striking "(ii) ASSUMPTION" and inserting "(iii) ASSUMPTION"; and

(vi) in clause (iii), as so redesignated, by striking "excercise" and inserting "exercise".

(B) Section 1919(b)(5)(A) of the Social Security Act, as added by section 4211(a)(3) of OBRA, is amended by striking "subparagraph (E)" and inserting "subparagraph (F)". 42 USC 1396r.

(C) Effective as of the date of the enactment of this Act and until the effective date of section 1919(c) of such Act, section 1905(c) of the Social Security Act is deemed to include the requirement described in section 1919(c)(3)(A) of such Act (as inserted by section 4211(a)(3) of OBRA). Effective date. 42 USC 1396d.

(D) Section 1919 of the Social Security Act, as inserted by section 4211(a)(3) of OBRA, is amended—

(i) in subsection (e)(1)(A), by striking "September 1, 1988" and inserting "January 1, 1989";

(ii) in subsection (e)(1)(B), by striking "September 1, 1990" and inserting "January 1, 1990";

(iii) in subsection (e)(7)(E), by striking "October 1, 1988" and inserting "April 1, 1989"; and

(iv) in subsection (f)(2), by striking "July 1, 1988" and inserting "September 1, 1988".

(E) Section 1902(a)(28)(D)(i) of the Social Security Act, as amended by section 4211(b)(1)(B) of OBRA, is amended by striking "1919(f)" and all that follows through "instrument)" and inserting "1919(e)". 42 USC 1396a.

(F) Section 4211(d)(2) of OBRA is amended by striking "For calendar quarters during fiscal years 1988 and 1989" and inserting "For the 8 calendar quarters (beginning with the calendar quarter that begins on July 1, 1988)". Effective date. 42 USC 1396b note.

(G) Section 4211(h)(10)(G) of OBRA is amended by adding before the period at the end the following: ", and by striking 'skilled nursing facility or intermediate care facility' in subparagraph (B) and inserting 'nursing facility' ". 42 USC 1396n.

(H) Section 4211(h)(2) of OBRA is amended— 42 USC 1396a.

(i) in subparagraph (C), by striking "inserting 'nursing facilities' " each place it appears and inserting "inserting 'nursing facilities and for intermediate care facilities for the mentally retarded' ",

(ii) in subparagraph (D)(i), by striking "inserting 'nursing facility' " and inserting "inserting 'nursing facility or intermediate care facility for the mentally retarded' ", and

(iii) in subparagraph (D)(ii), by striking "inserting 'nursing facility' " and inserting "inserting 'nursing facility services or services in an intermediate care facility for the mentally retarded' ".

(I) Subparagraph (B) of section 4211(h)(12) of OBRA is amended to read as follows: 42 USC 1396p.

"(B) in subsection (c)(2)(B)(ii), by striking 'skilled' each place it appears.".

(4) SECTION 4202.—Section 1819(g)(2)(C)(i) of the Social Security Act, as added by section 4202(a) of OBRA, is amended by striking "October 1, 1990" and inserting "January 1, 1990". 42 USC 1395i-3.

(5) SECTIONS 4202 AND 4212.—Sections 1819(g) and 1919(g) of the Social Security Act, as added by sections 4202(a)(2) and 4212(a) of OBRA, respectively, are amended—

42 USC 1395i-3, 1396r.

(A) in paragraph (1)(C), by striking ", review," and inserting "and timely review";

(B) in the first sentence of paragraph (1)(C), by inserting "or by another individual used by the facility in providing services to such a resident" after "a nursing facility";

(C) by striking the second sentence of paragraph (1)(C) and inserting the following: "The State shall, after notice to the individual involved and a reasonable opportunity for a hearing for the individual to rebut allegations, make a finding as to the accuracy of the allegations. If the State finds that a nurse aide has neglected or abused a resident or misappropriated resident property in a facility, the State shall notify the nurse aide and the registry of such finding. If the State finds that any other individual used by the facility has neglected or abused a resident or misappropriated resident property in a facility, the State shall notify the appropriate licensure authority.";

State and local governments. Health care professionals.

(D) in paragraph (1)(D), by striking "to establish standards under subsection (f)" and inserting "to issue regulations to carry out this subsection";

(E) in paragraph (2)(A)(i), by amending the third sentence to read as follows: "The provisions of section 1128A (other than subsections (a) and (b)) shall apply to a civil money penalty under the previous sentence in the same manner as such provisions apply to a penalty or proceeding under section 1128A(a).";

(F) in paragraph (3)(D) (relating to special surveys of compliance, as redesignated by paragraph (6)(A) in the case of section 1919(g)), by striking "on that basis" and inserting "on the basis of that survey"; and

(G) in paragraph (4), by striking "chronically".

(6) SECTION 4212.—(A) Section 1919(g)(3) of the Social Security Act, as added by section 4212(a) of OBRA, is amended by redesignating the second subparagraph (C) (relating to special surveys of compliance) as subparagraph (D).

42 USC 1395aa, 1396r.

(B) Section 4212(b) of OBRA is amended to read as follows:

"(b) POSTING SURVEY RESULTS.—Section 1919(c) of such Act is amended by adding at the end the following new paragraph:

"'(7) POSTING OF SURVEY RESULTS.—A nursing facility must post in a place readily accessible to residents, and family members and legal representatives of residents, the results of the most recent survey of the facility conducted under subsection (g).'".

42 USC 1396a.

(C) Section 1902(a)(33)(B) of the Social Security Act, as amended by section 4212(d)(3) of OBRA, is amended by striking "1919(d)" and inserting "1919(g)".

42 USC 1396a.

(D) Section 4212(e)(1)(B) of OBRA is amended by inserting "provided" after "services" each place it appears.

(E) Section 4212(e) of OBRA is amended by adding at the end the following new paragraph:

42 USC 1396r-3.

"(5) Section 1922(e) of such Act, as redesignated and transferred by section 4211(a)(2) of this Act, is amended by striking '1910(c)' in paragraphs (1) and (2)(A) and inserting '1910(b)'.".

(7) SECTIONS 4203 AND 4213.—(A) Sections 1819(h)(2)(B)(ii) and 1919(h)(3)(C)(ii) of the Social Security Act, as added by sections 4203(a)(2) and 4213(a) of OBRA, respectively, are each amended by striking "and the Secretary" and all that follows through "1128A." and inserting the following: ". The provisions of section 1128A (other than subsections (a) and (b)) shall apply to a civil money penalty under the previous sentence in the same manner as such provisions apply to a penalty or proceeding under section 1128A(a).". 42 USC 1395i-3, 1396r.

(B) Sections 1819(h)(6) and 1919(h)(9) of the Social Security Act, as added by sections 4203(a)(2) and 4213(a) of OBRA, respectively, are each amended by inserting "by such facilities" after "shall be made available".

(8) SECTION 4213.—(A) Section 4213(a) of OBRA is amended by striking "as inserted by section 4201 and amended by section 4202" and inserting "as inserted by section 4211 and amended by section 4212". 42 USC 1396r.

(B) Section 1919(h) of the Social Security Act, as added by section 4213(a) of OBRA, is amended—

(i) in the last sentence of paragraph (1), by striking "(2)(A)(i)" and inserting "(2)(A)(ii)",

(ii) in the second sentence of paragraph (2)(B)(i), by striking "or otherwise", and

(iii) in paragraph (5), by striking "State and the Secretary" and inserting "State or the Secretary, respectively".

(C) Paragraph (1) of section 4213(b) of OBRA is amended by striking "1902" and all that follows through the end and inserting the following: "1902(i) of such Act (42 U.S.C. 1396a(i)) is amended— 42 USC 1396a.

"(A) in paragraph (1), by striking 'skilled nursing facility or intermediate care facility' and inserting 'intermediate care facility for the mentally retarded';

"(B) in paragraph (1), by striking 'the provisions of section 1861(j) or section 1905(c), respectively,' and inserting 'the requirements for such a facility under this title'; and

"(C) in paragraphs (2) and (3), by striking 'the provisions of section 1861(j) or section 1905(c) (as the case may be)' and inserting 'the requirements for such a facility under this title'.".

(9) SECTION 4204.—(A) Section 4204(a) of OBRA is amended by striking "extended care". 42 USC 1395i-3 note.

(B) Section 4204 of OBRA is amended—

(i) in subsection (a), by striking "made by this part" and inserting "made by sections 4201 and 4202 (relating to skilled nursing facility requirements and survey and certification requirements)",

(ii) by redesignating subsection (c) as subsection (d), and

(iii) by inserting after subsection (a) the following new subsection:

"(b) ENFORCEMENT.—(1) Except as otherwise specifically provided in section 1819 of the Social Security Act, the amendments made by section 4203 of this Act apply January 1, 1988, without regard to whether regulations to implement such amendments are promulgated by such date. Effective date.

"(2) In applying the amendments made by section 4203 of this Act for services furnished by a skilled nursing facility before October 1, 1990, any reference to a requirement of subsection (b), (c), or (d), of section 1819 of the Social Security Act is deemed a reference to the provisions of section 1861(j) of such Act.".

42 USC 1396r note.

(10) SECTION 4214.—Section 4214 of OBRA is amended—

(A) by striking "(c) TRANSITIONAL RULE.—" and inserting "(2)",

(B) by inserting "of section 1919 of the Social Security Act" after "(b), (c), or (d)", and

(C) by redesignating subsection (d) as subsection (c).

(m) CORRECTIONS TO SUBTITLE E OF TITLE IV (RELATING TO RURAL HEALTH).—

Rural areas. 42 USC 912.

(1) SECTION 4401.—Section 711(b)(1) of the Social Security Act, as added by section 4401 of OBRA, is amended by striking "section 4083 of the Omnibus Budget Reconciliation Act of 1987" and inserting "section 4403 of the Omnibus Budget Reconciliation Act of 1987 (as such section pertains to rural health issues)".

42 USC 1395b-1 note.

(2) SECTION 4403.—(A) Section 4403 of OBRA is amended—

(i) in the heading, by striking "EXPERIMENTS AND DEMONSTRATION PROJECTS RELATING TO RURAL HEALTH CARE ISSUES" and inserting "RESEARCH AND DEMONSTRATION PROJECTS ON RURAL AND INNER-CITY HEALTH ISSUES";

(ii) in subsection (a)—

(I) by striking "SET ASIDE.—" and inserting "SET ASIDES FOR ISSUES OF HEALTH CARE IN RURAL AREAS AND IN INNER-CITY AREAS.—(1)",

(II) by striking "expended in each fiscal year" and all that follows through "1972" and inserting "annually appropriated to, and expended by, the Health Care Financing Administration for the conduct of research and demonstration projects in fiscal years 1988, 1989, and 1990",

(III) by striking "experiments" and inserting "research";

(iii) by adding at the end the following new paragraph:

Research and development. Urban areas.

"(2) Not less than ten percent of the total amounts annually appropriated to, and expended by, the Health Care Financing Administration for the conduct of research and demonstration projects in fiscal years 1988, 1989, and 1990 shall be expended for research and demonstration projects relating exclusively or substantially to issues of providing health care in inner-city areas, including (but not limited to) the impact of the payment methodology under section 1886(d) of the Social Security Act on the financial viability of inner-city hospitals and the impact of medicare policies on access to (and the quality of) health care in inner-city areas."; and

(iv) in subsection (b)—

(I) by striking "of experiments" and inserting "of research",

(II) by inserting "or to inner-city health issues" after "rural health issues", and

(III) by striking "experiments and".

(B) The item in the table of contents of OBRA relating to section 4403 is amended to read as follows:

"Sec. 4403. Set aside for research and demonstration projects on rural and inner-city health issues.".

(n) CORRECTIONS TO CERTAIN HEALTH-RELATED PROVISIONS IN TITLE IX.—

(1) SECTION 9010.—The last sentence of section 226(b) of the Social Security Act, as added by section 9010(e)(3) of OBRA, is amended to read as follows: "In determining when an individual's entitlement or status terminates for purposes of the preceding sentence, the term '36 months' in the second sentence of section 223(a)(1), in section 202(d)(1)(G)(i), in the last sentence of section 202(e)(1), and in the last sentence of section 202(f)(1) shall be applied as though it read '15 months'.". 42 USC 426.

(2) SECTION 9115.—Section 9115(b) of OBRA is amended by striking "1902(l)" and inserting "1902(o)". 42 USC 1396a.

(3) SECTION 9119.—Section 9119 of OBRA is amended by adding at the end the following new subsection:

"(d) CONFORMING AMENDMENTS TO MEDICAID PROGRAM FOR THE MEDICALLY NEEDY.—(1) Section 1902 of the Social Security Act (42 U.S.C. 1396a) is amended—

"(A) in subsection (a)—

"(i) by striking 'and' at the end of paragraph (48),

"(ii) by striking the period at the end of paragraph (49) and inserting '; and', and

"(iii) by inserting after paragraph (49) the following new paragraph:

" '(50) provide, in accordance with subsection (q), for a monthly personal needs allowance for certain institutionalized individuals and couples.'; and

"(B) by adding at the end the following new subsection:

" '(q)(1)(A) In order to meet the requirement of subsection (a)(50), the State plan must provide that, in the case of an institutionalized individual or couple described in subparagraph (B), in determining the amount of the individual's or couple's income to be applied monthly to payment for the cost of care in an institution, there shall be deducted from the monthly income (in addition to other allowances otherwise provided under the State plan) a monthly personal needs allowance— State and local governments.

" '(i) which is reasonable in amount for clothing and other personal needs of the individual (or couple) while in an institution, and

" '(ii) which is not less (and may be greater) than the minimum monthly personal needs allowance described in paragraph (2).

" '(B) In this subsection, the term "institutionalized individual or couple" means an individual or married couple—

" '(i) who is an inpatient (or who are inpatients) in a medical institution or nursing facility for which payments are made under this title throughout a month, and

" '(ii) who is or are determined to be eligible for medical assistance under the State plan.

" '(2) The minimum monthly personal needs allowance described in this paragraph is $30 for an institutionalized individual and $60 for an institutionalized couple (if both are aged, blind, or disabled, and their incomes are considered available to each other in determining eligibility).'. Blind persons. Handicapped persons.

"(2) The amendments made by paragraph (1) apply to payments under title XIX of the Social Security Act for calendar quarters beginning on or after July 1, 1988, without regard to whether or not Effective date. 42 USC 1396a note.

final regulations to carry out such amendments have been promulgated by such date.".

(o) SUBTITLE D OF TITLE IV.—

(1) SECTION 4303.—Section 2115 of the Public Health Service Act is amended—

42 USC 300aa-15.

(A) in subsection (i)(1), as added by section 4303(a) of OBRA, by striking "from appropriations under subsection (i)" and inserting "by the Secretary from appropriations under subsection (j)", and

(B) in subsection (j), as added by section 4303(b) of OBRA, by inserting "to the Department of Health and Human Services" after "to be appropriated".

42 USC 300aa-12.

(2) SECTION 4307.—Section 4307(3)(C) of OBRA is amended by striking "subsection (g)" and inserting "subsection (e), as redesignated by section 4303(d)(2)(A),".

(3) SECTION 4308.—(A) Subtitle D of title IV of OBRA is amended by adding at the end the following new section:

"SEC. 4308. TECHNICAL AMENDMENTS RELATING TO COURT OF CLAIMS PROCEDURES.

"(a) DUTIES OF SPECIAL MASTERS.—Section 2112(c)(2) of the Public Health Service Act (42 U.S.C. 300aa-12(a)) is amended—

"(1) by inserting ', shall prepare and submit to the court proposed findings of fact and conclusions of law,' after 'adjunct to the court',

"(2) by inserting 'and' at the end of subparagraph (C),

"(3) by striking ', and' at the end of subparagraph (D) and inserting a period, and

"(4) by striking subparagraph (E).

"(b) REQUIRING FILING OF APPEALS WITHIN 60 DAYS.—Section 2112(e) of such Act (42 U.S.C. 300aa-12(e)), as redesignated by section 4303(d)(2)(A), is amended by inserting 'within 60 days of the date of the judgment' after 'petition filed'.

"(c) CLARIFICATION ON TIMING OF BRINGING ADDITIONAL ACTIONS.—The second sentence of section 2121(a) of such Act (42 U.S.C. 300aa-21(a)) is amended by striking 'the entry of the court's judgment' and inserting 'the court's final judgment'.".

(B) The table of contents relating to title IV of OBRA is amended by inserting after the item relating to section 4307 the following new item:

"Sec. 4308. Technical amendments relating to Court of Claims procedures.".

Subtitle C—Miscellaneous Provisions

Employment and unemployment.
42 USC 1395b note.

SEC. 421. MAINTENANCE OF EFFORT.

(a) IN GENERAL.—

(1) DUPLICATIVE PART A BENEFITS.—If an employer described in subsection (b)(1) provides, as of the date of the enactment of this Act, health care benefits to an employee or retired former employee that are duplicative part A benefits (as defined in paragraph (3)(A)), the employer shall, during the period described in subsection (c)(1), provide to the employee or retired former employee an amount of additional benefits or refunds, or combination of such benefits and refunds, that total at least the

actuarial value of the duplicative part A benefits during the period described in subsection (c)(1)(A).

(2) DUPLICATIVE PART B BENEFITS.—If an employer described in subsection (b)(2) provides, as of the date of the enactment of this Act, health care benefits to an employee or retired former employee that are duplicative part B benefits (as defined in paragraph (3)(B)), the employer shall, during the period described in subsection (c)(2), provide to the employee or retired former employee an amount of additional benefits or refunds, or combination of such benefits and refunds, that total at least the actuarial value of the duplicative part B benefits during the period described in subsection (c)(1)(B).

(3) DUPLICATIVE BENEFITS DEFINED.—In this section:

(A) The term "duplicative part A benefits" means benefits which are duplicative of benefits under part A of title XVIII of the Social Security Act (as amended by this Act as of January 1, 1989), but which were not duplicative of such benefits as such part was in effect before the date of the enactment of this Act.

(B) The term "duplicative part B benefits" means benefits which are duplicative of benefits under part B of title XVIII of the Social Security Act (as amended by this Act as of January 1, 1990, but excluding any such benefits with respect to covered outpatient drugs), but which were not duplicative of such benefits as such part was in effect before the date of the enactment of this Act.

(C) Duplicative part A benefits and duplicative part B benefits shall be determined under this section net of any premiums payable by employees (or retired former employees) attributable to the respective duplicative benefits.

(b) EMPLOYERS COVERED.—

(1) DUPLICATIVE PART A BENEFITS.—An employer is described in this paragraph if the employer (including a public employer, other than an employer to which section 422 applies) provides, as of the date of the enactment of this Act, duplicative part A benefits the actuarial value of which is at least 50 percent of the national average actuarial value (discounted to the value as of the date of the enactment of this Act) of the duplicative part A benefits.

(2) DUPLICATIVE PART B BENEFITS.—An employer is described in this paragraph if the employer (including a public employer, other than an employer to which section 422 applies) provides, as of the date of the enactment of this Act, duplicative part B benefits the actuarial value of which is at least 50 percent of the national average actuarial value (discounted to the value as of the date of the enactment of this Act) of the duplicative part B benefits.

(3) ELECTION.—For purposes of this section—

(A) IN GENERAL.—An employer may elect to compute the actuarial value of duplicative part A benefits and duplicative part B benefits either—

(i) on the basis of average actuarial values published by the Secretary under subparagraph (B)(i), or

(ii) on the basis of the actuarial value with respect to that employer, computed using guidelines published by the Secretary under subparagraph (B)(ii).

(B) COMPUTATION OF ACTUARIAL VALUES.—The Secretary of Health and Human Services, before the beginning of each of 4 years (beginning with 1989 for duplicative part A benefits and beginning with 1990 for duplicative part B benefits) shall—

(i) calculate and publish the national average actuarial value of duplicative part A benefits and duplicative part B benefits for 1988 and the year involved, and

(ii) guidelines for employers to use, under subparagraph (A)(ii), in computing the actuarial value of such duplicative benefits with respect to each employer for such years.

The guidelines published under clause (ii) shall include instructions to assist employers in determining whether or not employers are described in paragraph (1) or (2) of this subsection.

(c) EFFECTIVE PERIOD.—

(1) IN GENERAL.—

(A) DUPLICATIVE PART A BENEFITS.—Subsection (a)(1) shall only be effective during the period beginning on January 1, 1989, and ending on December 31, 1989, or, if later, the date specified in paragraph (2).

(B) DUPLICATIVE PART B BENEFITS.—Subsection (a)(2) shall only be effective during the period beginning on January 1, 1990, and ending on December 31, 1990, or, if later, the date specified in paragraph (2).

(2) EXTENSION TO COVER CURRENT COLLECTIVE BARGAINING AGREEMENTS.—In the case of employees or retired former employees who are provided duplicative part A benefits or duplicative part B benefits under a collective bargaining agreement that is in effect on the date of enactment of this Act, the date specified in this paragraph is the date of the expiration of the agreement (determined without regard to any extension thereof agreed to after the date of the enactment of this Act).

(d) EXCLUSION OF MULTI-EMPLOYER PLANS.—This section shall not apply with respect to duplicative benefits provided under a plan—

(1) to which more than one employer is required to contribute, and

Contracts.

(2) which is maintained pursuant to one or more collective bargaining agreements between one or more employee organizations and more than one employer.

5 USC 8902 note.

SEC. 422. RATE REDUCTION FOR MEDICARE ELIGIBLE FEDERAL ANNUITANTS.

(a) IN GENERAL.—

(1) The Office of Personnel Management shall, in consultation with carriers offering health benefits plans contracted pursuant to section 8902 of title 5, United States Code, reduce the rates charged medicare eligible individuals participating in such health benefit plans, by the amount, prorated for each covered medicare eligible individual, of the estimated cost of medical services and supplies which, but for the amendments made by subtitle A of title I and subtitle A of title II of this Act, would have been payable by such plans.

Effective dates.

(2) The reduced rates as provided under paragraph (1), shall apply as of the effective dates of the respective amendments.

(b) AUTHORIZATION OF AVAILABILITY OF EMPLOYEE HEALTH BENEFITS FUND FOR RATE REDUCTION.—Funds in the Employees Health Benefits Fund established under section 8909 of title 5, United States Code, are available without fiscal year limitation for costs incurred by the Office of Personnel Management in making rate reductions provided under this section.

(c) DEFINITION.—For purposes of this section the term "medicare eligible individual" means any annuitant, survivor of an annuitant, or former spouse of an annuitant—

(1) who is—

(A) otherwise eligible for benefits under chapter 89 of title 5, United States Code;

(B) eligible for benefits under part A of title XVIII of the Social Security Act; and

(C) covered by the insurance program established under part B of such title; and

(2) for whom benefits paid under title XVIII of the Social Security Act are the primary source of health care benefits.

SEC. 423. STUDY AND REPORTS BY THE OFFICE OF PERSONNEL MANAGEMENT ON OFFERING MEDICARE SUPPLEMENTAL PLANS TO FEDERAL MEDICARE ELIGIBLE INDIVIDUALS, AND OTHER CHANGES.

(a) STUDY AND REPORT.—

(1) No later than April 1, 1989, the Director of the Office of Personnel Management shall conduct a study and submit a report to the Committee on Governmental Affairs of the Senate and the Committee on Post Office and Civil Service of the House of Representatives regarding changes to the health benefits program established under chapter 89 of title 5, United States Code, that may be required to incorporate plans designed specifically for medicare eligible individuals and to improve the efficiency and effectiveness of the program.

(2) Any medicare supplemental plan recommended by the Director of the Office of Personnel Management shall not duplicate benefits for which payment may be made under title XVIII of the Social Security Act, however such recommendation—

(A) shall cover expenses which are not payable under such title by reason of deductibles or coinsurance amounts; and

(B) may offer additional reimbursement—

(i) where benefits under such title are limited by fee schedule; and

(ii) for benefits not covered under such title which may be of value to medicare eligible individuals.

(b) FEASIBILITY STUDY AND REPORT.—No later than April 1, 1989, the Director of the Office of Personnel Management shall report to the appropriate committees of the Congress whether it is feasible to adopt such standards as issued by the National Association of Insurance Commissioners as required by section 1882 of the Social Security Act (42 U.S.C. 1395ss) for medicare supplemental policies, when providing medicare supplemental plans as a type of health benefits plan available for Federal employees pursuant to chapter 89 of title 5, United States Code.

Voluntarism.
42 USC 1395b-2 note.

SEC. 424. BENEFITS COUNSELING AND ASSISTANCE DEMONSTRATION PROJECT FOR CERTAIN MEDICARE AND MEDICAID BENEFICIARIES.

(a) TRAINING AND TECHNICAL ASSISTANCE.—

Contracts.

(1) The Secretary of Health and Human Services (in this section referred to as the "Secretary") shall establish a demonstration project through an agreement with a private or public nonprofit agency or organization, which demonstrates, to the satisfaction of the Secretary, that its volunteers are adequately trained and competent to render effective benefits counseling and assistance to the elderly, for the purpose of providing training and technical assistance to prepare volunteers to provide to elderly individuals receiving benefits under title XVIII or XIX of the Social Security Act counseling with respect to eligibility for such benefits and assistance in preparing such documentation as may be required to fully receive such benefits.

(2) In addition to any other forms of technical assistance provided under this subsection, the Secretary is authorized to provide to the project—

(A) material to be used in making elderly persons aware of the availability of assistance under volunteer assistance programs under this section; and

(B) technical materials and publications to be used by such volunteers.

(b) POWERS OF THE SECRETARY.—Under the demonstration project under this section, the Secretary is authorized—

(1) to provide for the training of volunteers, and assist in such training, to insure that volunteers are qualified to provide benefits and counseling assistance (as described in paragraph (1)) to the elderly;

(2) to provide reimbursement to volunteers through the agency or organization for transportation, meals, and other expenses incurred by them in training or providing benefits counseling and assistance under this section, and such other support and assistance as the Secretary determines to be appropriate in carrying out the provisions of this section; and

(3) to provide for the use of services, personnel, and facilities of Federal executive agencies and of State and local public agencies with their consent, with or without reimbursement therefor.

(c) EMPLOYMENT OF VOLUNTEERS.—

(1) Service as a volunteer in the demonstration project carried out under this section shall not be considered service as an employee of the United States. Volunteers under the project shall not be considered Federal employees and shall not be subject to the provisions of law relating to Federal employment, except that the provisions of section 1905 of title 18, United States Code, shall apply to volunteers as if they were employees of the United States.

Taxes.

(2) Amounts received by volunteers serving in any program carried out under this section as reimbursement for expenses are exempt from taxation under chapters 1 and 21 of the Internal Revenue Code of 1986.

(d) DEFINITION.—For purposes of this section, the term "elderly individual" means an individual who has attained the age of 60 years.

(e) AUTHORIZATION OF APPROPRIATIONS.—There are authorized to be appropriated, in appropriate parts from the Federal Hospital Insurance Trust Fund and from the Federal Supplementary Medical Insurance Trust Fund, for fiscal years 1989, 1990, and 1991 such sums as may be necessary to carry out the provisions of this section.

SEC. 425. CASE MANAGEMENT DEMONSTRATION PROJECTS.

Contracts.
42 USC 1395b-1 note.

(a) IN GENERAL.—Within 12 months after the date of the enactment of this Act, the Secretary of Health and Human Services (in this section referred to as the "Secretary") shall establish 4 demonstration projects under which an appropriate entity agrees to provide case management services to medicare beneficiaries with selected catastrophic illnesses, particularly those with high costs of health care services. At least one such demonstration project shall be conducted through an agreement with a utilization and quality control peer review organization with a contract with the Secretary under part B of title XI of the Social Security Act.

(b) PURPOSE OF PROJECTS.—It is the purpose of the demonstration projects established under this section to provide the Secretary and the Congress with the information necessary—

(1) to evaluate the appropriateness of providing case management services under the medicare program for medicare beneficiaries with high costs of medical care, and

(2) to determine the most effective approach to implementing a case management system under the program for such beneficiaries.

(c) AGREEMENT.—The agreement entered into under subsection (a) shall specify—

(1) the high cost cases with respect to which case management services will be provided under the project,

(2) the payments to be made to the entity conducting the project for carrying out the project, and

(3) such other terms and conditions as the Secretary and the entity conducting the project may agree to.

(d) WAIVERS.—The Secretary shall waive—

(1) such provisions of part B of title XI of the Social Security Act, and

(2) such provisions of title XVIII of such Act as relate to limitations or restrictions on benefits under such title,

as the Secretary determines to be appropriate for the conduct of demonstration projects under this section.

(e) DURATION.—

(1) Except as provided in paragraph (2), a demonstration project under this section shall be conducted for a 2-year period.

(2) The Secretary may terminate a demonstration project before the end of the 2-year period specified in paragraph (1) if the Secretary determines that the entity conducting the project is not in substantial compliance with the terms of the agreement entered into under subsection (a).

(f) INFORMATION AND REPORTS.—

(1) An entity with an agreement under subsection (a) shall furnish the Secretary with such information as the Secretary determines to be necessary to evaluate the results of that project.

(2)(A) The Secretary shall submit to the Congress an interim report on the projects conducted under this section based upon information that is derived from the first year of project operations and shall set forth any interim findings, recommendations, and conclusions that the Secretary determines to be appropriate.

(B) The Secretary shall submit to the Congress a final report on the demonstration projects conducted under this section based upon data derived from the projects and shall update the findings, recommendations, and conclusions set forth in the interim report submitted under paragraph (1).

(g) AUTHORIZATION TO USE CERTAIN FUNDS.—The Secretary shall provide for the transfer, from the Federal Hospital Insurance Trust Fund and the Federal Supplementary Insurance Trust Fund in such proportions as the Secretary determines to be appropriate, of not to exceed $2,000,000 in each of 2 fiscal years for administrative costs in carrying out the demonstration projects under this section. Such amounts shall be transferred without regard to amounts appropriated in advance in appropriation Acts.

SEC. 426. EXTENSIONS OF EXPIRING PROVISIONS.

42 USC 1395y note.

(a) HOSPICE WAIVER OF LIABILITY PROVISION.—Section 9305(f)(2) of the Omnibus Budget Reconciliation Act of 1986 is amended by striking "November 1, 1988" and inserting "November 1, 1990".

42 USC 1395y note.

(b) SKILLED NURSING FACILITY WAIVER OF LIABILITY PRESUMPTION.—The second sentence of section 9126(c) of the Consolidated Omnibus Budget Reconciliation Act of 1985 is amended—

(1) by striking "30-month", and

(2) by inserting before the period at the end the following: "and ending on October 31, 1990".

42 USC 1395pp note.

(c) HOME HEALTH SERVICES WAIVER OF LIABILITY PRESUMPTION.—Section 9305(g)(3) of the Omnibus Budget Reconciliation Act of 1986 is amended by striking "October 1, 1989" and inserting "November 1, 1990".

42 USC 1395y note.

(d) HOME HEALTH WAIVER OF LIABILITY PRESUMPTION.—The second sentence of section 9205 of the Consolidated Omnibus Budget Reconciliation Act of 1985 is amended by striking all that follows "until" and inserting "November 1, 1990.".

42 USC 1395ww note.

(e) PROHIBITION ON NEW COST-SAVING REGULATIONS.—Section 4039(d) of the Omnibus Budget Reconciliation Act of 1987 is amended—

(1) by striking "October 15, 1988" and inserting "October 15, 1989", and

(2) by inserting "or in fiscal year 1990" after "in fiscal year 1989".

42 USC 1395h note.

SEC. 427. ADVISORY COMMITTEE ON MEDICARE HOME HEALTH CLAIMS.

(a) ESTABLISHMENT.—The Administrator of the Health Care Financing Administration (in this section referred to as the "Administrator") shall, within 90 days after the date of the enactment of this Act, establish an advisory committee to be known as the Advisory Committee on Medicare Home Health Claims (in this section referred to as the "Advisory Committee").

(b) MEMBERSHIP.—The Advisory Committee shall be composed of 11 members appointed by the Administrator for the life of the Committee. Of the members appointed—

(1) at least 5 shall be representatives of home health or visiting nurse agencies, and

(2) the remaining members shall be representative of fiscal intermediaries, physician groups, and senior citizen groups, but

no more than 3 of such members may be representative of fiscal intermediaries.

Members shall be appointed so as to be representative of all geographic areas of the United States.

(c) DUTIES.—The Advisory Committee shall study the reasons for the increase in the denial of claims for home health services during 1986 and 1987, the ramifications of such increase, and the need to reform the process involved in such denials.

(d) REPORT.—The Advisory Committee shall report to the Administrator, the Committees on Ways and Means and Energy and Commerce of the House of Representatives, and the Committee on Finance of the Senate, not later than one year after the date of the enactment of this Act, on its study under subsection (c), the findings of its study, and its recommendations for changes in the regulations under title XVIII of the Social Security Act as they relate to denial of claims for home health services.

(e) MISCELLANEOUS PROVISIONS.—

(1) The Advisory Committee shall elect one of its members to serve as Chairman.

(2)(A) A majority of the members of the Advisory Committee shall constitute a quorum for the transaction of business.

(B) The Advisory Committee shall meet at the call of the Chairman, or at the call of a majority of its members.

(3) Members of the Advisory Committee shall serve without compensation, but shall be entitled to reimbusement for travel, subsistence, and other necessary expenses incurred in the performance of their duties as members of the Committee.

(4) The Advisory Committee may appoint and fix the compensation of such personnel as it deems advisable, in accordance with the provisions of title 5, United States Code, governing appointments to the competitive service, and the provisions of chapter 51 and subchapter III of chapter 53 of such title, relating to classification and General Schedule pay rates.

(5) In carrying out its duties, the Advisory Committee is authorized to hold such hearings, sit and act at such times and places, and take such testimony, with respect to matters for which is has a responsibility under this section, as the Committee may deem advisable.

(6) The Advisory Committee may secure directly from any department or agency of the United States such data and information as may be necessary to carry out its responsibilities. Upon request of the Committee, any such department or agency shall furnish any such data or information.

(7) The General Services Administration shall provide to the Commission, on a reimbursable basis, such administrative support services as the Advisory Committee may request.

(f) AUTHORIZATION OF APPROPRIATIONS.—There are authorized to be appropriated such sums as may be necessary to carry out this section.

SEC. 428. PROHIBITION OF MISUSE OF SYMBOLS, EMBLEMS, OR NAMES IN REFERENCE TO SOCIAL SECURITY OR MEDICARE.

(a) IN GENERAL.—Part A of title XI is amended by adding at the end the following new section:

"PROHIBITION OF MISUSE OF SYMBOLS, EMBLEMS, OR NAMES IN REFERENCE TO SOCIAL SECURITY OR MEDICARE

Law enforcement and crime.
42 USC 1320b-10.

"SEC. 1140. (a) No person may use, in connection with any item constituting an advertisement, solicitation, circular, book, pamphlet, or other communication, or a play, motion picture, broadcast, telecast, or other production, alone or with other words, letters, symbols, or emblems—

"(1) the words 'Social Security', 'Social Security Account', 'Social Security System', 'Social Security Administration', 'Medicare', 'Health Care Financing Administration', the letters 'SSA' or 'HCFA', or any other combination or variation of such words or letters, or

"(2) a symbol or emblem of the Social Security Administration (including the design of, or a reasonable facsimile of the design of, the social security card issued pursuant to section 205(c)(2)(E), the check used for payment of benefits under title II, or envelopes or other stationery used by the Social Security Administration) or of the Health Care Financing Administration, or any other combination or variation of such symbols or emblems,

in a manner which such person knows or should know would convey the false impression that such item is approved, endorsed, or authorized by the Social Security Administration, the Health Care Financing Administration, or the Department of Health and Human Services or that such person has some connection with, or authorization from, the Social Security Administration, the Health Care Financing Administration, or the Department of Health and Human Services.

"(b)(1) Subject to paragraph (2), the Secretary may, pursuant to regulations, impose a civil money penalty not to exceed—

"(A) except as provided in subparagraph (B), $5,000, or

"(B) in the case of a violation consisting of a broadcast or telecast, $25,000,

against any person for each violation by such person of subsection (a).

"(2) The total amount of penalties which may be imposed under paragraph (1) with respect to multiple violations in any one year period consisting of substantially identical communications or productions shall not exceed $100,000.

"(c)(1) Subsections (c), (d), (e), (g), (j), and (k) of section 1128A shall apply with respect to violations under subsection (a) and penalties imposed under subsection (b) in the same manner and to the same extent as such subsections apply with respect to claims in violation of section 1128A and penalties imposed under section 1128A(a).

Claims.

"(2) Penalties imposed against a person under subsection (b) may be compromised by the Secretary and may be recovered in a civil action in the name of the United States brought in the district court of the United States for the district in which the violation occurred or where the person resides, has its principal office, or may be found, as determined by the Secretary. Amounts recovered under this section shall be paid to the Secretary and shall be deposited as miscellaneous receipts of the Treasury of the United States. The amount of such penalty when finally determined, or the amount agreed upon in compromise, may be deducted from any sum then or later owing by the United States to the person against whom the penalty has been imposed.".

(b) AUTHORIZING CIVIL MONEY PENALTIES FOR CERTAIN VIOLATIONS RELATING TO MEDICAL SUPPLEMENTAL POLICIES.—Section 1882(d) (42 U.S.C. 1395ss(d)) is amended—

(1) by striking "shall be guilty" and all that follows through "or both" in each of paragraphs (1), (2), (3)(A), and (4)(A), and inserting in each case the following: "shall be fined under title 18, United States Code, or imprisoned not more than 5 years, or both, and, in addition to or in lieu of such a criminal penalty, is subject to a civil money penalty of not to exceed $5,000 for each such prohibited act", and

(2) by adding at the end the following new paragraph:

"(5) The provisions of section 1128A (other than subsections (a) and (b)) shall apply to civil money penalties under paragraphs (1), (2), (3)(A), and (4)(A) in the same manner as such provisions apply to penalties and proceedings under section 1128A(a).".

(c) EFFECTIVE DATE.—The amendments made by this section shall take effect on the date of the enactment of this Act and shall apply only with respect to violations occurring on or after such date. 42 USC 1320b-10 note.

SEC. 429. DEMONSTRATION PROJECTS WITH RESPECT TO CHRONIC VENTILATOR-DEPENDENT UNITS IN HOSPITALS. 42 USC 1395b-1 note.

(a) IN GENERAL.—The Secretary of Health and Human Services shall provide for up to 5 demonstration projects, for up to 3 years each, to review the appropriateness of classifying chronic ventilator-dependent units in hospitals as rehabilitation units. Such projects shall be conducted in consultation with the Prospective Payment Assessment Commission.

(b) WAIVER AUTHORITY.—In conducting demonstration projects under this section for units, the Secretary may treat such a unit as a rehabilitation unit described in section 1886(d)(1)(B) of the Social Security Act for purposes of such section.

Approved July 1, 1988.

LEGISLATIVE HISTORY—H.R. 2470 (S. 1127):

HOUSE REPORTS: No. 100-105, Pt. 1 (Comm. on Ways and Means) and Pt. 2 (Comm. on Energy and Commerce), and No. 100-661 (Comm. of Conference).
SENATE REPORTS: No. 100-126 accompanying S. 1127 (Comm. on Finance).
CONGRESSIONAL RECORD:
Vol. 133 (1987): July 22, considered and passed House.
Oct. 9, 13, 23, S. 1127 considered in Senate.
Oct. 27, H.R. 2470 considered and passed Senate, amended, in lieu of S. 1127.
Vol. 134 (1988): June 2, House agreed to conference report.
June 8, Senate agreed to conference report.
WEEKLY COMPILATION OF PRESIDENTIAL DOCUMENTS, Vol. 24 (1988):
July 1, Presidential statement.

100TH CONGRESS 2d Session } HOUSE OF REPRESENTATIVES { REPORT 100-661

MEDICARE CATASTROPHIC COVERAGE ACT OF 1988

MAY 31, 1988.—Ordered to be printed

Mr. ROSTENKOWSKI, from the committee of conference, submitted the following

CONFERENCE REPORT

[To accompany H.R. 2470][1]

JOINT EXPLANATORY STATEMENT OF THE COMMITTEE OF CONFERENCE

The managers on the part of the House and the Senate at the conference on the disagreeing votes of the two Houses on the amendment of the Senate to the bill (H.R. 2470) to amend title XVIII of the Social Security Act to provide protection against catastrophic medical expenses under the medicare program, and for other purposes, submit the following joint statement to the House and the Senate in explanation of the effect of the action agreed upon by the managers and recommended in the accompanying conference report:

The Senate amendment struck out all of the House bill after the enacting clause and inserted a substitute text.

The House recedes from its disagreement to the amendment of the Senate with an amendment which is a substitute for the House bill and the Senate amendment. The differences between the House bill, the Senate amendment, and the substitute agreed to in conference are noted below, except for clerical corrections, conforming changes made necessary by agreements reached by the conferees, and minor drafting and clarifying changes.

1. Short Title; References in Act; Table of Contents (Section 1 of House bill; Section 1 of Senate amendment)

Present law

No provision.

House bill

Specifies that the act may be cited as the "Medicare Catastrophic Protection Act of 1987." Specifies that, except as otherwise specifically provided, whenever an amendment in this act is stated as an amendment or repeal of a section or provision, the reference is to the Social Security Act. Includes a table of contents.

Senate amendment

Similar provision, except specifies that act may be cited as the "Medicare Catastrophic Loss Prevention Act of 1987."

Conference agreement

The conference agreement specifies that the Act may be cited as the Medicare Catastrophic Coverage Act of 1988.

[1]Public Law 100-360, page 355, this Bulletin.

2. Inpatient Hospital Services (Section 101 of House bill; Sections 2 and 3 of Senate amendment)

Present law

(a) Deductible/Spell of Illness.—During each "spell of illness", beneficiaries are required to pay an inpatient hospital deductible ($540 in 1988). A spell of illness is defined as beginning when a beneficiary enters a hospital and ending when he or she has not been in a hospital or skilled nursing facility for 60 days.

(b) Limitation on Covered Inpatient Days.—(1) A beneficiary is entitled to 90 days of inpatient hospital services during each spell of illness. An additional lifetime reserve of 60 days may be drawn upon when an individual exceeds 90 days in a spell of illness. Medicare payment ceases after a beneficiary has used 90 days in a benefit period and exhausted the lifetime reserve days.

(2) The program includes an inpatient psychiatric carryover restriction for persons who are inpatients of a psychiatric hospital on the first day of Medicare entitlement. Days during the immediately preceding 150 days that the individual is an inpatient of a psychiatric hospital are subtracted from the 150 days that would otherwise be available in the initial spell of illness for inpatient psychiatric services.

(c) Coinsurance.—Beneficiaries are liable for daily coinsurance charges, equal to one-quarter of the inpatient hospital deductible for days 61–90 in a spell of illness ($135 in 1988). In addition, beneficiaries are liable for daily coinsurance charges, equal to one-half of the inpatient hospital deductible, for the 60 lifetime reserve days ($270 in 1988).

(d) Part A Premium.—Individuals aged 65 or over who are not automatically entitled to Part A may voluntarily enroll in the program if they pay a monthly premium. The premium amount, updated annually for the following year, is equal to $33 multiplied by the ratio of the inpatient hospital deductible for the following year to the inpatient hospital deductible in 1973.

(e) Adjustment in PPS Payment Rates.—Annual adjustments are made in payment amounts to PPS and PPS-exempt hospitals. Beginning in fiscal year 1988, the Secretary is required to adjust annually hospital weighting factors. Adjustments to outlier cutoff points are made periodically.

House bill

(a) Deductible/Spell of Illness.—Specifies that the deductible is to be applied to the first period of continuous hospitalization that begins in a calendar year. A beneficiary is required to pay only one deductible in a calendar year.

Eliminates "spell of illness" concept.

Specifies that beneficiaries whose "spell of illness" (for which a deductible is imposed) began before January 1, 1988, and had not yet ended as of such date, would not be required to pay an additional deductible for that spell of illness in 1988 or 1989.

(b) Limitation on Covered Inpatient Days.—

(1) Repeals limitations on number of covered inpatient days.

(2) Specifies that the psychiatric carryover restriction applies for the period beginning on the first day of Medicare entitle-

ment and ending at the end of the first period of 60 consecutive days on which the individual is not receiving inpatient psychiatric hospital services. The 150-day limitation is retained.

(c) Coinsurance.—Repeals coinsurance requirements, including, those required for emergency hospital services provided by a hospital that does not participate in Medicare.

(d) Part A Premium.—Requires the Secretary in September of each year (beginning in 1987), to establish the Part A monthly premium amount for the following year equal to the estimated actuarial value of the Part A benefit for such year (rounded to the nearest dollar). The actuarial value equals one-twelfth of the estimated average per capita amount payable from the Federal Hospital Insurance Trust Fund for services and related administrative costs incurred with respect to persons aged 65 and over for Part A benefits for the entire year. The Secretary is required, when the premium amount is promulgated, to issue a public statement setting forth the actuarial assumptions and bases employed in arriving at an adequate actuarial rate.

(e) Adjustment in PPS Payment Rates.—Requires the Secretary (when adjusting payment rates for PPS and non-PPS hospitals, the target amounts, the weighting factors, and the outlier cutoff points), when appropriate, to take into account reductions in beneficiary payments to hospitals resulting from the repeal of the day limitation on inpatient hospital services.

Effective date.—(a) Applies to the deductible for 1988 and succeeding years. (b) and (c) apply to inpatient hospital services furnished on or after January 1, 1988. (d) Applies to premiums for months beginning with January 1, 1988. Conforming amendments effective January 1, 1988. (e) Effective on enactment.

Senate amendment

(a) Deductible/Spell of Illness.—Similar provision, except limited to persons covered under both Part A and Part B. The deductible applies to the first "period of hospitalization" beginning in a calendar year. "Period of hospitalization" is defined as beginning on the first day the individual is furnished inpatient hospital services and ending on the date of discharge from the hospital (or, in the case of a transfer, hospitals) involved.

Eliminates "spell of illness" for persons covered under both Parts A and B.

Specifies that beneficiaries whose period of hospitalization (for which a deductible is imposed) begins during December of a calendar year would not be required to pay an additional deductible for a hospitalization beginning in January of the following year.

(b) Limitation on Covered Inpatient Days.—

(1) Similar provision, except limited to persons covered under both Parts A and B.

(2) Repeals psychiatric carryover restriction for persons covered under both Parts A and B.

(c) Coinsurance.—Similar provision, except limited to persons covered under both Parts A and B. Coinsurance requirements for services furnished outside the United States are also eliminated for these persons.

(d) Part A Premium.—No provision.

(e) Adjustment in PPS Payment Rates.—No provision.

Effective date.—Applies to items and services furnished after December 31, 1987, Beneficiaries (covered under both Parts A and B) whose spell of illness begins before January 1, 1988 and whose period of hospitalization included in that spell of illness begins on or after January 1, 1988 and before February 1, 1988 would not have an inpatient hospital deductible imposed for that period of hospitalization.

(a) *Deductible/Spell of Illness.*—The conference agreement includes the House provision with an amendment. The agreement provides that a beneficiary, whose period of hospitalization (for which a deductible is imposed) begins during December of a calendar year, would not be required to pay an additional deductible for a hospitalization beginning in January of the following year.

The agreement provides that, if the Secretary terminates a contract with a health maintenance organization (HMO) or competitive medical plan (CMP) during a year, no inpatient hospital deductible will be imposed for the remainder of the year on a beneficiary who can demonstrate that he or she, while enrolled in the organization during the year, had an inpatient hospital admission paid for by the HMO or CMP.

(b) *Limitation on Covered Inpatient Days.*—The conference agreement includes the House provision.

(c) *Coinsurance.*—The conference agreement includes the Senate amendment with an amendment deleting the requirement that individuals be enrolled in both Parts A and B.

(d) *Part A Premium.*—The conference agreement includes the House provision with an amendment specifying that the Secretary is first required to establish the monthly premium in September of 1988 which will be in effect for calendar year 1989.

(e) *Adjustment in PPS Payment Rates.*—The conference agreement includes the House provision with an amendment. Under the agreement, the Secretary shall adjust the target amounts for each non-PPS hospital to reflect reductions in beneficiary payments to hospitals resulting from the enactment of this legislation.

(f) *Chronic Ventilator-Dependent Units in Hospitals.*—The conference agreement includes a provision requiring the Secretary to establish up to five demonstration projects for up to three years each to review the appropriateness of classifying chronic ventilator-dependent units in hospitals as rehabilitation units. The Secretary is authorized to treat such units as rehabilitation units for reimbursement purposes.

The conferees expect that the Secretary will establish criteria for the demonstration projects which will assure that (1) the units will serve patients who have recently undergone tracheostomy and are newly ventilator-dependent; (2) there is reasonable expectation at admission that the patient will be able to return home or to the community at discharge; (3) the major diagnoses of patients will include spinal cord injury, head trauma, advanced lung disease, Guillain-Barre syndrome, musuclar dystrophy—Duchenne type, polyomyositis and dermatomyositis, and phrenic nerve paralysis secondary to surgical trauma; (4) the rehabilitation programs within the units will include physcial therapy, patient and family instruction in the use of ventilator equipment, self-suctioning and medications, and psychological counseling; (5) expected length of stay within the units will be typically two to four months; and (6) other factors which the Secretary finds relevant.

In establishing the demonstrations the Secretary is required to consult with the Prospective Payment Assessment Commission. In addition, the conferees expect that the Secretary will consult with appropriate professional groups such as the American Thoracic Society and the American College of Chest Physicians.

Effective date.—The Conference agreement applies to the deductible for 1989 and succeeding years. Other provisions apply to care and services occurring on or after January 1, 1989, except that (d) is effective and applies to premiums for January 1989 and succeeding months and (e) is effective for PPS hospital discharges on or after January 1, 1989, and for non-PPS hospitals, for cost reporting periods beginning on or after October 1, 1989.

3. Extended Care Service (Section 102 of House bill; Sections 2 and 3 of Senate amendment)

Present law

(a) Coinsurance.—Beneficiaries are required to pay a daily coinsurance charge (equal to one-eighth of the inpatient hospital deductible) for days 21–100 of post-hospital extended care services furnished during each spell of illness.

(b) Limitation on Covered Days.—The program covers up to 100 days of post-hospital extended care services in a spell of illness.

(c) Prior Hospitalization Requirement.—In order to have payment made for extended care services, the beneficiary must have been an inpatient of a hospital for at least three consecutive calendar days and have been transferred to a participating SNF usually within 30 days. The law has authorized the Secretary to provide coverage for extended care services in a SNF without regard to the 3-day prior hospitalization requirement when he determines that such coverage will not lead to an increase in cost and will not alter the acute nature of the benefit; however, this provision has not been implemented.

House bill

(a) Coinsurance.—

(1) Eliminates current coinsurance requirements. Imposes a daily coinsurance charge for days 1–7 of post-hospital extended care services furnished in a calendar year.

(2) Requires the Secretary, before September 1 of each year (beginning in 1987), to estimate the national average per diem reasonable cost recognized under Part A for post-hospital extended care services which will be furnished in the succeeding calendar year. In September of each calendar year (beginning in 1987) the Secretary is required to promulgate the coinsurance amount for the following year. The amount equals 20 percent (rounded to the nearest $0.50) of the national average per diem reasonable cost estimated by the Secretary. The reference to "post-hospital" is deleted beginning January 1, 1989.

(b) Limitation on Covered Days.—Provides coverage for 150 days of extended care services in a calendar year.

(c) Prior Hospitalization Requirement.—Eliminates prior hospitalization requirement and reference to authority to provide coverage without regard to this requirement.

(d) Spell of Illness.—Repeals spell of illness concept.

Effective date.—Applies to extended care services furnished on or after January 1, 1988, except that elimination of prior hospitalization requirements (and related conforming changes) apply to extended care services furnished pursuant to an admission to a SNF occurring on or after January 1, 1989.

Senate amendment

(a) Coinsurance.—

(1) Similar provision, except limited to persons covered under both Parts A and B. The daily coinsurance charge is imposed on the first 10 days the beneficiary is furnished extended care services during any stay in a skilled nursing facility (SNF), but in no event can a coinsurance amount be imposed for more than 10 days in a calendar year.

(2) Similar provision, except coinsurance equals 15 percent (rounded to the nearest $1.00) of the estimated amount. Eliminates reference to "post-hospital".

(b) Limitation on Covered Days.—Similar provision, except limited to persons covered under both Part A and Part B.

(c) Prior Hospitalization Requirement.—Similar provisions, except limited to persons covered under both Parts A and B.

(d) Spell of Illness.—Similar provisions, except limited to persons covered under Parts A and B.

Effective date.—Applies to extended care services furnished after December 31, 1987. For beneficiaries receiving post-hospital extended care services on December 31, 1987, current law provisions will continue to apply until the spell of illness has ended.

Conference agreement

(a) *Coinsurance.*—The conference agreement includes the House provisions with a modification. The agreement provides that coinsurance charges are to be imposed on the first eight days of extended care services in a calendar year. The amount of the coinsurance is equal to 20% (rounded to the nearest $0.50) of the estimated national average per diem reasonable cost recognized under Part A of Medicare for extended care services.

The agreement extends the current coverage of extended care services in a Christian Science sanatoria from a maximum of 30 days per benefit period to 45 days per calendar year. As under current law, coinsurance would be applied for each day of covered care.

(b) *Limitation on Covered Days.*—The conference agreement includes the Senate amendment with an amendment deleting the requirement that individuals be enrolled in both Parts A and B.

(c) *Prior Hospitalization Requirement.*—The conference agreement includes the House provision.

(d) *Spell of Illness.*—The conference agreement includes the Senate amendment with amendments. The requirement that individuals be enrolled in both Parts A and B is deleted. Beneficiaries whose "spell of illness" began before January 1, 1989, and had not yet ended as of such date, would not be required to pay an additional hospital deductible for that spell of illness in 1989 and 1990.

Effective date.—The conference agreement applies to extended care services furnished on or after January 1, 1989.

4. Hospice Care (Section 103 of House bill; Section 12 of Senate amendment)

Present law

A beneficiary who is terminally ill may elect to receive hospice services for two 90-day periods and one subsequent 30-day period for a total of 210 days during his lifetime. Beneficiaries making this election must choose to receive services through a hospice and give up most other Medicare benefits.

House bill

Provides for a subsequent extension period beyond the current 210-day limit, if the beneficiary is recertified as terminally ill by the medical director or the physician member of the interdisciplinary group of the hospice program.

Effective date.—Applies to hospice care furnished on or after January 1, 1988.

Senate amendment

Similar provision.

Effective date.—Applies with respect to services furnished on or after date of enactment.

Conference agreement

The conference agreement includes the House provision with an amendment to further extend the favorable presumption under the waiver of liability provision for hospice care through October 1990.

Effective date.—The conference agreement applies to hospice care furnished on or after January 1, 1989.

5. Blood Deductible (Section 104 of House bill; Section 3 of Senate amendment)

Present law

Payment may not be made under Part A for the first 3 pints of whole blood (or equivalent quantities of packed red blood cells, as defined in regulations) furnished to a beneficiary during a spell of illness. A similar deductible is applied under Part B on a calendar year basis. Under Part B, the deductible (in accordance with regulations) is appropriately reduced to the extent that there has been a replacement of such blood (or equivalent quantities of packed red blood cells). For these purposes, blood furnished to an individual is deemed to be replaced when the institution or other person furnishing blood is given one pint of blood for each pint of blood furnished such individual for which the deductible is applicable.

The Part A and Part B blood deductibles are applied separately.

House bill

Specifies that the Part A blood deductible is applied on a calendar year basis. Replacement provisions (identical to those specified for Part (B) are added to Part A. The Part A blood deductible is to be reduced by any blood deductible imposed with respect to Part B.

Specifies that in the case of a beneficiary whose spell of illness begins before January 1, 1988 (and ends after that date), any Part A blood deductible required would be reduced during that spell of illness (during 1988 or 1989) to the extent that a Part A blood deductible had already been imposed for that spell of illness.

Effective date.—Applies to blood or blood cells furnished on or after January 1, 1988.

Senate amendment

Specifies that the Part A blood deductible is to be applied on a calendar year basis for persons covered under both Parts A and B.

Effective date.—Applies to items and services finished after December 31, 1987.

Conference agreement

The conference agreement includes the House provision.

Effective date.—The conference agreement applies to blood or blood cells furnished on or after January 1, 1989.

6. Home Health Benefits (Section 105 of House bill)

Present law

Home health services are covered under Parts A and B. Payments for home health services are always made under Part A except in cases where the beneficiary is enrolled under Part B, but is not entitled to Part A. In these cases, payment is made under Part B.

House bill

Provides that payments for home health services are to be made under Part A only in cases where the individual provided the services is not entitled to Part B in that month. Otherwise, payments are to be made under Part B.

Effective date.—Applies to home health services furnished on or after January 1, 1989.

Senate amendment

No provision.

Conference agreement

The conference agreement does not include the House provision.

7. Imposition of Supplemental Medicare Premium (Section 106 of House bill; Sections 6 and 27 of Senate amendment)

Present law

(a) and (b) In General and Applicability.—The following individuals are eligible for coverage under the Hospital Insurance (Part A) program of Medicare without payment of any premium: (1) those

who have attained age 65 and are eligible for monthly Social Security retirement or survivor benefits, (2) individuals of any age who have been entitled for not less than 24 months to Social Security or Railroad Retirement benefits on the basis of disability (and certain related individuals), (3) individuals of any age who have end-stage renal disease, and (4) certain Federal, State, and local Government employees who have attained age 65. Individuals age 65 or over who are not entitled to Part A benefits because they do not meet the above conditions may enroll in Part A if they pay a monthly premium.

All individuals age 65 and older may elect to enroll in the Supplementary Medical Insurance (Part B) program of Medicare by paying a monthly premium, which is $24.80 in 1988. Individuals who have not attained age 65 but who are eligible for the Part A program by virtue of disability or end-stage renal disease may also elect to enroll in Part B by paying the monthly premium.

(c) Premium Amount.—No provision.

(d) Calculation for Governmental Retirees.—Currently, the pensions of most government retirees are, for the most part, treated as income subject to taxation, while Social Security benefits are tax-exempt unless they exceed a certain threshold (i.e., if adjusted gross income plus 50 percent of the Social Security benefit exceeds $25,000 for individuals, or $32,000 for married couples filing joint returns). These differences in tax treatment of pension income result in larger adjusted gross incomes and tax liabilities for government retirees than for retirees with Social Security.

(e) Premium Indexing.—No provision.

(f) Maximum Supplemental Premium.—No provision.

(g) Joint Returns.—Provides rules for the filing of joint returns for married individuals under section 6013 of the Internal Revenue Code of 1986.

(h) Coordination with Tax Code Provisions.—Section 213 of the Internal Revenue Code of 1986 provides that expenses for medical care (including prescribed drugs or insulin), not compensated for by insurance or otherwise, may be deducted for Federal income tax purposes to the extent that they exceed 7.5 percent of adjusted gross income. Medical care includes insurance payments and Medicare Part B premiums.

House bill

(a) In General.—Amends the Internal Revenue Code of 1986 to impose an annual income-related supplemental premium on Medicare-eligible individuals (generally, those entitled to Part A who file a Federal tax return, except (1) individuals required to pay a premium for Part A coverage, (2) residents of U.S. possessions, and (3) qualified nonresidents) for each taxable year.

(b) Applicability.—Defines a "Medicare-eligible individual" who is liable for payment of the supplemental Medicare premium as an individual who, in any month, is entitled to (or, on application without the payment of an additional premium, would be entitled to) benefits under Part A of Medicare for such month. Provides for the following exceptions: (1) individuals entitled to Part A benefits solely by reason of the payment of the Part A premium, (2) residents of U.S. commonwealths and territories who pay a special

Part B premium and individuals who are enrolled under Part B but are not entitled to benefits under Part A, and (3) qualified nonresidents.

Defines a "qualified nonresident" as an individual who: (1) is not furnished any service for which payment was or will be made under Medicare Part A during the taxable year or any of the 4 preceding taxable years, (2) is not entitled to benefits under Medicare Part B at any time during the taxable year or any of the 4 preceding taxable years, and (3) is present in a foreign country or countries for at least 330 full days during the 12-month period ending at the close of the taxable year and each of the 4 consecutive preceding 12-month periods. An individual who dies during the taxable year is treated as meeting the 330-day test in that year if the individual spent at least 90 percent of the days before the date of death as full days in a foreign country or countries.

Provides that an individual (other than a nonresident alien) who has attained age 65 will be treated as a Medicare-eligible individual for the month in which he attains age 65 and any subsequent month unless he establishes to the satisfaction of the Secretary that he is not a Medicare-eligible individual for the month concerned.

(c) Premium Amount.—

Provides that for 1988, the premium is as follows:

If the adjusted gross income for the taxable year is: Over:	But not over:	The annual premium for the taxable year is:
$0	$6,000	$0
6,000	6,143	10
6,143	6,287	20
6,287	6,430	30
6,430	6,573	40
6,573	6,716	50
6,716	6,860	60
6,860	7,003	70
7,003	7,146	80
7,146	7,289	90
7,289	7,433	100
7,433	7,576	110
7,576	7,719	120
7,719	7,862	130
7,862	8,006	140
8,006	8,149	150
8,149	8,292	160
8,292	8,436	170
8,436	8,579	180
8,579	8,722	190
8,722	8,865	200
8,865	9,009	210
9,009	9,152	220
9,152	9,295	230
9,295	9,438	240
9,438	9,582	250
9,582	9,725	260
9,725	9,868	270
9,868	10,011	280
10,011	10,155	290
10,155	10,298	300
10,298	10,441	310

If the adjusted gross income for the taxable year is: Over:	But not over:	The annual premium for the taxable year is:
10,441	10,585	320
10,585	10,728	330
10,728	10,871	340
10,871	11,014	350
11,014	11,158	360
11,158	11,301	370
11,301	11,444	380
11,444	11,587	390
11,587	11,731	400
11,731	11,874	410
11,874	12,017	420
12,017	12,160	430
12,160	12,304	440
12,304	12,447	450
12,447	12,590	460
12,590	12,734	470
12,734	12,877	480
12,877	13,020	490
13,020	13,163	500
13,163	13,307	510
13,307	13,450	520
13,450	13,593	530
13,593	13,736	540
13,736	13,880	550
13,880	14,023	560
14,023	14,166	570
14,166		580

Provides that if an individual is not a Medicare-eligible individual for each month during the taxable year, the annual premium determined from the above table would be prorated based on the number of months an individual is a Medicare-eligible individual during the taxable year. A similar rule applies in the case of a taxable year of less than 12 months, except that the individual's adjusted gross income for the taxable year would be annualized.

(d) Calculation for Governmental Retirees.—No provision.

(e) Premium Indexing.—

(1) In General.—Requires the Secretary of the Treasury, not later than December 15 of 1988 and each subsequent calendar year, to prescribe a table of the supplemental premium amounts which will apply, instead of the 1988 table, with respect to taxable years beginning in the succeeding calendar year.

Requires that each premium dollar amount in the 1988 table be increased by the sum of the Medicare inflation factor and the prescription drug factor for the calendar year, and each other dollar amount in the table (i.e., the bracket amount and the threshold amount) be increased by the cost-of-living adjustment used to index the income tax brackets. If any increase is not a mulitple of $1, it is to be rounded to the nearest multiple of $1.

(2) Catastrophic Coverage Benefit.—Provides that the Medicare inflation factor is the percentage (if any) by which the Medicare value for a calendar year exceeds the Medicare value

for 1988. The Medicare value for any calendar year is the sum for January of such year of (a) 50 percent of the monthly actuarial rate promulgated under section 1818(d)(1) of the Social Security Act for such month (i.e., the Medicare Part A value), and (b) the excess of twice the monthly Part B actuarial rate under section 1839(a)(1) of the Social Security Act, over the amount of the monthly Part B premium under section 1839 (i.e., the Medicare Part B value).

(3) Prescription Drug Benefit.—Provides that the prescription drug factor for 1988 is zero percent, for 1989 is 5.5 percent, and subsequent years is determined as follows: The Secretary of the Treasury in September of each year (beginning with 1989) is required to determine a percent estimated to be necessary so that the total amount of supplemental premiums attributable to the prescription drug factor estimated to be collectible in the next year is equal to 25 percent of the total of the benefits and related administrative costs estimated by the Secretary of HHS under new section 1839(g)(2)(C) of the Social Security Act to be necessary to pay for covered outpatient drugs in the next year.

Requires the Secretary of the Treasury in September of each year (beginning with 1991) to determine whether the amount of the supplemental premium attributable to the prescription drug factor estimated to be collectible (for taxable years beginning in calendar years after 1988 and before the previous calendar year) is greater or less than 25 percent of the total benefits and administrative costs paid for covered outpatent drugs.

If there is a surplus or deficit, the Secretary of the Treasury is required to adjust the prescription drug factor so as to reduce or increase, respectively, the aggregate amount of the additional premiums which are estimated to be collected by the amount of the surplus or deficit, taking into account the effect of any previous adjustments.

Provides that, notwithstanding the adjustment described above, the prescription drug factor for a year after 1990 cannot exceed 120 percent of such factor for the previous year.

(f) Maximum Supplemental Premium.—Provides that the maximum supplemental premium in 1988 is $580. The Joint Committee on Taxation estimates that the maximum supplemental premium in future years would be: for the taxable year beginning in 1989, $737; in 1990, $842; in 1991, $934; and in 1992, $1,017.

(g) Joint Returns.—Provides that in the case of a joint return, the premium amounts according to the table are applied separately to each spouse, and the adjusted gross income of each spouse is one-half of their combined adjusted gross income.

(h) Coordination with Tax Code Provisions.—

(1) Medical Expense Deduction.—Provides that the supplemental premium cannot be treated as a medical expense for purposes of section 213 of the Internal Revenue Code of 1986.

(2) Not Treated as a Tax for Certain Purposes.—Provides that the supplemental premium is not treated as a tax imposed by chapter 1 (income taxes) of the Internal Revenue Code of 1986 for purposes of determining the amount of any credit allowed

under that chapter or the amount of the alternative minimum tax imposed by section 55.

(3) Treated as a Tax for Subtitle F.— Provides that the supplemental premium is treated as if it were an income tax for administrative purposes, such as estimated payments and collection.

(4) Section 15 Not to Apply.—Provides that section 15 (procedures for applying changes in tax rates) does not apply to the supplemental premium.

(i) Reporting Requirements.—Requires the Secretary of HHS to make a return to the Secretary of the Treasury (at such time and in such form as determined by the Secretary of the Treasury) stating the name, address, and taxpayer identification number of each individual entitled to Medicare Part A benefits for any month during the calendar year and the number of months so entitled. The provision does not apply with respect to those who pay a premium under section 1818 for Part A coverage, residents of U.S. commonwealths and territories paying a special Part B premium, and individuals enrolled under Part B but not entitled to benefits under Part A.

(j) Transfer to Trust Funds.—No provision.

Effective date.—Applies to taxable years beginning after December 31, 1987.

Senate amendment

(a) In General.—Amends the Social Security Act to require individuals covered by Medicare Part B to pay an annual income-related supplemental premium if their Federal tax liability for taxable years is not less than $150.

(b) Applicability.—Provides that any individual who is covered by Medicare Part B for any portion of any taxable year occurring after December 31, 1987, and who has Federal income tax liability for such taxable year in an amount not less than $150 must pay the applicable supplemental premium.

(c) Premium Amount.—Provides that the "applicable supplemental premium" equals the number of months in the taxable year during which the individual was covered by Part B, multiplied by the supplemental premium. The "supplemental premium" is defined as the premium rate for the taxable year ($1.09 for the 1988 taxable year), multipled by the amount determined by dividing the individual's adjusted Federal income tax liability for the taxable year by $150.

If the latter amount is not a whole number, it is to be rounded to the next lowest whole number.

(d) Calculation for Governmental Retirees.—For purposes of calculating the supplemental premium, defines "Federal income tax liability" as the tax imposed by chapter 1 (income tax) of the Internal Revenue Code of 1986, reduced by credits allowed under part IV of subchapter A, excluding the following refundable credits: Section 31 (wage withholding for income tax purposes); section 33 (tax withheld at source on nonresident aliens and foreign corporations); and section 34 (certain uses of gasoline and special fuels).

For purposes of calculating the supplemental premium, defines "adjusted Federal income tax liability" as an amount equal to Federal income tax liability, reduced by the following amount. The reduction is the excess (if any) of:

(1) 15 percent of the lesser of (a) the qualified Social Security exclusionary amount, or (b) the amount received as an annuity (whether for a period certain or during 1 or more lives) under a governmental plan which is includible in gross income under section 72 of the Internal Revenue Code of 1986, over

(2) the amount of credit allowed under the tax credit for the elderly and the permanently and totally disabled (section 22 of the Internal Revenue Code of 1986).

Defines "qualified Social Security exclusionary amount" as the excess (if any) of $6,000 ($9,000 in the case of married individuals filing a joint tax return) over the Social Security benefits (as defined in section 86(d) of the Internal Revenue Code of 1986) received during the taxable year. For taxable years beginning after Dec. 31, 1988, the $6,000 and $9,000 amounts are increased from the previous year's amounts by the Social Security cost-of-living adjustment for the calender year in which the taxable year begins.

(e) Premium Indexing.—

(1) In General.—Provides that the premium rate for any taxable year (beginning in a calendar year after 1988) is the previous year's rate, increased or decreased by (a) the premium rate adjustment used to index the monthly catastrophic coverage premium amount in years after 1988, and (b) the drug premium rate adjustment (for taxable years beginning in calendar years after 1989).

(2) Catastrophic Coverage Benefit.—The premium rate adjustment used to update the monthly catastrophic coverage premium amount is:

(a) the percentage (if any) necessary to increase the estimated total revenues collectable from the monthly catastrophic coverage premiums and the supplemental premiums (determined without regard to the drug premium rate adjustment amount) so that they equal the estimated total catastrophic coverage benefits and related administrative costs (including administrative costs for outpatient drug coverage), plus

(b) for calendar years before 1993, the percentage necessary to establish before 1993 a contingency fund equal to 20 percent or, if greater, a reserve fund equal to 5 percent.

(3) Prescription Drug Benefit.—Provides that the drug premium rate adjustment for taxable years beginning in a calendar year after 1989 is an amount equal to:

(a) 50 percent (60 percent for calendar year 1990 and 55 percent for calendar year 1991, as provided in Section 27 of the bill) of the modified per enrollee actuarial catastrophic drug benefit amount for that year plus

(b)(1) for any taxable year beginning in calendar year 1990, an amount necessary to cover 7.5 percent of the modified per enrollee actuarial catastrophic drug benefit amount for 1991, and

(2) for taxable years beginning in calendar years after 1990, an amount (when added to any unexpended amount determined for any preceding year) necessary to cover 7.5

percent of the modified per enrollee actuarial catastrophic drug benefit amount for the calendar year.

Defines "modified per enrollee actuarial catastrophic drug benefit amount" to mean (a) the total catastrophic drug coverage benefits and related administrative costs estimated to be paid in cash outlays from the Federal Catastrophic Drug Insurance Trust Fund divided by the total number of individuals estimated to be enrolled under Part B for the year, or (b) the reestimated per enrollee actuarial catastrophic drug benefit amount that reflects any adjustment the Secretary may make to the drug coverage benefit because the drug benefit premium amount was determined to exceed the premium limit for that year.

(f) Maximum Supplemental Premium.—Provides that the applicable supplemental premium for any individual cannot exceed the number of months in the taxable year the individual was covered by Part B divided by 12, multiplied by the appropriate amount, as follows: for the taxable year beginning in 1988, $800; in 1989, $850; in 1990, $900; in 1991, $950; and in 1992, $1,000.

For taxable years beginning in a calendar year after 1992, the applicable supplemental premium cannot exceed 65 percent of the product of the number of months in the taxable year the individual was covered by Part B, multiplied by the excess of:

(a) the sum of (1) 200 percent of the monthly actuarial basic rate for Part B enrollees age 65 and over (i.e., 200 percent of one-half of the benefit and administrative costs, including a contingency margin, payable for the aged from the Part B trust fund for Part B costs excluding the catastrophic coverage), plus (2) the monthly per enrollee actuarial comprehensive catastrophic benefit amount (i.e., the estimated monthly catastrophic coverage benefits and related administrative costs payable from the Federal Catastrophic Health Insurance Trust Fund divided by the estimated number of Part B enrollees) for the calendar year, over

(b) the sum of the basic and catastrophic monthly premiums for the year, determined without regard to current and new certain hold harmless provisions (which provide limits to any increases in the Part B and catastrophic premiums based on cost-of-living increases in Social Security benefits).

(g) Joint Returns.—Provides that for married individuals (as defined in section 7703 of the Internal Revenue Code of 1986), the supplemental premium is determined by treating such individuals as one individual if they: (1) file a joint return (under section 6013 of such Code) and (2) one or both of them are covered by Part B for any portion of the taxable year and have Federal income tax liability of not less than $150. The number of months of Part B coverage is determined according to the spouse covered for the longer period during the taxable year. When married individuals are treated as one individual in order to calculate the supplemental premium, the limit on such premium equals the sum of the limits computed separately for each spouse.

(h) Coordination With Tax Code Provisions.—

(1) Medical Expense Deduction.—Provides that the supplemental premium is treated as a premium paid under Medicare

Part B in the taxable year following the taxable year to which the premium relates for purposes of section 213(d)(1)(C) of the Internal Revenue Code of 1986.

(2) Not Treated as a Tax for Certain Purposes.—Similar provision.

(3) Treated as a Tax for Subtitle F.—Similar provision.

(4) Section 15 Not to Apply.—Similar provision.

(i) Reporting Requirements.—Requires that the Secretary of HHSA include on the current return to the Secretary of the Treasury relating to Social Security benefits, the number of months any individual is covered under Medicare Part B for the calendar year. Requires the Secretary of HHS to include on the statements sent to Social Security beneficiaries information on the name of the agency making the determination and the number of months of coverage under Medicare Part B.

(j) Transfer to Trust Funds.—Requires the Secretary of the Treasury, from time to time, to transfer from the general fund of the Treasury to the Federal Catastrophic Health Insurance Trust Fund amounts equal to the aggregate monthly supplemental premiums paid (excluding the drug premium rate adjustment), plus the amount the Secretary of the Treasury estimates Federal outlays are reduced under the Medicaid program because of the catastrophic provisions of this bill (after taking into account the provisions of Section 14 of the bill related to Medicaid savings and State requirements). Such transfers are to be appropriately adjusted to the extent that prior transfers were in excess of or less than amounts required to be transferred.

Also requires the Secretary of the Treasury, from time to time, to transfer from the general fund of the Treasury to the Federal Catastrophic Drug Insurance Trust Fund amounts equal to the aggregate drug premium rate adjustment paid, adjusted to the extent that prior transfers were in excess of less than the amounts required to be transferred.

Effective date.—Applies to taxable years ending after December 31, 1987. The supplemental premium rate for any taxable year beginning before 1988 and ending after December 31, 1987, is the rate applicable to 1987.

Conference agreement

(a) *In General.*—Under the conference agreement, medicare Part A eligible individuals are required to pay a new tax-related supplemental premium. The supplemental premium is intended to provide approximately 63 percent of catastrophic coverage and prescription drug benefit financing on a calendar year liability basis, with flat monthly premiums financing the remaining 37 percent (subject to limitations on increases and decreases in the supplemental premium, described below).

The supplemental premium is drafted in the tax Code, collected with income tax payments, and after 1989 subject to income tax estimated payments. Medicare Part A eligible individuals with less than $150 of income tax liability are exempt from the supplemental premium.

To reduce confusion among beneficiaries, the conferees intend that the Secretary of the Treasury is to (1) implement the supplemental premium in an easy to understand manner (including the use of premium tables in lieu of taxpayer calculations, and separate tables as necessary for government retirees), (2) identify the supplemental premium on the applicable forms, worksheets, tables, and instructions as a premium to pay for a portion of the cost of new medicare catastrophic and prescription drug coverage, and (3) seek comments and advice from medicare enrollees and their representatives regarding the design of such forms, worksheets, tables, and instructions.

(b) *Applicability.*—The definition of medicare Part A eligible individuals generally follows the House bill, except that no special proration rule is provided for residents of U.S. commonwealths and territories. Residents of U.S. commonwealths and territories who do not have U.S. income tax liability are not subject to the supplemental premium. An individual is liable for the supplemental premium if such individual is medicare Part A eligible for more than 6 full months during the taxable year and has $150 or more of adjusted U.S. source income tax liability.

Unlike the House bill, individuals who attain the age of 65 during the taxable year are not presumed to be medicare eligible for the purposes of paying the supplemental premium. The conferees intend that the Internal Revenue Service will inform taxpayers that they are liable for the supplemental premium if they are eligible for Part A of Medicare even if they have not actually enrolled.

(c) *Premium Amount.*—For taxable years beginning before 1994, the supplemental premium rate is the sum of the catastrophic coverage and prescription drug premium rates shown below:

SUPPLEMENTAL PREMUIM RATES, 1989–93

[Per $150 of adjusted Federal income tax liability]

	Catastrophic coverage premium rate	Prescription drug premium rate	Total supplemental premium rate
Year in which taxable year begins:			
1989	$22.50	$0	$22.50
1990	27.14	10.36	37.50
1991	30.17	8.83	39.00
1992	30.55	9.95	40.50
1993	29.55	12.45	42.00

The supplemental premium is to be determined under tables (similar to the income tax tables) prescribed by the Secretary of the Treasury which may provide income tax liability brackets of less than $150.

For purposes of computing the supplemental premium, adjusted Federal income tax liability is defined as under the Senate amendment.

The conferees have determined these premium rates to raise sufficient revenue with reference to the tax rates and other important features of the tax Code that determine the liability of the medicare Part A eligible population. The conferees intend that if tax rates or these features are changed in future legislation, the premium rates should be recalibrated.

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(d) *Calculation for Government Retirees.*—The Conference agreement generally follows the Senate amendment with changes designed to conform the adjustment for government retirees with the computation of the credit for the elderly and disabled. For government retirees, tax liability is adjusted by subtracting 15 percent of the excess (if any) of (1) the lesser of (i) $6,000 ($9,000 in the case of a joint return where both spouses are medicare eligible for more than 6 full months, and $4,500 for married individuals filing separate returns), or (ii) government annuities includible in gross income during the taxable year, the lower quantity then reduced by social security benefits received during the taxable year; over (2) the credit for the elderly and disabled allowable for the taxable year. After 1989, the $4,500, $6,000 and $9,000 amounts are increased by social security cost-of-living adjustments ("COLAs") determined for calendar years after 1989, and rounded to the nearest multiple of $50.

In the case of a joint return where only one spouse is medicare eligible for more than 6 full months during the taxable year, only government annuities attributable to such spouse are taken into account for purposes of the adjustment for government retirees. In the case of a married individual filing a separate return, such individual shall be treated as receiving not less than half of the social security benefits received by both spouses.

(e) *Premium Indexing.*—(1) *In general.* The method of indexing the supplemental catastrophic coverage and prescription drug premiums was selected by the conferees (1) to assure that premium receipts will be sufficient to pay for all catastrophic coverage and prescription drug benefits (i.e., budget neutrality), and (2) to minimize the Treasury Secretary's discretion over the adjustment of supplemental premium rates.

The indexing formula minimizes discretion by using information on prior year program costs and receipts, rather than subjective projections, and by limiting the amount by which the supplemental premium can be increased in any year.

The indexing machanism seeks to assure budget neutrality by several means: (1) prescription drug outlays may only be made from a new Federal Catastrophic Drug Insurance Trust Fund which is entirely financed by monthly and supplemental prescription drug premiums (and interest on fund balances); (2) monthly and supplemental catastrophic coverage premiums are increased to recoup with interest shortfalls in prior years (monthly premiums are increased to make up for any limitation on the increase in the supplemental premium); and (3) a contingency margin of at lest 20 percent is built into catastrophic coverage and prescription drug premiums.

For taxable years beginning after 1993, the supplemental premium rate is the sum of the adjusted catastrophic coverage premium rate and the adjusted prescription drug premium rate, subject to two limitations. The supplemental premium rate may not (1) be less than the rate in effect for the preceding year; and (2) be more than $1.50 per $150 of tax liability higher than the rate in effect for the preceding year. If either of these two limitations are applicable, the supplemental premium rate is allocated between the catastrophic coverage and prescription drug premium rates in proportion to the respective amounts of these premium rates without regard to the limitations.

(2) *Catastrophic coverage premium.*—The adjusted catastrophic coverage premium rate for any calendar year after 1993 is equal to the rate for the preceding calendar year, without regard to the two limitations on the supplemental premium described above in any prior year, adjusted by a percentage equal to the sum of the outlay-premium and reserve account percentages.

The outlay-premium percentage is designed to index the supplemental catastrophic coverage premium rate by the difference between the projected growth rates of catastrophic coverage outlays and premiums. For years after 1993, the growth in outlays and premiums is projected by a formula which uses data available for the second and third preceding years, plus more recent information on trends in the consumer price index.

The outlay-premium percentage for any calendar year is (1) the percentage change in per capita catastrophic outlays from the third to the second preceding calendar year; minus (2) the percentage change in per capita catastrophic coverage premium liability from the third to the second preceding calendar year (determined as if the supplemental premium rate had not changed from the third to the second preceding year).

The per capita catastrophic outlay for any calendar year, as determined by the Secretary of HHS, is equal to outlays debited from the Medicare Catastrophic Coverage Account (the "Account," see section 17, below) for such year, divided by the average number of individuals entitled to receive Part A benefits during such year.

The per capita catastrophic coverage premium liability for any calendar year, as determined by the Secretary of the Treasury, is equal to supplemental premium liability attributable to the catastrophic coverage premium for taxable years beginning in such year, divided by the number of individuals who had premium liability for taxable years beginning in such year.

The outlay-premium percentage, described above, is adjusted up (or down) by 50 percent of the amount by which the consumer price index ("CPI") inflation rate in the second preceding year exceeds (or is less than) one percentage point.

The CPI inflation rate for any year is defined as the percentage by which the CPI for May of such year exceeds such index for May of the preceding year. The CPI means the last CPI for all-urban consumers published by the Department of Labor, which is most consistent with the CPI for calendar year 1986.

The reserve account percentage is designed to adjust the supplemental catastrophic coverage premium rate to recoup 63 percent of any cumulative shortfall or deficit in the catastrophic coverage program (the other 37 percent is recouped by a corresponding adjustment in the flat premium). For years after 1993, the shortfall or surplus in the catastrophic coverage program is determined from data available for the second proceding year.

The reserve account percentage for any calendar year is the ratio of (1) the change in the catastrophic coverage premium rate for the second preceding year which the Secretary determines would have increased (or decreased) supplemental premium liability for such year by an amount equal to 63 percent of the shortfall (or surplus) in the Account in such year, over (2) the catastrophic coverage premium rate for the preceding calendar year, without regard to the two limitations on the supplemental premium described above.

The shortfall (or surplus) in the Account for any calendar year is determined as (1) 20 percent of catastrophic outlays debited against the Account; minus (2) the Account balance at the end of such year (including flat and supplemental premium increase amounts attributable to reserve account percentages in prior years that have not yet been credited to the account.

(3) *Prescription Drug Premium.*—The adjusted prescription drug premium rate for any calendar year after 1993 is equal to the rate for the preceding calendar year, without regard to the two limitations, described above, which may have applied to the supplemental premium for any prior year, adjusted by a percentage determined in a manner similar to the catastrophic coverage premium, with the following changes: (1) in determining the premium-outlay percentage, prescription drug outlays rather than catastrophic outlays are used; (2) in determining the reserve account percentage, the Federal Catastrophic Drug Insurance Trust Fund balance (see section 16, below) is used rather than the Account balance; (3) the reserve account percentage is 75 percent for 1994, 50 percent for 1995, and 25 percent for 1996 and 1997, instead of 20 percent; and (4) the outlay-premium percentage is deemed to be zero for calendar years before 1998.

For calendar years after 1992 the following procedure is to be followed for announcing supplemental premium rate changes. The Secretary of the Treasury shall: (1) not later than July 1, announce the preliminary increase in the supplemental premium for the following year; and (2) not later than October 1, announce the actual supplemental premium rates for the following year. (For additional detail see sections 16 and 17, below).

(f) *Maximum Supplemental Premium.*—For taxable years beginning before 1994, the maximum supplemental premium for an individual filing a single return is $800 in 1989, $850 in 1990, $900 in 1991, $950 in 1992, and $1050 in 1993.

For calendar years after 1993, the maximum supplemental premium is equal to such maximum in the preceding year (before rounding) increased by the percentage (if any) by which the medicare-part B value for the second preceding year exceeds such value for the third preceding year. The maximum supplemental premium is rounded to the nearest multiple of $50. The conferees designed the formula to maintain the miximum supplemental premium as a constant fraction of the value of Part B benefits not paid for by monthly premiums.

The midicare-part B value for any calendar year is defined as the excess of per capita Part B outlays the year over 12 times the generally applicable monthly Part B premium for months in such calendar year. Per capita Part B outlays are outlays from Part B of title XVIII of the Social Security Act divided by the average number of individuals covered under such part during the year. In computing the maximum supplemental premium for years before 1988, the medicare-Part B value is computed by excluding outlays and monthly premiums for covered outpatient drugs.

(g) *Joint and Separate Returns.*—(1) *Joint returns.*—In the case of a joint return where both spouses are medicare Part A eligible for more than 6 full months during the taxable year, such spouses are treated as a single individual, except that the maximum supplemental premium is twice the amount that applies for single returns.

In the case of a joint return where only one spouse is medicare eligible for more than 6 full months during the taxable year, income tax liability for the medicare-eligible spouse is determined as one-half of the tax liability of the joint return.

(2) *Separate Returns.*—In the case of a married individual filing a separate return who did not live apart from his or her spouse at all times during the taxable year, such individual is treated as medicare Part A eligible for 6 full months during the taxable year if the individual or the individual's spouse was so eligible. In addition, the maximum supplemental premium is twice the amount that applies for single returns if, without regard to this provision, both spouses are Medicare Part A eligible for 6 full months during the taxable year.

These rules are intended to prevent the supplemental premium from creating an incentive for separate filing.

(h) *Coordination with Tax Code Provisions.*—(1) *Medical expense deduction.*—As under the House bill, the supplemental premium is not deductible as an itemized medical expense.

(2) *Not treated as a tax for certain purposes.*—As under the House bill and the Senate amendment, the supplemental premium is not treated as an income tax for purposes of determining the amount of any tax credit or the amount of the alternative minimum tax. Revenues from the supplemental premium are not covered over to any possession of the United States, and the supplemental premium is not automatically reflected in the tax laws of territories that "mirror" the U.S. tax Code. In the case of a taxable years of less than 12 months, the supplemental premium shall be applied under regulations prescribed by the Secretary.

(3) *Treated as a Tax for Subtitle F.*—The supplemental premium generally is treated as if it were an income tax for administrative purposes, such as estimated payment and collection. The conference agreement provides that estimated tax penalties do not apply with respect to supplemental premium liability for taxable years beginning in 1989. The conferees intend that the Internal Revenue Service will where appropriate exercise its discretion to provide relief from estimated tax penalties in the first year in which an individual becomes liable for the supplemental premium (similar relief already is provided for newly retired or disabled individuals in sec. 6654(e)(3)(B)).

(4) *Section 15 not to Apply.*—The supplemental premium is not treated as a change in income tax rate.

(i) *Reporting Requirements.*—The Secretary of HHS shall include in the existing return to the Secretary of the Treasury relating to social security benefits, a determination of whether any individual was medicare Part A eligible for more than 6 full months during the year. The Secretary of HHS is to include the same information on the statements sent to social security and railroad retirement beneficiaries, as well as the name of the agency which determines medicare eligibility.

The Secretary of HHS may provide such additional information to the Secretary of the Treasury as is required to assure compliance with the supplemental premium.

(j) *Transfer to Trust Funds.*—Receipts attributable to the supplemental prescription drug premium rate are appropriated to the CDI trust fund. The Secretary of the Treasury is to transfer these appropriated amounts from the general fund to the CDI trust fund not less frequently than monthly, and at the close of the calendar year, determined on the basis of estimates; adjustments are made in subsequent transfers to take account of estimating errors. For individuals paying the maxmium supplemental premium, receipts are allocated between the supplemental prescription drug and catastrophic coverage premiums pro rata on the basis of the respective premium rates.

Receipts attributable to the supplemental catastrophic coverage premium rate, which are not otherwise appropriated to the Federal Hospital Insurance Catastrophic Coverage Reserve Fund (the "Reserve Fund") are appropriated to the SMI trust fund. The Secretary of the Treasury is to transfer these appropriated amounts from the general fund to the SMI trust fund not less frequently than monthly, and at the close of the calendar year, determined on the basis of estimates; adjustments are made in subsequent transfers to take account of estimating errors. For individuals paying the maximum supplemental premium, receipts are allocated between the supplemental prescription drug and catastrophic coverage premiums pro rata on the basis of the respective premium rates.

Effective date.—The supplemental premium is effective for taxable years beginning after December 31, 1988.

8. Delay in Organ Procurement Requirements (Section 26 of Senate amendment)

Present law

The Omnibus Budget Reconciliation Act of 1986 provided that Medicare payments for organ procurement would not be made unless: (a) the organ procurement agency involved met specified requirements and was designated by the Secretary as the sole procurement agency in its service area, and (b) hospitals establish protocols for making a routine inquiry for organ donation by potential donors, and are members of the National Organ Procurement and Transplantation Network.

Under the Omnibus Budget Reconciliation Act of 1986, these provisions were to be effective as of October 1, 1987. The Balanced Budget and Emergency Deficit Control Reaffirmation Act of 1987 changed this effective date to November 21, 1987. The Omnibus Budget Reconciliation Act of 1987 extends the effective date for item (a) to March 31, 1988.

House bill

No provision.

Senate amendment

Extends to December 31, 1988, the date by which the Secretary must complete the organ procurement agency designation process, the effective date of the requirements for hospital protocols for organ procurement, and the effective date for requiring hospitals to be members of the National Organ Procurement Network.

Effective date.—Enactment.

Conference agreement

The conference agreement does not include the Senate provision. The conferees note that a related provision was included in the Omnibus Budget Reconciliation Act of 1987.

9. Limitation on Medicare Out-of-Pocket Expenses (Section 201 of House bill; Sections 4 and 29 of Senate amendment)

Present law

Under current law, beneficiaries are liable for specified cost-sharing charges, in form of deductibles and coinsurance amounts, in connection with their use of inpatient hospital, skilled nursing facility, and hospice services, and blood under Part A.

Beneficiaries enrolling in Part B are required to pay a monthly premium. The program generally pays 80 percent of the reasonable charge for physicians and other covered medical services (including immunosuppressive drugs furnished within one year of a covered organ transplant) after the beneficiary has met the $75 deductible. The beneficiary is liable for the remaining 20 percent of the reasonable charge (coinsurance). In addition, where a physician does not accept assignment (i.e., does not agree to accept Medicare's determination of reasonable charge amount as payment in full for covered services), the beneficiary is liable for the difference between Medicare's reasonable charge and the physician's actual charge (the "balance billed amount"). The beneficiary is also liable for a separate Part B deductible.

There is no upper limit on the amount of cost-sharing charges beneficiaries are required to pay in connection with covered Medicare services.

House bill

(a) In General.—Establishes an annual limit on beneficiary out-of-pocket expenses (not including balance billed amounts) for covered part B services.

(b) Payment When Limit Has Been Reached.—Provides that if an individual has incurred out-of-pocket Part B expenses in a calendar year (beginning in 1989) equal to the Part B catastrophic limit for that year, the program will pay 100 percent of Part B reasonable charges (or costs) for covered Part B services (including physicians' services, ambulatory surgical center services, and dialysis services). In addition, after the beneficiary has reached the limit, no further blood deductible is required.

(c) Expenses Counting Toward the Catastrophic Limit.—Specifies that the following beneficiary expenses count toward the catastrophic limit:

(1) the Part B deductible, and blood deductible;
(2) Part B coinsurance charges; and
(3) a maximum of $250 in covered outpatient mental health expenses.

(d) Catastrophic Limit.—Specifies that the Part B catastrophic limit for 1989 is $1,043. The limit for any succeeding year is the limit for the preceding year increased by the Social Security cost-of-living adjustment (COLA), rounded to the nearest dollar. The Secretary is required to promulgate the Part B catastrophic limit by November 15 of each year (beginning with 1988) that will be in effect for the following year.

(e) Payments to Prepaid Health Plans Paid on a Reasonable Cost Basis.—Requires the Secretary to provide for an appropriate adjustment to payment rates for prepaid health plans paid on a reasonable cost basis to reflect the new catastrophic protection. The adjustment is to reflect: (1) the aggregate increase in payments which would otherwise be made for enrollees if they were not enrolled in the organization; or (2) the amount that would be paid to the organization or a facility if payments were made on an individual by individual basis. The organization is required to provide assurances, satisfactory to the Secretary, that it will not undertake to charge an individual during a year for covered services after the individual has reached the catastrophic limit (whether through the organization facility, or otherwise). [See Item 19(b)]

(f) Limitation on Charges When Catastrophic Limit Reached.—Specifies that providers (i.e., hospitals, skilled nursing facilities, comprehensive outpatient rehabilitation facilities, home health agencies, or hospice programs) with agreements with the Medicare program may not charge beneficiaries for services for which catastrophic benefit payments are made to the provider.

(g) Notice for Beneficiaries Reaching Catastrophic Limit.—Requires Medicare carriers to provide individuals, who have incurred sufficient out-of-pocket expenses, to qualify for catastrophic benefits, with a notice in a form appropriate for presentation to a physician. The notice is to: (1) state that the individual has reached the Part B catastrophic limit for the year; and (2) encourage the physician not to charge the individual amounts in excess of Medicare's reasonable charge and to accept payment on an assignment related basis for the remainder of the year.

(h) No provision.

Effective date.—Enactment (applies to items and services furnished after December 31, 1988).

Senate amendment

(a) In General.—Establishes an annual limit on beneficiary out-of-pocket expenses (not including balance billed amounts) for covered Part A and B services and entitles a Part B beneficiary to have payment made to him or on his behalf for specific catastrophic medical expenses.

(b) Payment When Limit Has Been Reached.—Provides for payment of 100 percent of catastrophic medical expenses. "Catastrophic medical expenses" are defined with respect to an individual for a calendar year (beginning with 1988) as any beneficiary cost sharing amounts incurred by an individual after the individual has in-

curred specific out-of-pocket medical expenses equal to the catastrophic limit. The program will pay beneficiary cost sharing amounts for: (1) the hospital deductible, SNF coinsurance charges, hospice coinsurance charges, and the Part A blood deductible; (2) the Part B deductible and Part B blood deductible; and (3) Part B coinsurance charges.

(c) Expenses Counting Toward the Catastrophic Limit.—Specifies that the following beneficiary expenses count toward the catastrophic limit:

(1) the Part A hospital deductible, SNF coinsurance charges, hospice coinsurance charges, and blood deductible;

(2) the Part B deductible and blood deductible;

(3) Part B coinsurance charges;

(4) amounts expended for qualified services for the prevention of illness or injury. A service meets this definition if:

(A) The service is one of the following: glaucoma screening by tonometry, cholesterol screening, a "Pap" test for detecting breast cancer, an immunization or booster for tetanus, influenza, or bacterial pneumonia, an occult blood stool test, or tuberculosis sensitivity testing;

(B) The service has not been provided to the beneficiary in the preceding 12 months; and

(C) The service is provided incident to a comprehensive physical which is performed by a physician, which includes a full history and other specified components, and which meets such other requirements as the Secretary may prescribe, including requirements to ensure a comprehensive approach for preventive health services.

Requires the Secretary to establish guidelines for the described preventive services no later than January 1, 1989.

(d) Catastrophic Limit.—Specifies that the Medicare catastrophic limit is $1,850 for 1988 and $2,030 for 1989. The limit for any succeeding year is the limit for the preceding year increased by the percentage, as determined by the Secretary, which will ensure that the percentage of Part B eligibles (other than those enrolled in HMOs or CMPs) whose out-of-pocket costs are projected to exceed the limit during that year will be the same as the percentage whose costs exceeded the limit in 1989. The Secretary is required to promulgate the limit by November 15 of each year (beginning with 1987) that will be in effect for the following year.

(e) Payments to Prepaid Health Plans Paid on a Reasonable Cost Basis.—Similar provision. Adjustments in payment rates are also applicable for renal dialysis facilities. Assurances to the Secretary specify that the organization or facility will not charge the individual during a year for any catastrophic medical expense incurred during that year.

(f) Limitation on Charges When Catastrophic Limit is Reached.—Similar provision.

(g) Notice for Beneficiaries Reaching Catastrophic Limit.—No provision.

(h) Beneficiary Costs of Catastrophic Insurance.—

(1) Findings.—States that the Senate finds that: (A) Medicare catastrophic insurance will provide beneficiaries with important and far-reaching protection, greatly reducing out-of-pocket

liability for those who incur high medical expenses; (B) the new benefits will be financed through premiums collected from all beneficiaries; (C) the Department has announced that the Part B premium will increase by 38.5 percent in January, 1988; (D) Medicare beneficiaries already are liable for Medicare premiums equal to 2.9 percent of their median income; and (E) it is the responsibility of Congress to ensure that the additional premiums for catastrophic coverage do not reach such levels as to unreasonably increase the out-of-pocket liability of Medicare beneficiaries.

(2) Sense of the Senate.—Expresses that it is the sense of the Senate that conferees take all necessary steps to ensure that cost controls on new benefits, particularly coverage of prescription drugs, are sufficient to protect program integrity, prevent escalation of costs, and reduce amounts required for premium financing. In addition, it is the sense of the Senate that Senate conferees be instructed to take all feasible steps to minimize beneficiary costs by keeping premiums at the lowest possible level, ensuring that year-to-year premium increases are gradual and predictable, ensuring that the income related premiums do not unduly burden middle-income older Americans, and ensuring that the combined basic and supplemental premiums do not exceed the value of the program to beneficiaries.

Effective date.—(a)-(g) Applies to items and services furnished after December 31, 1987. In determining whether an individual has incurred out-of-pocket medical expenses in 1988 equal to the catastrophic limit, only expenses incurred on or after July 1, 1988, are taken into account. (h) Effective on enactment.

Conference agreement

(a) *In General.*—The conference agreement includes the House provision with an amendment.

(b) *Payment When Limit Has Been Reached.*—The conference agreement includes the House provision.

(c) *Expenses Counting Toward the Catastrophic Limit.*—The conference agreement includes the Senate amendment with a modification. The agreement does not include expenses for Part A cost-sharing, or for preventive services in the calculation of expenses counting toward the catastrophic limit.

The conference agreement, in section 204, provides coverage of screening mammography (including associated professional and technical services) effective January 1, 1990, subject to frequency limitations, quality standards, and special payment rules.

The agreement provides coverage for a biennial screening mammography for women aged 65 and over. For disabled women under age 65, a baseline screening would be available between age 35 and 40. Between ages 40 and 49, screenings would be available every other year, except that screenings could be provided each year for high risk women. Between ages 50 and 64 screenings could be provided on an annual basis.

The agreement requires the Secretary, in consultation with the Director of the National Cancer Institute, to review periodically the appropriate frequency for performing screening mammographies, based on age or other factors. The Secretary, on the basis of this review, may revise the frequency for covered screenings performed on or after January 1, 1992.

The agreement requires the Secretary to establish standards to assure the safety and accuracy of screening mammographies. The standards must include the following requirements: (i) the equipment used must be specifically designed for mammography and must meet radiologic standards established by the Secretary; (ii) the screening must be performed by an individual who is either licensed by the State to perform radiologic procedures or is certified as qualified to perform such procedures by an appropriate organization recognized by the Secretary; (iii) the results of the mammography must be interpreted by a physician who either is certified by the American Board of Radiology or is otherwise certified by a program recognized by the Secretary by regulation as assuring that the physician is qualified to interpret the results of screening mammography; and (iv) there must be assurances that the results of the first screening paid for by Medicare will be placed in permanent medical records maintained for the woman.

The conferees understand that a bilateral four-view procedure is currently considered to be the standard of care in the United States for screening mammography. The conferees therefore anticipate that this would be initially included in the quality standards to be developed by the Secretary as a requirement for coverage, subject to change with new technology and additional medical information. The conferees also note that the reimbursement level provided for under this provision is premised on the understanding that a four-view procedure would be provided.

State survey and certification agencies and private accreditation programs (if approved) could be used to verify compliance with required quality standards.

Payment would be 80% of the least of: (i) the actual charge, (ii) the fee schedule allownce (with respect to both the professional and technical components of screening mammography) established under Section 1834(b) of the Social Security Act, or (iii) a reasonable charge limit. The limit would be $50 in 1990 and would be indexed thereafter by the percent increase in the Medicare Economic Index (MEI).

Beginning January 1, 1992, the Secretary may reduce the reasonable charge limit, as it applies nationally or in an area, if the Secretary finds such action both appropriate and consistent with maintaining convenient access for beneficiaries to screening services.

The agreement provides for an appropriate allocation of the reasonable charge limit between professional and technical components in the case of hospital outpatient screening mammographies (and comparable situations) where there is a claim for professional services separate from the claim for associated technical services. In these cases, payment for the technical component would be based on the allocated reasonable charge limit.

The agreement sets maximum allowable actual charge (MAAC) limits for screening mammographies performed by nonparticipating physicians. These MAAC limits are based on the fee schedule established for radiologists under Section 1834(b) of the Act.

The MAAC limits are 125% of the reasonable charge limit in 1990, 120% of the reasonable charge limit in 1991, and 115% of the reasonable charge limit in 1991 and subsequent years. The Secretary is empowered to impose sanctions against physicians or suppliers who knowingly and willfully impose charges in excess of the limits.

The MAAC limits would be in effect until such time as the Secretary implements a fee schedule for physicians' services based on the relative value scale mandated under Section 1845(e) of the Social Security Act.

The conferees are aware of concern that the $50 reasonable charge limit might limit the availability of mammography in physicians' offices even though the procedure may be available at clinics, hospital outpatient departments, and outpatient radiology facilities. Accordingly, the conference agreement requires the Physician Payment Review Commission to study the cost of providing screening mammography in a variety of settings and at different volume levels. The report would be submitted to Congress by July 1, 1990.

Finally, the conference agreement requires GAO to conduct a study of the quality of screening mammography provided in clinics, hospital outpatient departments, and outpatient radiology facilities as compared with physician offices. This report would also be due by July 1, 1990.

(d) *Catastrophic Limit.*—The conference agreement includes the Senate amendment with a modification. The agreement sets the Part B catastrophic limit for 1990 at $1370. The agreement requires the Secretary to set the limit for future years at an amount necessary to ensure that the percentage of Part B enrollees (not including enrollees in health maintenance organizations) whose expenses are expected to exceed the cap during that year is 7 percent.

The conference agreement requires the Secretary to promulgate, not later than September 1 of each year (beginning in 1990), the catastrophic limit which will be in effect for the following calendar year.

(e) *Payments to Prepaid Health Plans Paid on a Reasonable Cost Basis.*—The conference agreement includes the House provision, with amendments. The provisions relating to charges for covered services after an individual has reached the catastrophic limit apply to organizations with a risksharing contract, as well as to those paid on a reasonable cost basis. Different rules apply depending on whether the organization does or does not "buy out" Part B deductible and coinsurance charges for enrolled beneficiaries. A plan is deemed to be a buy-out plan if the actuarial value of the coinsurance and deductible charges it imposes on enrollees for Part B services (other than for outpatient drugs) is less than 50 percent of the national average actuarial value of the Part B coinsurance and deductible for all Medicare beneficiaries.

In the case of a buy-out plan, actual cost-sharing amounts for Part B services incurred by a beneficiary while enrolled in the plan are not counted towards the catastrophic limit. However, the enrollee is deemed to have incurred Part B cost-sharing expenses for each month of enrollment equal to the monthly national average actuarial value of Part B deductible and coinsurance amounts.

In the case of a plan than is not a buy-out plan, cost-sharing amounts for Part B services incurred by a beneficiary while enrolled in the plan are counted towards the catastrophic limit. The plan may not enter into a Medicare contract or receive Medicare payment unless it provides assurance satisfactory to the Secretary that: (i) it will maintain, in coordination with the appropriate Part B carriers, accounts of Part B cost-sharing expenses incurred by enrollees during each year, including out-of-plan services; (ii) it will make the accounts available to an enrollee and to the carrier if an enrollee disenrolls during the year (or at any time, in the case of an organization paid under section 1833); and (iii) it will not undertake to charge any enrollee for Part B services (other than outpatient drugs) after the enrollee has incurred cost-sharing expenses, whether through the organization or otherwise, equal to the catastrophic limit for the year.

The conferees expect that the Secretary, in establishing contracts with Part B carriers under section 1842, will require the carriers to provide information on expenses for out-of-plan services to the plans without charge.

If a beneficiary is enrolled in a plan which has its contract terminated by the Secretary during a year, no inpatient hospital deductible will be imposed on an individual who can demonstrate to the satisfaction of the Secretary that he or she was admitted to a hospital during the calendar year.

(f) *Limitation on Charges When Catastrophic Limit Reached.*—The conference agreement includes the Senate amendment.

(g) *Notice for Beneficiaries Reaching Catastrophic Limit.*—The conference agreement includes the House provision with a modification. The required notice is to state that the individual has reached the Part B catastrophic limit for the year.

(h) *Beneficiary Costs of Catastrophic Insurance.*—The conference agreement does not include the Senate amendment. The amendment expressed the sense of the Senate, and was duly passed by the Senate.

Effective date.—The conference agreement applies to items and services furnished on and after January 1, 1990.

10. Coverage of Catastrophic Expenses for Prescription Drugs (Section 202 of House bill; Sections 11 and 28 of Senate amendment)

Present law

Medicare generally does not cover outpatient prescription drugs which can be self-administered by the patient. The program covers under Part B immunosuppressive drugs which are furnished within one year of an organ transplant covered by Medicare.

House bill

(a) In General.—Adds "covered outpatient drugs" to services included within the definition of "medical and other health services". Defines a "covered outpatient drug" as one that is: (1) approved for safety and effectiveness under the Federal Food, Drug, and Cosmetic Act, or, in the case of a drug which is a biological product, is licensed under the Public Health Service Act; and (2) insulin certi-

fied under the Federal Food, Drug, and Cosmetic Act. The term does not include any drug or insulin provided to an inpatient as part of inpatient hospital services, extended care services, or incident to physicians' services. The term does not include immunosuppressive drugs which are furnished within 1 year of a covered organ transplant.

(b) Phase-In Coverage.—No provision.

(c) Deductible.—

(1) Provides that expenses for covered outpatient drugs do not count toward the Part B deductible and that the Part B deductible is not applicable for covered outpatient drugs.

(2) Requires the individual, before the program makes payments for covered outpatient drugs, to establish that he has incurred (or has had paid in his behalf) expenses for covered outpatient drugs during the year equal to the drug deductible. The Secretary is required, upon application by the individual, to promptly notify the individual (and, if submitted by or through a participating pharmacy, the pharmacy) as to whether he has met the deductible.

(3) Sets the deductible at $500 in 1989. The increase in 1990 and 1991 is equal to the increase in the medical care component of the consumer price index (for the 1-year period ending the previous August). In future years, it is increased by the percentage increase in the outpatient prescription drug index established by the Secretary. The base point of the index is the prices of covered outpatient drugs as of August 1990. In September of each year (beginning in 1991), the Secretary is to determine the percentage change for the preceding 12 months (rounded to the nearest dollar). The Secretary is required to publish the deductible each year beginning in 1989.

(d) Adjustment in Deductible.—Provides for an adjustment if the Secretary's estimate of the additional Part B premium needed to finance the drug benefit indicates an increase of more than 20 percent over the previous year. In this case, the Secretary would increase the deductible by an amount sufficient to reduce the costs of the program to the level that would be financed by a 20 percent premium increase. (The premium is to cover 75 percent of total costs of the drug benefit; see Item 15.)

(e) Authority to Reduce Deductible—No provision.

(f) Payment Amount.—

(1) Specifies that, subject to the deductible, the amount paid with respect to a covered outpatient drug is equal to lesser of the actual charge or the applicable payment limit minus 20 percent of the actual charge. The payment amounts are also applicable for payments for immunosuppressive drugs during the first year following a covered organ transplant.

(2) Specifies that the payment calculation periods are the 6-month periods beginning with January and July of each year.

(3) Requires the Secretary, (before each 6-month payment calculation period beginning on or after January 1, 1989), to provide information on payment limits to participating pharmacies and groups representing or assisting beneficiaries.

(4) Requires the Secretary to provide for an appropriate adjustment to payment rates for prepaid health plans paid on a

reasonable cost basis to reflect the new catastrophic drug benefit. The adjustment is to reflect: (A) the aggregate increase in payments which would otherwise be made for enrollees if they were not enrolled in the organization; or (B) the amount that would be paid to the organization or a facility if payments were made on an individual by individual basis. The organization is required to provide assurances, satisfactory to the Secretary, that it will not undertake to charge an individual more than 20 percent of the reasonable cost plus any amount needed to satisfy the deductible.

(g) Payment Limits for Non-Multiple Source Drugs and Drugs With Restrictive Prescriptions.—

(1) Provides that the payment limit for a drug which is either not a multiple source drug or a multiple source drug with a restrictive prescription is the sum of: (A) the product of the number of dosage units or tablet units and the average per tablet or unit wholesale price; plus (B) an administrative allowance.

(2) Requires the Secretary to determine (with respect to dispensing a covered outpatient drug in a payment calculation period beginning on or after January 1, 1989) the average per tablet or unit wholesale price based on the average wholesale price for purchases in reasonable quantities. The determination is to be based on wholesale prices for the first day of the third month before the beginning of the payment calculation period. The determination and calculation of the payment limits are to be made on a national basis, except that the determination and calculation may be done on a regional basis to take into account limitations in availability or variations in average wholesale prices for a drug product.

(3) Specifies that a drug has a restrictive prescription only if the prescription indicates, in the handwriting of the physician (or other person prescribing the drug), and with an appropriate phrase recognized by the Secretary, that the particular drug must be dispensed. An appropriate phrase may be "brand medically necessary)."

(h) Payment Limit for Multiple Source Drugs Without Restrictive Prescriptions.—

(1) Provides that the payment limit for a multiple source drug without a restrictive prescription is the sum of: (A) the product of the number of tablets or dosage units and the unit limit, plus (B) the administrative allowance. Specifies that the unit limit is 50 percent of the brand name reference price for the reference drug product for the period.

(2) Requires the Secretary to establish a brand name reference price for each reference drug product for each payment calculation period. For the 6-month period beginning January 1, 1987, the brand name reference price for a drug product is the average per tablet or unit wholesale price (based on purchases of reasonable quantities) as of January 1, 1987.

Specifies that for each subsequent 6-month payment calculation period, the reference price is increased by the increase in the consumer price index (for the 6-month period ending in the third month of the previous calculation period).

Specifies that for a reference drug product which was not available on January 1, 1987, the base period is the first month of the first payment calculation period in which it is available.

Specifies that brand name reference prices are to be established on a national basis, except that the prices may be established on a regional basis to take into account limitations in availability or variations in the average wholesale price for a drug product.

(3) Defines a multiple source drug as a covered outpatient drug for which (during the payment calculation period) there are 2 or more drug products which: (A) are rated thereapeutically equivalent under the Food and Drug Administration's most recent publication of "Approved Drug Products With Therapeutic Equivalence Evaluations" which is available on the first day of the third month before the beginning of the period; and (B) are sold or marketed during the period.

Specifies that a drug is considered as sold or marketed if it listed in the FDA publication unless the Secretary determines that the sale or marketing is not actually taking place.

(4) Defines a "reference drug period" as a multiple source drug in reference to which other drug products are rated as therapeutically equivalent in the FDA publication.

(i) Administrative Allowance.—Specifies that the administrative allowance is $4.50 for drugs dispensed in a payment calculation period beginning in 1989. For each subsequent payment calculation period, the administrative allowance is increased by the percentage increase (if any) in the implicit price deflator for gross national product.

(j) Assuring Appropriate Utilization.—

(1) Provides that the Secretary may provide that payment for covered outpatient drugs may not be made if they are prescribed or dispensed with excessive frequency or in excessive quantities. The Secretary is required to establish a utilization review program for covered outpatient drugs to identify instances of unnecessary or inappropriate prescribing or dispensing practices and to identify quality of care problems.

(2) No provision.

(k) Treatment of Certain Prepaid Organizations.—Establishes rules with respect to prepaid organizations which do not impose charges on covered outpatient drugs. For purposes of the drug provision, the actual charges of the organization are the organization's standard charges to members and other persons not entitled to drug benefits. The standard charges are to be used for purposes of the drug deductible.

(l) Physician Guide.—Requires the Secretary to develop, and update annually an information guide for physicians on the comparative average wholesale prices of at least 500 of the most commonly prescribed covered outpatient prescription drugs. To the extent practicable, the guide is to group drugs in a manner useful to physicians by therapeutic category or conditions for which they are prescribed. The guide is to specify the wholesale prices on the basis of the amount required for a typical daily therapeutic regimen. The Secretary is required to mail the guide by March 1 of each year (beginning in 1989) to each hospital with a provider

agreement with Medicare and each physician who routinely provides Medicare services.

(m) Special Cost-control Measures.—No provision. See Item 10(d) on adjustment in deductible for requirement that Secretary increase drug benefit deductible to prevent excessive increase in premiums.

(n) High Volume Pharmacies.—No provision.

(o) Report on Payment Limits.—Requires the Secretary to review the payment limits established for covered outpatient drugs and report to Congress by April 1, 1989, on the appropriateness of the limits, together with any recommendations for change.

(p) Report on Covered Outpatient Drug Index.—Requires the Secretary to report to Congress by January 1, 1991, on the covered outpatient drug index.

(q) Participating Pharmacies.—

(1) Defines a participating pharmacy as one which is authorized under State law to dispense covered outpatient drugs and which has entered into an agreement with the Secretary. Under the agreement, the entity agrees:

(A) Not to refuse to dispense covered outpatient drug items, stocked by the entity, to Medicare Part B beneficiaries and not to charge them more for such drugs than charged to the general public;

(B) To keep patient records (including records on expenses incurred by beneficiaries) for all covered outpatient drugs dispensed to beneficiaries;

(C) To assist beneficiaries in determining whether they have met the drug deductible including providing the necessary documentation;

(D) To provide, upon request of a beneficiary, a copy of his records to another participating pharmacy or Medicare carrier;

(E) To offer to counsel or offer to provide information to each beneficiary on the appropriate use of a dispensed drug and whether there are potential interactions between this drug and others dispensed to the beneficiary;

(F) To advise the beneficiary on the availability (consistent with State drug substitution laws) of therapeutically equivalent covered outpatient prescription drugs; and

(G) To submit, effective January 1, 1992, all claims requests electronically, except this requirement may be waived by the Secretary in cases of undue hardship.

Pharmacies operated by prepaid organizations for the exclusive benefit of its members are not required to dispense covered outpatient drugs to nonmembers.

(2) Requires the Secretary to provide each participating pharmacy with a distinctive emblem and, before each payment calculation period, information on payment limits established under the drug benefit.

(3) Requires the Secretary to provide for periodic audits of participating pharmacies to insure that they do not impose charges on beneficiaries in excess of those charged to the general public.

(4) Payments for covered outpatient drugs may only be made on an assignment basis in the case of participating pharmacies.

(r) Civil Monetary Penalty.—No provision.

(s) Limitation to 60 Day Prescription.—Prohibits Part B payments for covered outpatient drugs if dispensed in excess of a 60-day supply.

(t) Additional Premium for Prescription Drug Benefit.—Refers to section 106(a) of the bill. (See Item 15.)

(u) Use of Carriers in Administration.—

(1) Requires carriers making determinations or payments with respect to covered outpatient drugs to: (A) offer to receive payment requests electronically; and (B) respond to requests by participating pharmacies as to whether an individual has met the deductible. The Secretary may enter into agreements for processing of drug claims on a regional basis.

(2) No provision.

(v) Modification of HMO/CMP Provisions.—

(1) Requires HMOs and CMPs with Medicare risk sharing contracts to take into account drug expenses incurred in a year by individuals who enroll after January 1 of a year.

(2) No provision.

(3) No provision.

(w) Medicaid Requirements.—See Item 33.

(x) Beneficiary Drug Cost Survey and CBO Report.—

(1) Requires the Secretary to conduct a statistically valid survey, and report to Congress by March 1, 1989, on expenses incurred by beneficiaries for covered outpatient drugs. The Secretary is required to consult with the General Accounting Office (GAO) and the Congressional Budget Office (CBO) concerning survey design. The survey is to provide information on the distribution of expenses for covered outpatient drugs for Medicare beneficiaries generally and the distribution of expenses by age, sex, income, and institutional status.

(2) Requires the CBO (within 2 months of submission of the report) to estimate Medicare expenditures for fiscal year 1990–93 for covered outpatient drugs.

(3) No provision.

(y) Prescription Drug Payment Review Commission.—Requires the Director of the Office of Technology Assessment (OTA) to provide for the appointment of a Prescription Drug Payment Review Commission to be composed of individuals with expertise in the provision and financing of covered outpatient prescription drugs. The Director of OTA shall appoint the 11 Commission members by October 1, 1988, for staggered 3-year terms. The membership must include recognized experts in health care economics, medicine, pharmacology, pharmacy, and prescription drug reimbursement, as well as one Medicare beneficary. The Commission is required to make annual recommendations to the Secretary.

(z) Additional Studies.—

(1) Requires the Secretary to conduct studies on:

(A) Extent of private or other third-party drug coverage for beneficiaries;

(B) Comparison of published average wholesale price and actual pharmacy acquisition costs by type of pharmacy;

(C) Overhead costs of retail pharmacies;

(D) Potential application of new claims processing and billing technologies;

(E) Methods for utilization review;

(F) Alternative payment methodologies that promote greater program efficiencies; and

(G) Potential for induced demand resulting from the drug benefit.

(2) Requires the Secretary, as part of the studies, to conduct a longitudinal study on the use of covered outpatient drugs by beneficiaries with respect to medical necessity, potential for adverse drug interactions, and patient stockpiling or wastage. The Secretary is required to report to Congress on the results of the studies by January 1, 1991.

(3) No provision.

(aa) Study of Treatment of Prescription Drugs.—No provision.

(bb) Simplification of Recordkeeping.—No provision.

Effective date.—Applies to drugs dispensed on or after January 1, 1989. (u) and (y) effective on enactment. (v) applies to new enrollments effected on or after January 1, 1989.

Senate amendment

(a) In General.—Adds "covered outpatient drugs" to services included within the definition of "medical and other health services". Defines a covered outpatient drug as one which is: (1) approved for safety and effectiveness under the Federal Food, Drug, and Cosmetic Act, or is recognized in the "United States Pharmacopoeia" (and is available only under a prescription); or (2) in the case of a prescription drug which is a biological product, is licensed under the Public Health Service Act. The term does not include any drug or biological which would have been paid for under Medicare prior to enactment of this law. The term does not include immunosuppressive drugs which are furnished during the first year following a covered transplant.

(b) Phase-In Coverage.—

(1) Specifies that in 1990, the term covered outpatient drug includes a drug which is an intraveneously administered anti-infective agent, a cancer chemotherapeutic agent (including a drug used to enhance the safety and efficacy or counteract the toxicity of anticancer drugs) or immunosuppressive drugs after the first year following a covered organ transplant.

(2) Specifies that in 1991 and 1992, the term covered outpatient drug includes drugs specified under item (1) and any cardiovascular or diuretic drug.

(c) Deductible.—

(1) Similar provision.

(2) Identical provision.

(3) Sets the deductible at $600 in 1990. In subsequent years, it is increased by the percentage by which the Part B beneficiary drug expenditure amount for the 12-month period ending the previous August exceeds such amount for the preceding 12 months (rounded to the nearest dollar). [See Item 15 below for definition of beneficiary drug expenditure amount.] The Secre-

tary is required to publish each September (beginning in 1990) the deductible for the following year.

(d) Adjustment in Deductible.—No provision.

(e) Authority to Reduce Deductible.—Provides that if the Secretary determines there is sufficient revenue to pay all of the benefits and administrative costs, and to provide an adequate contingency margin (as determined by the Secretary), the Secretary may reduce the deductible amount to $500 in 1991, $400 in 1992, and $300 in 1993.

(f) Payment Amount.—

(1) Similar provision, except specifies that the applicable payment limit is subject to reductions applied to high volume pharmacies.

(2) Specifies that the payment calculation period is the 12-month period beginning every January (after 1989).

(3) Similar provision except: (A) applies to payment calculation periods beginning on or after January 1, 1990; and (B) also requires provision of information on any reductions applied for high volume pharmacies.

(4) Permits a prepaid health plan paid on a reasonable cost basis to elect to be paid 80 percent of the reasonable cost of immunosuppressive and covered outpatient drugs. Such organization may not charge individuals more than 20 percent of the reasonable cost plus any amount needed to satisfy the deductible.

(g) Payment Limits for Non-Multiple Source Drugs and Drugs With Restrictive Prescriptions.—

(1) Similar provision.

(2) Similar provision except: (A) applies to determinations for payment calculation periods beginning on or after January 1, 1990; (B) specifies that the average per tablet or unit wholesale price is the most recently published figure; and (C) requires the calculation to be made on a national basis if the drug is available on a national basis.

(3) Similar provision, except applies to written prescriptions. Specifies that for telephone prescriptions, the physician or other person (through the use of an appropriate phrase) states that the particular drug must be dispensed.

(h) Payment Limit for Multiple Source Drugs Without Restrictive Prescriptions.—

(1) Provides that the payment limit for a multiple source drug without a restrictive prescription is the sum of (A) the product of the number of tablets (or other dosage units) and 150 percent of the lowest average per tablet or unit wholesale price for the drug; and (B) the administrative allowance.

(2) Requires the Secretary to determine with respect to covered outpatient drugs for the payment calculation period (beginning on or after January 1, 1990) the average per tablet or per unit wholesale price for the drug for purchases in reasonable quantities. Specifies that for the period beginning January 1, 1987, the average is the average per tablet or per unit wholesale price for the drug as of January 1, 1987.

Specifies that for subsequent payment calculation periods, the amount is the lesser of: (A) the most recently published average per tablet or per unit wholesale price; or (B) the average per tablet or unit price established for the previous payment calculation period increased by the percentage change in the Consumer Price Index for the 12-month period ending the preceding August.

Requires the Secretary to establish the average per tablet or per unit wholesale price, in the case of a covered outpatient drug which is not available as of January 1, 1987, for the first month of the first payment calculation period in which it is available.

Requires the Secretary to make determinations on a national basis if the drug is available on a national basis. If not, the Secretary may make determinations and calculate payment limits on a regional basis to take into account the availability of drug products and variations in average wholesale prices.

(3) Defines a multiple source drug as a covered outpatient drug for which (during the payment calculation period), there are 2 or more drug products (or in the case of a covered outpatient drug subject to a patent, 3 or more drug products) generally available to beneficiaries through retail pharmacies which the Secretary determines are: (A) pharmaceutically equivalent, bioequivalent, adequately labeled, and manufactured in compliance with the Current Good Manufacturing Practice regulations; and (B) sold or marketed during the period.

Specifies that drug products are pharmaceutically equivalent if the products contain identical amounts of the same active drug ingredient in the same dosage form and meet compendial or other applicable standards of strength, quality, purity, and identity. Drugs are bioequivalent if they do not present a known or potential bioequivalence problem, or if they do present such a problem, are shown to meet an appropriate bioequivalence standard.

Specifies that a drug is considered to be sold or marketed during a period if it is listed in the Food and Drug Administration's most recent publication of "Approved Drug Products With Therapeutic Equivalance Evaluations" for the third month before the beginning of the period, unless the Secretary determines that such sale or marketing is not actually taking place.

(4) No provision.

(i) Administrative Allowance.—Similar provision, except: (A) administrative allowance is $3.50 for nonparticipating pharmacies for the payment calculation period beginning January 1, 1990; and (B) the amounts are increased annually rather than biannually.

(j) Assuring Appropriate Utilization.—

(1) Provides that the Secretary may provide that payment for covered outpatient drugs may not be made in specific instances if they are prescribed or dispensed with excessive frequency or in excessive quantities. The Secretary is required to establish a utilization review program for covered outpatient drugs to identify patterns of unnecessary or inappropriate prescribing or dispensing practices, including excessive charging in the dispensing of drugs and to identify patterns of substandard care.

(2) Requires the Secretary in carrying out the utilization review program, to use diagnosis and indication codes and establish standards for the prescribing, dispensing, and utilization for each covered outpatient drug. In establishing the standards, the Secretary (after providing notice in the Federal Register and not less than a 60-day comment period) may incorporate standards from current authoritative medical references as he may select.

(k) Treatment of Certain Prepaid Organizations.—Identical provision.

(l) Physician Guide.—Similar provision, except guide must be mailed by January 1 of each year (beginning in 1990).

(m) Special Cost-Control Measures.—Requires the Secretary to institute necessary cost control measures if he determines that the monthly catastrophic drug benefit premium will exceed the limits established under this bill. (See Item 15.) In carrying out this provision, the Secretary may not exclude from coverage or limit payment for any specific covered outpatient drug or specific class of covered outpatient drugs or change the methodology for calculating whether the individual has met the deductible. However, the Secretary may exclude from coverage all drugs listed in a major classification of the most recently issued version of Veterans' Administration Medication Classification System.

(n) High Volume Pharmacies.—Authorizes the Secretary, after 1990, to reduce by regulation the payment limits established (both for nonmultiple source and multiple source drugs) dispensed by a high volume pharmacy (as defined by the Secretary). The reductions are to be based on differences between high volume pharmacies and other pharmacies with respect to operating costs, quantity discounts, and other economies. The Secretary is required to consult with high volume pharmacists, elderly groups and private insurers in making such adjustments. A minimum 90-day public comment period is required for proposed regulations.

(o) Report on Payment Limits.—Requires the OTA and the Secretary to submit to the Congress before beginning of the calendar year (for years after 1990) recommendations for adjustments to the payment limits. The Secretary is required to request the National Academy of Sciences, acting through the Institute of Medicine, to enter into a contract to make such recommendations. Each is required to consult with pharmacists, pharmaceutical manufacturers, elderly groups, and private insurers in making such recommendations.

(p) Report on Covered Outpatient Drug Index.—No provision.

(q) Participating Pharmacies.—

(1) Similar provision except:

(A) Does not apply in the case of any entity which dispenses covered outpatient drugs exclusively to beneficiaries enrolled in HMOs and CMPs;

(B) Identical provision;

(C) To assist beneficiaries in determining whether or not their expenses for covered outpatient drugs exceed the deductible and to certify to the Secretary, with respect to such beneficiaries that their expenses exceed the deductible and make available supporting documentation. Nothing is to be construed as authorizing the Secretary to require submission of the documentation with respect to prescriptions other than pursuant to an audit, upon certification under this provision, or for monitoring purposes from a sample of up to 7.5 percent of participating pharmacies;

(D) Identical provision;

(E) Specifies that the provision of information to beneficiaries is to be consistent with State law respecting the provision of such information;

(F) Identical provision;

(G) Changes the effective date to January 1, 1991.

(2) Identical provision.

(3) Identical provision.

(4) Identical provision.

(r) Civil Monetary Penalty.—Provides that civil monetary penalties may be imposed in the case of participating or nonparticipating pharmacy which presents, or causes to be presented, a request for payment for covered outpatient drugs at a charge greater than that charged the general public.

(s) Limitation to 60 Day Prescription.—Similar provision except permits up to a 90 day supply in the case of an individual receiving chronic maintenance drug therapy as defined by the Secretary.

(t) Additional Premium for Prescription Drug Benefit.—No specific cross reference (See Item 15).

(u) Use of Carriers in Administration.—

(1) Similar provision, except includes fiscal intermediaries in title.

(2) Specifies that 95 percent of clean claims for covered outpatient drugs are to be paid within 45 days of receipt.

Specifies that contracts with carriers shall provide that no payment shall be issued, mailed, or otherwise transmitted for covered outpatient drugs within 30 days after the claim is received.

(3) Authorizes the Secretary to enter into contracts with intermediaries and carriers for performance of functions relating to home intravenous drug therapy on a regional basis.

(v) Modification of HMO/CMP Provisions.—

(1) Identical provision.

(2) Specifies that the calculation of the premium rate and the actuarial value of the deductible and coinsurance for individuals enrolled only in Part A or Part B is to be made separately for the drug benefit.

(3) Specifies that additional benefits required to be provided by an HMO/CMP may include reduction of premium rate or other charges made with respect to drugs.

(w) Medicaid Requirements.—See Item 33.

(x) Beneficiary Drug Cost Survey and CBO Report.—

(1) Similar provision, except requires the Secretary also to consult with consumer groups and representatives of the pharmaceutical and pharmacist industries. Report on survey due by January 19, 1989.

(2) Identical provision.

(3) Requires the GAO (within 2 months of submission of the report) to report on the validity of the survey and the extent to

which pharmacies accept assignment and barriers, if any, to such acceptance.

(y) Prescription Drug Payment Review Commission.—No provision.

(z) Additional Studies.—

(1) Similar provision, except does not include Item B. Adds study requirement on the possibility of including drugs which have not yet been approved under the Federal Food, Drug, and Cosmetic Act, but which are commonly used in the treatment of cancer or immunosuppressive therapy as covered outpatient drugs. The study shall be conducted in consultation with an advisory board of consumers, experts in the field of cancer therapy and immunosuppressive therapy, representatives of pharmaceutical manufacturers, and such other individuals as the Secretary may select.

(2) Similar provision except requires an interim report by not later than January 1989.

(3) Requires the Secretary and the GAO to each conduct and periodically update a study on comparison of published average wholesale prices and actual pharmacy acquisition costs by type of pharmacy. A report is to be sumitted to Congress on the results of each study and update with the first report due no later than January 1, 1989.

(aa) Study of Treatment of Prescription Drugs.—

(1) Requires the OTA to conduct a study to identify additional or alternative covered outpatient drugs that can be included under the Medicare definition for 1991 and 1992.

(2) Requires the Secretary to request the National Academy of Sciences, through the Institute of Medicine, to enter into a contract under which the Institute, in consultation with representatives of appropriate research and health care organizations, will also conduct the study described in (1). The Secretary is to be responsible for related expenses incurred by the Academy.

Specifies that in conducting the study, the Office and the Institute are to give particular attention to those drugs that meet any or all of the following criteria:

(A) The drug is used by a large number of beneficiaries;

(B) The drug can be covered without significant administrative difficulties;

(C) Coverage will provide useful information with respect to utilization and cost of covered outpatient drugs under Medicare;

(D) Coverage will not cause an unreasonble increase in premiums under Medicare;

(E) The drug is expensive when used as part of a chronic drug regimen.

Requires the OTA and the Institute to submit to the Secretary and appropriate congressional committees an interim report within 6 months of enactment, and a final report containing specific findings and recommendations within 12 months.

(bb) Simplification of Recordkeeping.—Requires the Secretary, by October 1, 1988, to enter into an agreement with two or more pri-

vate entities to conduct demonstration projects to test the use of magnetic cards, electronic billing, and other technological devices in the administration of the drug benefit.

Specifies that the Secretary shall select among applications submitted by entities in the form prescribed by the Secretary. The Secretary shall determine the time necessary to carry out the project and submit a report within 6 months of completion.

Specifies that the projects are to be conducted at statistically relevant locations and be used for providing quick data for projecting total cost of the drug benefit.

Requires the Secretary to develop, in consultation with representatives of participating pharmacies, consumers, and other interested individuals, a standard receipt to be used by Medicare beneficiaries in making purchases from participating pharmacies. The receipt is to be distributed by January 1, 1990. The Secretary is to take appropriate steps to insure that such pharmacies used the receipt.

Effective date.—Enactment.

Conference agreement

(a) *In General.*—The conference agreement includes the House provision with an amendment. The agreement includes coverage for two additional categories of prescription drugs. The first category includes those drugs (i) which were commercially used or sold prior to the Drug Amendments of 1962 and (ii) which are identical, similar or related to those described in clause (i) provided that the Secretary has not made a final determination that the drugs described in clause (i) or (ii) are "new drugs." These drugs are the so-called "pre-1938" drugs and are not subject to current requirements regarding pre-market approval by the Food and Drug Administration (FDA) for safety and efficacy.

The conference agreement also includes coverage for certain so-called DESI drugs. Under the provisions of the 1962 amendments to the Federal Food, Drug, and Cosmetic Act, all new drugs must be shown to be effective and safe rather than just safe as had been required previously. This legislation also applied retroactively to all drugs approved as safe from 1938 to 1962. The program established to review the effectiveness of these drugs was named the Drug Efficacy Study Implementation (DESI) program. Under the program, drugs were labelled effective, probably effective, possibly effective, or ineffective. The FDA reviewed any additional evidence submitted by the manufacturer for those drugs determined to be less than effective. If the FDA decides that a drug product lacks substantial evidence of effectiveness for the conditions it is intended to treat, it publishes a notice of opportunity for hearing in the Federal Register on a proposal to withdraw approval for marketing. This affords the manufacturer an opportunity for a hearing before a final determination is made. The conference agreement includes coverage for DESI drugs for which the Secretary has not issued a notice for an opportunity for a hearing and for which the Secretary has determined there is compelling justification for its medical need. Also included are identical, similar or related drugs. It is the understanding of the conferees that the only DESI drug which would be covered by this provision, because a notice for an opportunity for a hearing has not been issued, is nitroglycerin patches.

The agreement further clarifies that the term "covered outpatient drugs" does not include drugs which are already being reimbursed under current law because they are provided as part of, or incident, to other covered services.

(b) *Phase-in Coverage.*—The conference agreement includes the Senate amendment with modifications. The agreement provides coverage for two categories of drugs in 1990—drugs used in immunosuppressive therapy and covered home intravenous (IV) drugs.

Drugs used in immunosuppressive therapy are currently covered for only one year after a transplant that is covered by Medicare. The conference agreement would retain this coverage, which would remain subject to current rules on coinsurance. The conference agreement would add subsequent coverage as well, irrespective of whether the transplant was covered by Medicare. This subsequent coverage would be subject to the same rules regarding deductible and coinsurance as apply to other newly covered prescription drugs.

The agreement provides for coverage of all "covered outpatient prescription drugs" effective January 1, 1991. The agreement provides for a phase-in of the benefit by reducing the requisite beneficiary coinsurance over a three-year period.

Coinsurance is set at 50% in FY 1990 and FY 1991, 40% in FY 1992, and 20% in FY 1993 and each year thereafter. The agreement limits coinsurance to 20%, starting in 1990 with no phase-in, for home IV drugs and immunosuppressive drugs used during the first year after a Medicare covered transplant. (For subsequent use of immunosuppressive drugs, coinsurance would be determined by the general rule.)

The agreement defines a covered home IV drug as one that is intravenously administered in a home setting. The term includes antibiotic drugs, unless the Secretary has determined, for a specific drug or for the indication for which it is applied, that it cannot generally be safely or effectively administered in a home setting. The term includes additional IV drugs (other than antibiotics) only if the Secretary determines that for the specific drug and the indication for which it is being applied, that it can generally be administered safely and effectively in a home setting. The Secretary could establish guidelines or precautions necessary to assure the safety and effectiveness of specific IV drugs in a home setting.

The agreement does not require the Secretary to consult with an advisory panel in making these determinations. The conferees note that the Secretary could refer review of safety and effectiveness issues to the Public Health Service's Office of Health Technology Assessment.

The conferees expect that the Secretary will complete a review of the safety and effectiveness of home IV cancer chemotherapy drugs as soon as possible.

A drug, which would otherwise be covered as an outpatient drug, is excluded from coverage if the drug is intravenously administered in a home setting and does not satisfy the definition of a covered home IV drug.

(c) *Deductible.*—

(1) The conference agreement includes the Senate amendment.

(2) The conference agreement includes the House provision. In determining whether a beneficiary has met the deductible, the Secretary would count all expenses paid on behalf of the beneficiary, such as those paid pursuant to an insurance policy. In calculating the deductible, the Secretary must include amounts actually paid by the beneficiary (or on the beneficiary's behalf) and may not reduce such amounts by applying Medicare payment screens below the deductible.

(3) The conference agreement includes the Senate amendment with a modification. The agreement sets the deductible at $550 in 1990, $600 in 1991, and $652 in 1992. In future years the deductible will be indexed so as to ensure that the percentage of Part B enrollees (not including enrollees in health maintenance organizations) whose expenses for covered outpatient drugs are expected to exceed the deductible during that year is 16.8%. This is the same percentage as the percentage of enrollees whose costs are expected to exceed the deductible in 1991. The conference agreement specifies a deductible for 1992 in the law rather than relying on indexing by the Secretary, because actual program data necessary for reliable indexation would not be available in time for setting the 1992 deductible.

The agreement requires the Secretary to publish by May 1 of each year (beginning in 1992) a proposed regulation establishing the deductible for the next year. The Secretary would be required to publish a final regulation during the last 3 days of September. The final deductible established in September may not exceed deductible proposed in May.

The conference agreement provides that the drug deductible will not apply for home IV drugs dispensed as part of a continuous course of therapy initiated while the beneficiary was a hospital inpatient. Further, the drug deductible does not apply with respect to immunosuppressive drugs furnished within one year following a covered organ transplant.

(d) *Adjustment in Deductible.*—The conference agreement does not include the House provision.

(e) *Authority To Reduce Deductible.*—The conference agreement does not include the Senate amendment. Because the deductible after 1992 will be indexed to ensure that 16.8% of beneficiaries reach the deductible, the Secretary would be authorized to lower or raise the deductible.

(f) *Payment Amount.*—

(1) The conference agreement includes the Senate amendment with a modification. The agreement specifies that the amount paid for a covered outpatient drug is equal to the "payment percent" multiplied by the lesser of the actual charge or the applicable payment limit. The payment percent is 100% minus the required coinsurance. Thus, in 1990 (and thereafter), the payment percent is 80% for home IV drugs and for immunosuppressive drugs used during the first year post transplant. The payment percent for other covered outpatient drugs is 50% in 1990 and 1991, 60% in 1992, and 80% thereafter.

The agreement deletes the reference to high volume pharmacies.

(2) The conference agreement includes the House provision with an amendment specifying that the first payment calculation period begins January 1, 1990.

(3) The conference agreement deletes the Senate amendment requiring that the information on payment limits be provided on a list sent to pharmacies. The conferees note, however, that this information will be available through the electronic system. The reference to high volume pharmacies also is deleted.

(4) The conference agreement includes the Senate amendment, with modifications. The provisions relating to charges for covered services after an individual has met the catastrophic deductible for outpatient drugs apply to organizations with a risk-sharing contract and those paid on a reasonable cost basis as well as to those health care prepayment plans that have elected to provide the catastrophic drug benefit. Different rules apply depending on whether the organization does or does not "buy out" drug charges below the catastrophic deductible amount for enrolled beneficiaries. A plan is deemed to be a buy-out plan if the deductible charge it imposes on enrolles for covered outpatient drugs is less than 50 percent of the Medicare catastrophic deductible for outpatient drugs.

In the case of a buy-out plan, actual expenses for outpatient drugs incurred by a beneficiary while enrolled in the plan are not counted towards the catastrophic limit. However, if an enrollee disenrolls during a year, he or she is deemed to have incurred expenses for covered drugs during each month of enrollment during the year equal to the monthly national average drug expenses during that year for all Medicare beneficiaries. The Secretary is required, in December of each year, to estimate the national average expense for covered drugs for the following year.

In the case of a plan that is not a buy-out plan, expenses for covered outpatient drugs incurred by a beneficiary while enrolled in the plan are counted towards the catastrophic limit. The plan may not enter into a Medicare contract or receive Medicare payment unless it provides assurances satisfactory to the Secretary that: (i) it will maintain, in coordination with the Part B carriers, accounts of expenses for covered drugs incurred by or on behalf of enrollees during each year, and will make the accounts available to an enrollee and to the carrier if an enrollee disenrolls during the year; and (ii) in determining whether an enrollee has met any deductible under its own plan, the organization will take into account all those expenses for covered drugs that are to be counted towards the catastrophic drug deductible.

The conferees expected that the Secretary, in establishing contracts with Part B carriers under section 1842, will require the carriers to provide information on expenses for out-of-plan services to the plans without charge.

(g) *Payment Limits for Non-Multiple Source Drugs and Multiple Source Drugs With Restrictive Prescriptions.—*

(1) The conference agreement includes the House provision with a modification. The Medicare payment limit for a single

source drug or a multiple source drugs with a restrictive prescription is the lessor of:

(A) the 90th percentile of actual charges for the drug adjusted (as appropriate by the Secretary) to reflect the number of dosage units or tablet units dispensed; or

(B) the administrative allowance plus the number of tablets or dosage units dispensed times the per tablet or per unit average wholesale price. The agreement specifies that the 90th percentile limit would be computed on a statewide, carrier-wide or other appropriate geographic area basis (as determined by the Secretary) using charge data from the second previous payment calculation period. The 90th percentile limit would not be used before January 1, 1992 because the necessary data would not be available.

(2) The conference agreement includes the House provision with an amendment. The agreement requires the Secretary to conduct a biannual survey of a representative sample of direct sellers, wholesalers, or pharmacists (as appropriate) to determine the applicable average wholesale price or comparable direct price for each single source drug as of the first day of the first month of the previous payment calculation period. The Secretary would be prohibited from taking into account any discounts that might be provided by wholesalers or direct sellers to pharmacies in determining the applicable average wholesale or direct prices.

Because the survey is a necessary part of the drug benefit and is vital to ensuring the integrity of reimbursement limits, the conference agreement permits the Secretary to impose civil money penalties of up to $10,000 if a wholesaler or direct seller refuses, after a request by the Secretary, to provide information required for the survey or provides information that is false. The conference agreement also requires pharmacies to cooperate with the survey and provides penalties for non-compliance. (*See* subparagraph (g), below.) Information gathered pursuant to the survey would be confidential and could not be disclosed by the Secretary, except as the Secretary determines to be necessary to administer the drug benefit.

The Secretary would not be required to conduct a survey with respect to a specific drug if the Secretary determines that such a survey would not be appropriate because of low volume of sales or other appropriate reason. The survey requirement could also be waived for covered outpatient drugs dispensed during 1990. In these circumstances, the Secretary would rely on published average wholesale prices from reliable sources and would have the authority to set the average wholesale price on the basis of the lowest reliable published price.

The agreement specifies that the Secretary shall make the determination of the average wholesale price based on the price or prices of purchases in reasonable quantities. The Secretary is further required to make the determinations and calculate the payment limit on a national basis. However, the Secretary could make such determinations on a regional basis to take into account limitations on the availability of drug products and variations in average wholesale prices among regions.

(3) The conference agreement includes the Senate amendment with an amendment. In the case of telephone prescriptions, a drug would only be subject to a restrictive prescription if the physician (or other person) through use of an appropriate phrase (as required for written prescriptions) states that a particular brand must be dispensed and submits a written confirmation to the pharmacy involved within thirty days after the date of the telephone prescription. If such confirmation is not submitted, payment would be based on limits for the corresponding multiple source drug.

(h) *Payment Limit For Multiple Source Drugs Without Restrictive Prescriptions.—*

(1) The conference agreement includes the Senate amendment with an amendment. The payment limit for a multiple source drug without a restrictive prescription is the sum of: (A) the product of the number of dosage units or tablet units dispensed and the unweighted median of the per unit average wholesale prices of the available drug products plus (B) an administrative allowance.

To determine the median, the Secretary would array the average wholesale prices (by appropriate dosage or tablet unit) for all FDA approved drug products that are rated by the FDA as therapeutically equivalent, including the corresponding brand name drug. (*See* subparagraph (3), below.

(2) The conference agreement includes the Senate amendment with a modification. In calculating the unweighted median, the Secretary is generally expected to use the average wholesale price for multiple source drugs based on reliable published sources. However, where appropriate, the Secretary may conduct a biannual survey of average wholesale prices of specific multiple source drugs. Such a survey is comparable to (and could be conducted in conjunction with) the annual survey of such prices for single source drugs. The conferees intend that the Secretary may exclude a drug from the calculation of the median if it is not being actively marketed.

(3) The conference agreement includes the House provision with an amendment. The agreement provides that in order for drugs to be multiple source drugs, the FDA must determine that they are pharmaceutically equivalent and bioequivalent as defined by the Medicare statute. This definition is the same as that currently used by the FDA. The agreement assumes that such FDA determination would be made at the time FDA approves the drug; it does not require a new or subsequent determination.

If the FDA changes the definition of therapeutic equivalence through a formal rule-making procedure (including a 90 day comment period), the requirement of pharmaceutical equivalence and bioequivalence as contained in the Medicare statute would not apply and the drug would only be required to meet the revised FDA definition of therapeutic equivalence.

(4) The conference agreement does not include the House provision.

(i) *Administrative Allowance.*—The conference agreement includes the Senate amendment with an amendment setting the administrative allowance for participating pharmacies at $4.50 in 1990 and 1991 and for nonparticipating pharmacies at $2.50 in 1990 and 1991. Thereafter, the allowances are indexed by the GNP price deflator.

(J) *Assuring Appropriate Utilization.*—

(1) The conference agreement includes the Senate amendment with modifications. The agreement does not include the provision authorizing the Secretary to deny payment for drugs prescribed or dispensed with excessive frequency or in excessive quantities. The conferees note that such new authority is unnecessary. The Secretary already has authority under Section 1862(a)(1) of the Social Security Act to deny payment for items and services that are not reasonable and necessary for the diagnosis or treatment of illness or injury. Pursuant to this authority, the Secretary could deny payment for drugs prescribed or dispensed with excessive frequency or in excessive quantities.

The conference agreement requires the Secretary to establish a program to identify: (i) instances and patterns of unnecessary or inappropriate prescribing or dispensing practices; (ii) instances or patterns of substandard care; and (iii) potential adverse drug reactions.

The conferees expect that participating pharmacists will review the medication profile of beneficiaries for potential adverse reactions before filling prescriptions. The conferees further intend that carriers will review claims retrospectively to identify practitioners exhibiting a pattern of inappropriate drug prescribing or dispensing.

The conference agreement also requires the Secretary to establish an educational program to educate physicians and pharmacists about inappropriate prescribing and dispensing practices. This program is expected to include a range of educational interventions, ranging from written to face-to-face communications.

(2) The conference agreement includes the Senate amendment with modifications.

The conference agreement does not include the Senate provision which would have required the use of diagnosis codes on all prescriptions. The conferees believe this requirement would have been unduly burdensome for physicians. Instead, the conference agreement requires physicians to report the appropriate diagnosis code (or codes) on all claims for services they provide. This information would be available for immediate use for utilization review of physician services (and could be used for prepayment screens) and could be used in the future to facilitate drug utilization review by merging Part B with drug claims data.

To enforce the requirement of submission of diagnosis codes, the Secretary would be authorized to deny payment on assigned claims if the required diagnostic information is not provided. In the case of non-assigned claims, if a physician knowingly and willfully fails to respond to a request by a carrier to provide required information not initially included, the physician could be subject to civil money penalties of up to $2,000. Moreover, if a physician knowingly and willfully continues not to provide the required diagnostic information on the initial claims after being notified of the specific obligation to provide such information, the physician could be subject to civil monetary penalties and or exclusion from Medicare under Section 1842(j)(2)(A) of the Social Security Act.

The conferees intend that the Secretary will take appropriate measures to insure the confidentiality of patient-specific information which has been obtained.

The conference agreement includes the Senate provision on drug utilization review standards with modifications. The Secretary would be required to establish standards for the use of each covered outpatient drug based on accepted medical practice. In establishing these standards, the Secretary would be required to incorporate standards from one (or more) current authoritative compendia as the Secretary may select.

The conferees expect that included among the compendia the Secretary will consider for use are the United States Pharmacopoeia Dispensing Information, volume 1 (Drug Information for the Health Care Professional), the American Medical Association's Drug Evaluations, and American Hospital Formulary Service Drug Information. The conferees expect that the Secretary will use only those compendia which base such standards on a review of published scientific and medical information, which provide for a public comment and review process, and which provide adequate assurances that the panelists who establish standards are free of financial (or other) conflicts of interest.

The Secretary, through rule-making, may modify these standards, for use in the Medicare program, on the basis of published scientific and medical information indicating that such standards are not consistent with the safe and effective use of such drug.

The conference agreement also specifies that nothing in Title XVIII of the Social Security Act should be construed as authorizing the Secretary to establish a formulary by excluding from coverage: (i) any specific covered outpatient drug or class of drugs or (ii) the specific use of any covered outpatient drug with respect to a specific indication, unless the exclusion is pursuant to Section 1862(a)(1) and is based on a finding by the Secretary that such use is not safe or effective. The Secretary could, however, exclude certain drugs pursuant to Section 1862(c), relating to exclusions for drugs subject to a proposed order by the FDA to withdraw marketing approval, or 1861(t)(4)(A), relating to the definition of covered home IV therapy drugs (*See* subparagraph (b), above).

(k) *Treatment of Certain Prepaid Organizations.*—The conference agreement does not include the House provision or the Senate amendment. (*See* subparagraph (q), below.)

(l) *Physician Guide.*—The conference agreement includes the Senate amendment with a clarification. The Secretary is required to mail the guide by January 1 of each year, beginning in 1991, to participating hospitals, to each physician who routinely provides Part B services, to Social Security offices, to senior citizen centers, and to other appropriate places.

(m) *Special Cost Control Measures.*—The conference agreement includes the Senate amendment with a modification. The agreement requires the Secretary, immediately upon enactment, to begin compiling information on prices charged by manufacturers and by retail pharmacies for covered outpatient drugs. The Secretary shall compare increases in drug prices for each six month period beginning January 1, 1987, with the average semi-annual increase in such prices during the January 1, 1981 to January 1, 1987 period. The agreement also requires the Secretary to review all available information on the use of prescription drugs by Medicare beneficiaries. The conference agreement requires the Secretary to file a report with the House Committees on Ways and Means and Energy and Commerce and the Senate Committee on Finance in May and November of 1989 and 1990 and in May of each succeeding year containing this information.

Each report submitted after 1991 will also include an explanation of the extent to which increases in expenditures for covered outpatient drugs are the result of price increases by manufacturers and pharmacists and increased drug use by beneficiaries and will include information: (i) on the projected budgetary status of the prescription drug trust fund for the succeeding year; (ii) projected increases in manufacturer's and pharmacists' prices; (iii) the projected level of utilization of covered outpatient drugs by beneficiaries; and (iv) projected administrative costs.

The conference agreement requires the Secretary to submit monthly reports to the Congress, from October 1991 through April 1993, showing monthly outlays and receipts of the Federal Catastrophic Drug Insurance Trust Fund.

The agreement further specifies that the Secretary's May 1, 1992 and 1993 reports will determine whether the anticipated outlays and receipts of the new trust fund are sufficient to achieve the established contingency reserve margin for 1993 and 1994. If not, the report will recommend necessary changes (which will also be published in the Federal Register by May 1 as a proposed regulation). Any such recommended changes should appropriately address each of the causes of increased or unanticipated costs for the program.

If the Secretary has published a proposed regulation by May 1 of 1992 or 1993, the Secretary may publish a final regulation during the last 3 days of September of such year to implement the changes proposed. Such changes will become effective as of January 1 of the next year and will apply only during such year and will take effect notwithstanding any other provisions of this part.

Several limitations, however, would apply to the Secretary's cost control authority. First, the final regulation may not provide for a net reduction in outlays in excess of the net reduction provided in the proposed regulation. Second, the Secretary may not provide for a formulary in violation of the prohibition contained in subparagraph (j). Third, the Secretary may not change the methodology for calculating whether the drug deductible has been met (but could change the level of the deductible). Finally, the Secretary could not increase the coinsurance above the level in effect during the previous year.

The conferees intend that, in designing any cost control recommendations, the Secretary will attempt to insure that beneficiary access will not be adversely affected.

The conferees expect and encourage the Secretary to make other recommendations concerning legislative changes that would improve the administration of the new outpatient prescription drug

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benefit. Such recommendations would be subject to approval by the Congress as part of the normal legislative process.

The conferees understand that the proposed and final regulations will not be reflected in the Congressional Budget Office's August baseline for FY 1993 and FY 1994.

(n) *High Volume Pharmacies.*—The conference agreement includes the Senate amendment with a modification limiting the Secretary's authority to reducing the administrative allowance for mail service pharmacies. Such reductions (if any) must be based on differences between mail service pharmacies and other pharmacies with respect to operating costs and other economies.

(o) *Report on Payment Limits.*—The conference agreement deletes this provision. The conferees intend to request, by letter, the Office of Technology Assessment to prepare a study on possible alternative payment methodologies.

(p) *Report on Covered Outpatient Drug Index.*—The conference agreement does not include the House provision.

(q) *Participating Pharmacies.*—

(1)(A).—The conference agreement includes the Senate amendment. The conferees note that some prepaid health plans operate pharmacies which charge members of the plan less than the pharmacy charges members of the general public. In this case, the conferees intend that the test of compliance with this provision be based on the pharmacy's charges to members of the general public who are not members of the prepaid health plan.

(1)(B).—The conference agreement includes the House provision.

(1)(C).—The conference agreement includes the House provision with a modification. The Secretary would be required by January 1, 1991 to establish an electronic point-of-sale claims processing system for use by carriers and participating pharmacies. Participating pharmacies would be required to transmit information regarding all covered outpatient drugs dispensed to Medicare beneficiaries by such pharmacies regardless of deductible status.

The conferees consider the electronic billing system integral to the smooth administration of the prescription drug benefit. The conferees expect that the Secretary will devote the necessary resources to make the electronic system fully and successfully operational by January 1, 1991. Moreover, the conferees expect that the system will be thoroughly tested prior to that date.

(1)(D).—The conference agreement does not include the House or Senate provision.

(1)(E).—The conference agreement includes the Senate amendment.

(1)(F).—The conference agreement includes the Senate amendment.

(1)(G).—The conference agreement includes the Senate amendment with an amendment deleting the exemption for undue hardship. As noted above, the agreement requires the Secretary to implement an electronic point-of-sale system by January 1, 1991. The agreement further requires the Secretary to provide, upon request, such electronic equipment and technical assistance (other than costs associated with obtaining, maintaining, or expanding telephone service) as the Secretary determines may be necessary for a pharmacy to submit claims through the electronic system. Because the equipment would be provided where necessary an exemption for hardship cases is not needed.

The conference agreement requires participating pharmacies to provide information requested by the Secretary in conjunction with biannual surveys conducted by the Secretary to determine average wholesale prices. (see Item 10g).

All of the preceding requirements for participating pharmacies would be first effective for covered outpatient drugs dispensed on or after January 1, 1991. Claims for drugs dispensed during 1990 would be handled by existing Medicare carriers and the beneficiary's deductible status would be determined by these carriers as under current law.

The Secretary would have authority to specify claims processing and payment procedures in the event of temporary failure of the electronic claims processing system.

(2).—The conference agreement includes the Senate amendment with an amendment deleting the requirement that the Secretary submit lists of payment limit to pharmacies in advance of the payment calculation period.

(3).—The conference agreement includes the Senate amendment with a modification. The agreement provides that the audits would assure compliance with requirements for participation and would assure the accuracy of information submitted by pharmacies.

(4).—The conference agreement includes the Senate amendment with an amendment clarifying that the requirement to accept assignment begins at the point where the Secretary, through the electronic point-of-sale system or otherwise, notifies the pharmacy that the beneficiary has met the deductible.

(r) *Civil Monetary Penalty.*—The conference agreement includes the Senate amendment authorizing civil monetary penalties for pharmacies that charge Medicare beneficiaries more than they charge the general public. For purposes of this provision, the price charged to the general public is the pharmacy's price to a customer who is not a member of any group which has obtained a discounted price from that pharmacy, such as an HMO.

The conference agreement also authorizes civil monetary penalties for pharmacies that fail to provide information requested by the Secretary as part of the biannual survey of wholesale prices (see Item 10g).

(s) *Limitation to 60 Day Prescription.*—The conference agreement includes the Senate amendment with an amendment. No payment may be made for any expense incurred for a covered outpatient drug if it is dispensed in a quantity exceeding a 30 day supply, except that the Secretary may authorize a longer supply (not exceeding 90 days, except in exceptional circumstances). Such extended supply policies may apply to specific drugs or classes of drugs and may be subject to appropriate conditions as the Secretary may establish.

(t) *Additional Premium for Prescription Drug Benefit.*—See Item No. 15.

(u) *Use of Carriers in Administration.*—

(1) The conference agreement includes the Senate amendment with modifications.

Current law requires that a Medicare carrier be an insurer of health care services. The conference agreement waives this requirement and authorizes the Secretary to contract with other entities for implementation and operation of the electronic point-of-sale claims processing system and for related functions. Such entities include voluntary associations, corporations, partnerships, or other nongovernmental organizations. Such contracts may be on a regional basis.

If the Secretary requires a carrier to subcontract with such an entity for this purpose, the conferees expect the Secretary to take this arrangement into account in evaluating the carrier's performance. The failure of such entity to properly carry out its responsibilities should not adversely affect the carrier's performance rating.

The conferees further intend that the term "related functions" would apply to functions closely related to the implementation and operation of the electronic system, such as initial claims denials made through the system. Other functions, such as the handling of beneficiary inquiries and carrier fair hearings, would remain with the traditional Medicare carriers.

The agreement permits the Secretary to use fixed-price contracts for electronic claims processing (and related functions) but requires the Secretary to: (i) publish in the Federal Register general criteria and standards used for evaluating contractors and provide opportunity for public comment; (ii) publish in the Federal Register any new policy or procedure that substantially affects the performance of contracts 30 days before such policy or procedure is to take effect; and (iii) negotiate necessary contractual modifications with contractors before requiring them to perform any additional functions.

The conferees expect that the Secretary would initially contract with more than one entity to establish more than one electronic system.

The agreement specifies that current law requirements regarding coordination of benefits payments with Medicare supplemental insurers will not apply to covered outpatient drugs until January 1, 1993.

(2) The conference agreement includes the Senate amendment with a modification. The agreement requires contractors processing claims for prescription drugs to provide for a monthly payment cycle. All claims received and approved for each participating pharmacy or individual submitting claims in the period since the previous payment date would be paid at the end of the payment cycle.

The conferees understand that under this system, claims would be paid, on average, 15 days after receipt. If payment is delayed more than 5 days after the requisite payment date, interest shall accrue until payment is made.

(3) The conference agreement includes the Senate amendment.

(v) *Modification of HMO/CMP Provisions.*—

(1) The conference agreement does not include the House provision or the Senate amendment.

(2) The conference agreement includes the Senate amendment.

(3) The conference agreement includes the Senate amendment.

(w) *Medicaid Requirements.*—See Item No. 33.

(x) *Beneficiary Drug Cost Survey and CBO Report.*—

(1) The conference agreement includes the Senate amendment with a modification. Data obtained from the 1987 National medical Expenditure Survey (NMES) would be used in lieu of conducting a new survey. Based on this data, the Secretary would submit a report on expenses incurred by Medicare beneficiaries for outpatient drugs to Congress by April 1, 1989. Also by this date, the Secretary would provide the Director of the Congressional Budget Office any data from the survey that the Director may request to make the estimates required under subparagraph (2) below.

(2) The conference agreement includes the Senate amendment with an amendment specifying the CBO report is due by June 1, 1989, or 60 days after the date the Secretary provides the requested data under subparagraph (1). The report is to include estimated outlays and revenues (with projected trust fund balances) for the period from FY 1990 through FY 1993.

(3) The conference agreement does not include the Senate amendment.

(y) *Prescription Drug Payment Review Commission.*—The conference agreement includes the House provision with an amendment. The Commission is to be established by January 1, 1989. The conferees expect that one of the eleven commissioners would be associated with a brand name drug manufacturer while another would be associated with a generic drug manufacturer.

The Commission is directed to submit an annual report to Congress by May 1 of each year, beginning May 1, 1990. The report would concern methods of determining payment for the outpatient prescription drug benefit authorized under this legislation. Beginning in 1992, the annual report must include comments on both the budgetary status of the Federal Catastrophic Drug Insurance Trust Fund and recommendations for any changes necessary to reduce outlays in order to achieve the established contingency margin for the following year. These recommendations are to take into account the causes of increased or unanticipated outlays for covered drugs in the year.

Beginning in 1992, the annual report would also include information on increases in manufacturers' prices for prescription drugs, increases in pharmacies' charges for such drugs, utilization of the outpatient prescription drug benefit by beneficiaries, and administrative costs associated with the benefit.

(z) *Additional Studies.*—The conference agreement includes the Senate amendment with modifications. The requirement for a report on third party coverage is not included. The conferees note that under subparagraph (x) the Secretary is required to conduct a study of drug expenditures by the elderly. It is expected that the issue of third party coverage will be addressed in that study.

The conference agreement provides for a one-time study by the GAO which would include: (i) a comparison of average wholesale drug prices and actual acquisition costs by type of pharmacy; (ii) an analysis of the discounts offered by pharmacies to other third-party insurers; and (iii) an analysis of overhead costs of retail pharmacies. The study would be due to Congress by May 1, 1991.

Pharmacies participating in Medicare or Medicaid would be required to provide the GAO with reasonable access to records needed to conduct the study; non-compliance would be subject to exclusion from Medicare or Medicaid under Section 1128(a) of the Social Security Act. The conferees expect that the GAO would not release any data from the study in a manner which could be identified with individual pharmacies.

The conference agreement does not include a requirement for a study on the potential application of new claims processing and billing technologies. The conferees note that the agreement requires the Secretary to implement an electronic point-of-sale claims processing system.

The conference agreement requires a study of methods to improve utilization review of covered outpatient drugs. The study is due to the Congress by January 1, 1993.

The conference agreement does not include the requirement that the Secretary study alternative payment methodologies for covered outpatient drugs. The conferees note that under subparagraph (o) above, the conferees intend to request the Office of Technology Assessment to conduct a similar study.

The conference agreement also does not include the study on induced demand. The conferees expect that this issue will be addressed in the study required under subparagraph (x).

The conference agreement specifies that the longitudinal study of the use of covered outpatient drugs by Medicare beneficiaries is to be conducted as a follow-up to the 1987 NMES study. The report is due January 1, 1993.

The conference agreement expands the scope of the requisite study on experimental cancer drugs to include other experimental drugs and biologicals. This report is due January 1, 1990.

The conference agreement also requires the Secretary to study the potential of mail service pharmacies to reduce the cost of covered outpatient drugs for beneficiaries and for the Medicare program and to report to Congress by January 1, 1990.

(aa) *Study of the Treatment of Prescription Drugs.*—The conference agreement does not include the Senate amemdment.

(bb) *Simplification of Recordkeeping.*—The conference agreement includes the Senate amendment with modifications. The agreement requires the Secretary to develop a standard claims form and a standard format for electronically submitted claims to be used by Medicare and other third parties for covered outpatient drugs. The Secretary would consult with representatives of pharmacies and other interested individuals in developing these standards. The Secretary would be required to distribute official sample copies by October 1, 1989.

The conference agreement does not include the requirement for demonstration projects testing various electronic billing systems. The conferees note that the Secretary is required to implement a point-of-sale electronic claims processing system.

Effective Date.—Applies to items dispensed on or after January 1, 1990, except for the following.

Prompt payment requirements for carriers take effect on January 1, 1991, but are not to be construed as requiring payment before February 1, 1991, thereby permitting implementation of staggered billing cycles.

Provisions relating to modification of HMO/CMP contracts apply to new enrollments effective on or after January 1, 1990.

Diagnostic coding requirements apply to services furnished on or after April 1, 1989.

11. Coverage of Home Intravenous Drug Therapy (Section 7A of Senate amendment)

Present Law

(a) General.—Drugs and biologicals, which cannot be self-administered and which are furnished as an incident to a physician's professional service, are included within the definition of "medical and other health services," and are covered under Part B. Such coverage also includes antigens prepared by a physician and administered by or under the supervision of a physician.

(b) Payment.—No provision.

(c) Certification.—Except for certain inpatient or outpatient services provided by hospitals, payments for services to providers under Part B may only be made if a physician certifies (and recertifies where such services are furnished over an extended period) that the services are necessary.

(d) Certification of Providers.—The Secretary, in carrying out his functions related to determination of conditions of participation of providers of services, shall consult with appropriate national listing and accreditation bodies, and may consult with appropriate local agencies. If a State imposes higher requirements on institutions as a condition of payment under titles I, XVI, or XIX (Medicaid) of the Social Security Act, the Secretary shall impose like requirements under Medicare.

(e) Intermediate Sanctions for Home Intravenous Drug Therapy Providers.—No provision.

(f) Publication Requirement.—No provision.

House bill

No provision.

Senate amendment

(a) General.—Provides for Medicare coverage of intravenous drug therapies provided in the home. Home intravenous therapy is defined as items and services that: (1) are provided to an individual who is under the care of a physician; (2) are provided in the residence used as the individual's home; (3) are provided by a qualified home intravenous drug therapy provider or by others under ar-

rangement with such provider; and (4) are provided under a plan established and periodically reviewed by a physician.

Coverage for home intravenous drug therapy includes nursing, pharmacy and related services as are necessary to safely and effectively conduct an intravenously administered anti-infective or cancer chemotherapeutic drug regimen through the use of a covered outpatient drug or use of any other intravenously administered drug which the Secretary (in consultation with providers, clinicians and consumers) determines may be safely provided in the home.

A qualified home intravenous drug therapy provider is defined as a home health agency certified by the Secretary as meeting certain conditions of particpation, or other entity certified by the Secretary as meeting certain conditions of participation. The conditions of participation require that the home health agency or other entity: (1) is capable of providing or arranging for the provision of home intravenous drug therapy; (2) maintains clinical records; (3) has written policies to govern the provision of services; (4) makes services available 24 hours per day, seven days a week as necessary; (5) coordinates all services with the patient's physician; (6) conducts a quality assessment and assurance program, including drug regimen review and coordination of patient care; (7) assures that only trained personnel provide chemotherapy or any other service where training is required to safely provide the service; (8) assumes responsibility for the quality of services provided by others under arrangements; and (9) meets such other conditions as the Secretary determines are necessary for the safe and effective provision of services and as necessary for the efficient administration of the benefit.

(b) Payment.—Requires the Secretary to establish a fee schedule for home intravenous drug therapy prior to the beginning of each calendar year, beginning prior to calendar year 1990. The fee schedule is to be established on a per diem basis. The fee schedule is to be based on a study of current reimbursement for similar items and services provided under Medicare, on the customary charges for such therapy, and on such other information as the Secretary deems appropriate.

Reimbursement for home intravenous drug therapy is 100 percent of the lesser of the actual charge and the fee schedule amount. Payments for these items and services is not subject to the annual Part B deductible amount.

(c) Certification.—Provides that coverage for home intravenous drug therapy is limited to cases in which a physician certifies that (1) such therapy is required by the individual, (2) a plan for furnishing the therapy has been established and is periodically reviewed by a physician, (3) the therapy is furnished while the individual is under the care of a physician, and (4) the therapy is provided in a place of residence used as the individual's home.

(d) Certification of Providers.—Adds home intravenous drug therapy providers to the list of providers for which the Secretary shall consult with appropriate State agencies and recognized national listing or accrediting bodies, and appropriate local agencies in determining the conditions of participation.

(e) Intermediate Sanctions for Home Intravenous Drug Therapy Providers.—Provides that the Secretary shall develop and implement "intermediate sanctions," in lieu of canceling the certification of the provider, that may be imposed for a period of up to one year against home intravenous drug therapy providers that are determined by the Secretary to no longer meet the conditions of participation. The Secretary shall provide appropriate appeals procedures relating to the imposition of such intermediate sanctions. The intermediate sanctions shall include civil money penalties and suspension of all or part of reimbursement amounts that would otherwise be made under Medicare. Such sanctions are in addition to sanctions otherwise available under State or Federal law.

The Secretary shall develop and implement specific procedures with respect to when and how each of the intermediate sanctions may be imposed, the amount of any fines and the severity of each penalty. The procedures are to be designed to minimize the time between the identification of violations and imposition of the sanction, and shall provide for the imposition of increasingly severe fines for repeated or uncorrected deficiencies.

(f) Publication Requirement.—Provides that the Secretary shall publish a list of categories of drugs that are considered covered outpatient drugs with respect to home intravenous drug therapy not later than January 1, 1990.

Effective date.—Applies to items and services furnished on or after January 1, 1990

Conference agreement

(a) *General.*—The conference agreement includes the Senate amendment with amendments.

Covered home IV drug therapy services include nursing, pharmacy, and related items and services (such as medical supplies, IV fluids, delivery, and equipment) as are necessary for the safe and effective administration of covered home IV drugs. Drug therapy services would not be subject to the Part B deductible or to coinsurance.

Drugs used for home IV drug therapy are not included in the definition of covered home IV drug therapy services, and are not included in the reimbursement for these services. Instead, these drugs are covered and reimbursed under the catastrophic prescription drug benefit. (See Item 10 concerning coverage of IV drugs).

A qualified home IV drug therapy provider must comply with requirements contained in the Senate provision. The conference agreement adds the requirement that the provider must adhere to written protocols with respect to provision of services and expands the requirement pertaining to use of trained personnel to cover provision of all home IV drugs. Further, the entity must be licensed, or approved as meeting the requirements for licensure, if State or local law provides for licensure of home IV drug providers.

A home health agency may qualify as a home IV drug therapy provider if it meets these requirements. In this case, the home health agency would not have to be recertified with respect to any conditions that it had previously met to be certified as a home health agency.

(b) *Payment.*—The conference agreement includes the Senate amendment with amendments. Under the agreement, Medicare payment would be the lower of the provider's actual charge or the fee schedule amount.

The fee schedule would be established by the Secretary by regulation before January 1, 1990 and would provide payment on a per diem basis. In establishing the fee schedule, the Secretary could consider cost information, charge information, and payment rates for similar items and services covered under Medicare. The Secretary could not, however, require routine cost reporting.

The conference agreement provides the Secretary with broad flexibility in establishing the fee schedule. The conferees expect that the Secretary will use this flexibility to establish a fee schedule which assures adequate access to services while preventing excessive payments. The conferees note that exclusive reliance on customary charges has previously resulted in excessive reimbursement levels for similar services.

The conferees expect that the availability of home IV therapy will facilitate shorter hospital lengths of stay for a variety of illnesses. The conference agreement therefore requires the Prospective Payment Assessment Commission to study and report to the Congress and the Secretary by March 1, 1991 concerning adjustments to DRG payments which may be appropriate in view of the expected savings to hospitals.

Finally, the conference agreement prohibits a home IV therapy provider from providing services to a Medicare beneficiary based on a referral from a physician who has an ownership interest in, or receives compensation from, the provider. The prohibition would also apply to ownership or compensation arrangements involving an immediate family member of the referring physician. The referring physician is the physician who prescribes the home IV drug therapy or establishes the plan of care for such therapy.

Several exceptions to this prohibition are provided: (i) ownership of publicly traded stock purchased on terms available to the general public; (ii) sole community rural home IV therapy providers as defined by the Secretary; (iii) compensation reasonably related to items or services actually provided by the physician which does not vary in proportion to the number of referrals made; (iv) physicians whose only relationship with the provider is as an uncompensated officer or director of the provider; and (v) other exceptions established by the Secretary by regulation, for ownership or compensation arrangements which the Secretary determines do not pose a substantial risk of program abuse. The exception under clause (iii) would not apply for compensation paid by the home IV provider to the referring physician for direct patient care services. It is expected that the physician would bill Medicare (or the beneficiary) for such services.

Payment would be denied for services provided pursuant to a prohibited referral. The home IV provider would also be prohibited from billing for such services on an unassigned basis. Moreover, a physician who knowingly and willfully makes a prohibited referral or a provider who knowingly and willfully accepts such a referral would subject to civil monetary penalties of up to $15,000 for each such referral and/or exclusion from the Medicare program.

The conferees intend that this prohibition not be construed in any way as altering (or reflecting on) the scope and application of the anti-kickback provisions contained in Section 1128B of the Social Security Act.

The conferees are aware of the growing prevalence of physician ownership and compensation arrangements which are developed and marketed by providers of medical services. These arrangements are often initiated with the intent of binding together the financial interests of referring physicians with those of the providers.

Because of the resulting economic alliance, physicians are less likely to exercise independent judgment in making referral recommendations. Moreover, such alliances pose a risk of inducing over utilization even if the physician's income does not vary in proportion to the number of referrals made.

Some of these arrangements may involve indirect referral fees. Investment opportunities may be restricted to physicians who are able refer substantial business to the provider, and such investments often have returns which are substantially higher than what would be expected for comparable investments.

For these reasons, the conference agreement includes a requirement that the HHS Inspector General conduct a study of physician owneship of, and compensation by, other suppliers of Medicare covered services to which they make referrals. The report would (i) include a description of the full range of such arrangements and the means by which they are marketed to physicians; (ii) evaluate the potential of such arrangements to influence physician decisionmaking and to result in inappropriate utilization; (iii) assess the practical difficulties involved in enforcement actions under current anti-kickback provisions; and (iv) make recommendations regarding possible changes in the law to strengthen protections against program abuse. The report would be due to Congress by May 1, 1989.

(c) *Certification.*—The conference agreement includes the Senate amendment with an amendment.

The conference agreement requires that all home IV therapy services be reviewed and approved for medical necessity and quality by a Peer Review Organization (PROs) during a three-year period (1990–1992).

Prior approval by a PRO is required for home IV therapy initiated immediately upon hospital discharge. Except in exceptional circumstances (specified by the Secretary), home IV therapy services initiated on an outpatient basis (without a preceding hospital stay) must be approved by the PRO within one working day after the initiation of therapy. PROs would be required to complete reviews within one working day of receipt of a request for review.

To assure the validity and uniformity of PRO reviews, the conference agreement requires the Secretary to establish criteria that would be used by PROs in conducting reviews with respect to the appropriateness of home IV therapy services. Such criteria should assure that beneficiaries are discharged from hospitals to home IV therapy only if this is appropriate from a medical standpoint and the patient (or a family member) is able to carry out the home care regimen properly.

The conferees expect that after 1982, the Secretary could require PROs to conduct some focused reviews and could require prior approval in appropriate circumstances.

(d) *Certification of Providers.*—The conference agreement includes the Senate amendment with a clarifying amendment specifying that a home IV drug therapy provider is a "provider" of services as defined under Medicare.

The conference agreement further requires the Secretary, in consultation with State agencies and other organizations to develop conditions of participation for home IV drug theraphy providers.

(e) *Intermediate Sanctions for Home Intravenous Drug Therapy Providers.*—The conference agreement includes the Senate amendment.

(f) *Publication Requirement.*—The conference agreement includes the Senate amendment.

Effective date.—Applies to services furnished on or after January 1, 1990.

12. In-Home Care for Certain Chronically Dependent Individuals (Section 203 of House bill)

Present law

No provision.

House bill

(a) Services Covered.—Adds a new benefit to Part B of Medicare: in-home care for a chronically dependent individual for up to 80 hours in any calendar year. [Such care provided on any day for 3 hours or less is counted as 3 hours.]

Defines "in-home care" as including (1) services of a homemaker/home health aide (who has successfully completed a training program approved by the Secretary); (2) personal care services; and (3) nursing care provided by a licensed professional nurse. Requires that these services be furnished, under the supervision of a registered professional nurse, by a home health agency or others under arrangements with the agency. Also requires that the services be furnished in a place of residence used as the chronically dependent individual's home.

(b) Persons Eligible.—Provides that the above services be available to chronically dependent individuals who are Medicare beneficiaries. Defines "chronically dependent individual" as a person who (1) is dependent on a daily basis on a primary caregiver who is living with the individual and is assisting the individual without monetary compensation in the performance of at least 2 specified activities of daily living (ADLs); and (2) without this assistance could not perform these ADLs. Specifies that the individual be dependent in at least 2 of the following ADLs: eating, bathing, dressing, toileting, or transferring in and out of a bed or in and out of a chair.

(c) Payment.—Provides that payment for in-home services be made on the basis of hourly rates based on reasonable costs of furnishing care.

Requires the Secretary to provide for an appropriate adjustment to payment rates for prepaid health plans paid on a reasonable cost basis to reflect the new catastrophic protection. The adjustment is to reflect: (1) the aggregate increase in payments which would otherwise be made for enrollees if they were not enrolled in the organization; or (2) the amount that would be paid to the organization or facility if payments were made on an individual by individual basis. The organization is required to provide assurances, satisfactory to the Secretary, that it will not undertake to charge an individual more than 20 percent of reasonable costs plus any deductible amounts.

(d) Certification.—Requires a physician to certify, in the case of in-home services provided to a chronically dependent individual during a 12-month period, that the individual was chronically dependent during the immediately preceding 3-month period.

(e) Standards for Utilization.—Specifies that payment may not be made for in-home care for chronically dependent individuals unless such care is reasonable and necessary to assure the health and condition of the individual is maintained in the individual's non-institutional residence. The Secretary is required to take appropriate efforts to assure the quality and provide for the appropriate utilization of in-home care for chronically dependent individuals.

(f) Study of Alternative Out-of-Home Services.—Requires the Secretary to study and report to Congress, within 18 months of enactment, on the advisability of providing to chronically dependent individuals (eligible for services under this provision) with out-of-home services (such as adult day health services or nursing facility services) as an alternative to in-home care.

(g) Study of In-Home Care.—Requires the Secretary to study and report to Congress by June 1, 1991, on the extent of use, cost, and effectiveness of in-home care provided chronically dependent individuals under this provision. [See also item 25]

Effective date.—(a) through (e) apply to items and services furnished on or after January 1, 1989, and before January 1, 1992. Study provisions (f) and (g) effective on enactment.

Senate amendment

No provision.

Conference agreement

(a) *Services Covered.*—The conference agreement includes the House provision, with the amendment noted below regarding the 12 month period of eligibility for the services.

(b) *Persons Eligible.*—The conference agreement includes the House provision, with an amendment. It retains the definition of chronically dependent individual. However, such an individual qualifies for these services only if the individual has been determined either: (i) to have incurred expenses for Part B coinsurance and deductible payments in an amount equal to the catastrophic limit on Part B cost-sharing for the year; or (ii) to have incurred expenses for covered outpatient drugs equal to the outpatient drug deductible for the year. In-home services would then be available to such a beneficiary for 12 months from the date the beneficiary was determined by the Medicare carrier to have incurred such expenses.

If a beneficiary met a second limit within twelve months after meeting a prior limit, this would initiate a new twelve month period of eligibility. In this situation, the beneficiary would be entitled to receive up to 80 hours of care during the new eligibility period, but could not carry over any hours not used during the prior eligibility period. Moreover, in no event could a beneficiary receive more than 80 hours of care during a calendar year.

An individual receiving these services would be responsible for 20 percent coinsurance, notwithstanding that he or she had already met the Part B catastrophic limit in the current year. However, these coinsurance payments could be counted towards the catastrophic limit, during the calendar year in which they were incurred.

The Secretary would be required to take appropriate measures to assure that HMO members who would otherwise qualify for this benefit are properly identified.

(c) *Payment.*—The conference agreement includes the House provision.

(d) *Certification.*—The conference agreement includes the House provision.

(e) *Standards for Utilization.*—The conference agreement includes the House provision.

(f) *Study of Alternative Out-of-Home Services.*—The conference agreement includes the House provision.

(g) *Study of In-Home Care.*—The conference agreement does not include the House provision.

Effective Date.—The conference agreement applies to services furnished on or after January 1, 1990.

13. Extending Home Health Services (Section 204 of House bill; Sections 7 and 8 of Senate amendment)

Present law

(a) Intermittent/Daily Home Health Care.—Home health services are covered under Medicare if the services are required because the individual is homebound and requires skilled nursing care on an intermittent basis or physical or speech thereapy. Current program guidelines specify that to meet the requirement for intermittent skilled nursing care, an individual must have medically predicable recurring need for skilled nursing services. The guidelines define "intermittent" as permitting daily skilled nursing visits for up to eight hours a day for up to two or three weeks if medically reasonable and necessary. Daily is defined as five, six, or seven days per week.

(b) Homebound.—Comparable provision included in the Omnibus Budget Reconciliation Act of 1987, section 4024 of Public Law 100-203.

House bill

(a) Intermittent/Daily Home Health Care.—Specifies that nursing care and home health aide services are considered intermittent if they are furnished less than 7 days a week. These services may be provided 7 days a week for an initial period up to 35 consecutive days. More than 35 consecutive days may be covered if the physi-

cian certifies that exceptional circumstances require additional care on a daily basis.

Effective date.—(a) Applies to services furnished on or after January 1, 1989.

Senate amendment

(a) Intermittent/Daily Home Health Care.—Provides that nursing care and home health aide services may be provided 7 days a week (with one or more visits per day) for up to 21 days with a physician's certification of the need for such care. For a beneficiary enrolled in Part B, up to 45 days of consecutive care would be allowed if he was discharged from a hospital or skilled nursing home within 30 days prior to beginning home health care.

Effective date.—(a) Applies to items and services furnished after December 31, 1987.

Conference agreement

(a) *Intermittent/Daily Home Health Care.*—The conference agreement includes the Senate amendment with a modification. The agreement provides that nursing care and home health aide services may be provided 7 days a week (with one or more visits per day) for up to 38 consecutive days. The conferees intend that current coverage policies which allow for additional days of care under unusual circumstances would continue to be covered under Medicare.

The conference agreement further extends the favorable presumption under the waiver of liability provisions for skilled nursing facilities and home health agencies. The Secretary is prohibited from modifying the presumption criteria for these waivers through October 1990.

The conference agreement requires the Administrator of the Health Care Financing Administration to appoint an 11 member Advisory Committee on Home Health Claims. At least five members shall be representatives of home health agencies or visiting nurse associations. The remaining members are to be representative of physicians' groups, senior citizens' groups and fiscal intermediaries, with no more than 3 members representative of fiscal intermediaries. The advisory committee is to study the reasons for the increase in the denial rate for home health claims during 1986 and 1987, the ramifications of such increase, and the need to reform the process involved in such denials. A report on the committee's findings is due to the Health Care Financing Administration and to the Congress within one year of enactment.

(b) *Homebound.*—The conference agreement does not include the Senate provision. The conferees note that a comparable provision was included in the Omnibus Budget Reconciliation Act of 1987.

Effective date.—The conference agreement applies to home health services furnished on or after January 1, 1990.

14. Increase in Maximum Payment Allowed for Outpatient Mental Health Services (Section 205 of House bill)

Present law

A special limit is applicable with respect to expenses incurred in a calendar year in connection with the treatment of a mental, psychoneurotic or personality disorder of a beneficiary who is not an inpatient of a hospital at the time services are rendered. Medicare recognizes 62.5 percent of reasonable charges for such services. It pays 80 percent of the recognized amount up to a maximum of $250. The Omnibus Budget Reconciliation Act of 1987 increases the maximum payment amount to $450 in 1988 and $1,100 in 1989.

House bill

Increases the medicare outpatient mental health payment limit to $1,000.

A maximum of $250 in out-of-pocket expenses may be counted toward the catastrophic limit. The effective beneficiary coinsurance rate remains the same.

Effective date.—Applies to expenses incurred for services furnished on or after January 1, 1989.

Senate amendment

No provision.

Conference agreement

The conference agreement does not include the House provision. The conferees note that a provision was included in Section 4070 of the Omnibus Budget Reconciliation Act of 1987 which increased the maximum payment amount for mental health services beyond that provided in this legislation.

15. Adjustments in Medicare Part B Premium (Section 206 of House bill; Sections 5 and 27 of Senate amendment)

Present law

(a) Part B Premiums.—Under current law, premiums for Medicare Part B are charged to Part B enrollees on a monthly basis according to an amount established in advance for each calendar year. The monthly Part B premium for 1988 is $24.80.

During September of each year, the Secretary determines the monthly actuarial rate for the succeeding calendar year for Part B enrollees age 65 and over equal to one-half of the benefits and administrative costs for aged Part B enrollees, including a contingency margin.

The Secretary also determines during September of each year the monthly actuarial rate for disabled enrollees under age 65 for the succeeding calendar year equal to one-half of the benefits and administrative costs estimated to be payable from the Part B trust fund for services and related administrative costs for disabled enrollees under age 65, including a contingency margin.

The current method of determining the monthly premium (temporarily in effect for 1984-89) is to use a formula that sets the premium rate at 50 percent of the monthly actuarial rate for enrollees age 65 and over (i.e., 25 percent of the amount needed to cover program costs for aged beneficiaries). Disabled enrollees pay the same premium.

If there is no Social Security cost-of-living increase (COLA) in a year, the Part B premium is not increased that year. For 1986–89, a beneficiary who has his Part B premium deducted from his Social Security check and experiences a premium increase that is greater than the COLA adjustment, the premium increase is reduced to avoid a reduction in the individual's Social Security check.

Beginning January 1, 1990, the premium will be calculated according to prior law, which provided that the premium would be the lower of: (1) an amount sufficient to cover one-half of the costs of the program for the aged, or (2) the current premium amount increased by the Social Security COLA.

(b) Catastrophic Coverage Premium.—No provision.

(c) Premium for Prescription Drug Benefit.—No provision.

(d) Benefit Premium for In-Home Care Benefit.—No provision.

(e) Monthly Premiums for Residents of U.S. Commonwealths and Territories.—All Medicare beneficiaries voluntarily enrolled in Part B are subject to the same Part B premium payment rules and receive the same Medicare benefits, including those residing in the U.S. commonwealths and territories. An individual need not be entitled to Part A benefits to voluntarily enroll in Part B.

(f) Monthly Premiums for Individuals Enrolled Under Part B But Not Entitled to Benefits Under Part A.—All Medicare beneficiaries voluntarily enrolled in Part B are subject to the same Part B premium payment rules and receive the same Medicare benefits, including those not entitled to benefits under Part A.

(g) Transfers to Catastrophic Health Insurance Trust Fund.—No provision.

House bill

(a) In General.—Provides for increases to the monthly Part B premium to finance the catastrophic coverage benefit (through the transitional adjustment in 1991 and 1992), the prescription drug benefit (beginning in 1989), and the in-home care benefit (in 1989, 1990, and 1991.)

(b) Catastrophic Coverage Premium.—

(1) Premium Amount.—Provides for a transitional adjustment increase to the monthly Part B premium otherwise determined of $1.00 in 1991 and $1.30 in 1992.

(2) Indexing.—Provides that the transitional increase in 1991 will not be taken into account when determining Part B increases in subsequent years under section 1839(a)(3), but the transitional increase in 1992 will be taken into account when determining Part B increases in 1993 and each subsequent year.

(c) Premium for Prescription Drug Benefit.—Amends section 1839 (amount of the Part B premium) to provide for an additional monthly premium for the prescription drug benefit.

(1) Premium Amount.—Provides that the basic monthly drug premium increase for a year is, subject to certain limits, the monthly actuarial rate. The monthly actuarial rate for the prescription drug benefit for 1989 is $2.30.

Provides that for subsequent years, the Secretary will determine in September of each year, beginning with 1989, (a) the total benefits and administrative costs estimated to be paid from the Part B trust fund for each succeeding year for covered outpatient drugs and related administrative costs, and (b) a monthly actuarial rate for covered outpatient drugs applicable for the succeeding calendar year estimated so that the aggregate amount of the increase in drug premiums collected or received for such year will equal 75 percent of the total estimated cost of drug benefits and administrative costs.

Requires the Secretary to determine in September of each year, beginning in 1990, the aggregate amount of the increase in drug premiums collected or received during the previous year, the total benefits and administrative costs paid from the Part B trust fund during the previous year for covered outpatient drugs and related administrative costs, and whether the premiums were greater or less than 75 percent of the total paid from the Part B trust fund for drugs. Provides that if the Secretary determines that there was a surplus or deficit in the previous year, the monthly actuarial rate for covered outpatient drugs for the succeeding calendar year must be adjusted by the amount of the surplus or deficit.

If the drug premium increase is not a multiple of 10 cents, it will be rounded to the nearest multiple of 10 cents.

Requires the Secretary in September of each year beginning with 1989 to determine, for purposes of calculating the prescription drug factor used to adjust the supplemental premium yearly, the total monthly drug premium increases estimated to be collected or received in the succeeding year. The calculation is to be made as if the monthly actuarial rate (without regard to any adjustment for surplus or deficit in the previous year) were substituted for the basic monthly drug premium increase.

(2) Limit on Drug Benefit Premium Amount.—Provides a limit on the basic monthly drug premium amount as follows: not to exceed $3.40 in 1990, and in 1991 and subsequent years, not to exceed 120 percent of the basic monthly drug premium increase for months in the preceding year.

(3) Definitions.—No provision.

(4) Report on Projected Excess Premium Increases.—Requires the Secretary to report to Congress in May of each year beginning with 1990 concerning whether the Secretary anticipates that the monthly actuarial rate for the drug benefit for the succeeding year will exceed the limit on the basic monthly drug premium increase for that year. If so, the Secretary is required to include in the report recommendations for changes in policies under Part B sufficient to reduce Part B expenditures for covered outpatient drugs for the succeeding year so that the monthly actuarial rate (as reduced by such expenditure reductions) will not exceed the limit on the basic monthly drug premium amount for the year.

(d) Premium for In-Home Care Benefit.—

(1) Premium Amount.—Requires the Secretary, during September of 1988, 1989, and 1990, to determine (1) the total benefits and related administrative costs estimated to be paid from

the Part B trust fund in the succeeding calendar year for in-home care, and (2) a monthly actuarial rate for in-home care applicable in the succeeding calendar year. The monthly actuarial rate, subject to the adjustment described below, is an amount the Secretary estimates would be necessary so that the aggregate amount of the increase in premiums collected or paid for the year will equal 100 percent of the total benefits and administrative costs paid from the Part B trust fund.

Requires the Secretary in September of 1990, to determine the aggregate amount of the monthly premium increases collected or received for the in-home care benefit during the previous year, the total benefits and administrative costs which were paid in the previous year from the Part B trust fund for in-home care, and whether the amount of the premiums is greater or less than 100 percent of the total costs.

Provides that if the Secretary determines that there was a surplus or deficit in 1989, the Secretary must adjust the monthly actuarial rate otherwise determined for in-home care for 1991 to reduce or increase the aggregate amount of the monthly premium increase accordingly.

Provides that the monthly Part B premium of each individual enrolled in Part B for each month in a year after December 1988 and before January 1992 will be increased by the monthly actuarial rate for that year for the in-home care benefit, except that if the increase is not a multiple of 10 cents, it will be rounded to the nearest multiple of 10 cents.

(2) Limit on In-Home Care Benefit Premium Amount.—Provides that the increase in the monthly premium for the in-home benefit may not exceed in 1989, $0.30; in 1990, $0.50; and in 1991, 120 percent of the monthly premium increase in 1990. If the monthly actuarial rate for 1991 exceeds 120 percent of the monthly premium increase in 1990, the Secretary is required to decrease the maximum number of hours of in-home care in 1991 by such an amount that will assure that the aggregate amount of the monthly premium increase collected or paid for 1991 for all enrollees is equal to the total benefits and administrative costs estimated to be paid from the Part B trust fund in 1991 for in-home care.

Provides for certain conforming amendments.

(e) Monthly Premiums for Residents of U.S. Commonwealths and Territories.—

(1) Part B Premium.—Provides a separate Part B premium calculation for Medicare beneficiaries who are residents of a commonwealth or territory, defined as Puerto Rico, the Virgin Islands, Guam, American Samoa, or the Northern Mariana Islands.

For such residents during a month in 1988 or 1989, their monthly Part B premium otherwise determined is increased by one-twelfth of the product of: the average per capita additional benefits and related administrative costs due to the amendments in this bill, excluding benefits under section 202 (prescription drugs and insulin) and section 203 (in-home care), as determined by the Secretary during September of the previous year, times the following ratio. The ratio (determined by the

Secretary for that commonwealth or territory during September 1987) is (1) the per capita actuarial value of Medicare benefits for residents of the commonwealth or territory who are entitled to both Part A and Part B benefits, divided by (2) the per capita actuarial value of the Medicare benefits for residents of the United States who are entitled to both Part A and Part B benefits.

Provides that for 1990, the monthly Part B premium for such residents would be the monthly Part B premium otherwise determined for months in 1989, plus the increase for 1989 described above, increased by the Social Security COLA percentage increase for 1990.

For succeeding years, the Part B premium is the previous year's monthly amount, increased by the Social Security COLA for that year.

Provides that if any premium amount is not a multiple of 10 cents, it is rounded to the nearest multiple of 10 cents.

(2) Drug Premium for Residents of Commonwealth or Territories.—Provides that for residents of a commonwealth or territory, the monthly Part B premium is increased by the product of 133⅓ percent of the basic monthly drug premium for that year, times the ratio determined by the Secretary for that commonwealth or territory. The ratio is the per capita actuarial value of Medicare benefits for residents of the commonwealth or territory entitled to Medicare Part A and Part B, divided by the per capita actuarial value of Medicare benefits for residents of the United States entitled to Medicare Part A and Part B.

(f) Monthly Premiums for Individuals Enrolled Under Part B But Not Entitled to Benefits Under Part A.—

(1) Part B Premium.—Provides a separate Part B premium calculation for Part B only individuals. Defines such persons as those who: (1) are not residents of a commonwealth or territory as defined in the bill; (2) are entitled to Part B benefits; and (3) are not entitled to, or on application without payment of an additional premium would not be entitled to, benefits under Part A.

Provides that in 1989, the monthly Part B premium is the monthly Part B premium otherwise determined under current law, increased by one-twelfth of the per capita additional benefits and related administrative costs that the Secretary estimates will be paid under Part B during 1989 because of the amendments made by this bill, excluding benefits under section 202 (prescription drugs and insulin) and section 203 (inhome care).

Provides that in 1990, the monthly Part B premium is the 1989 monthly premium otherwise determined under section 1839(a)(3), plus the increase for 1989 determined above, increased by the percentage increase in the Social Security COLA for 1990. For succeeding years, provides that the monthly Part B premium is the amount for months in the previous year increased by the percentage increase in the Social Security COLA for that year. If any amount is not a multiple of 10 cents, it will be rounded to the nearest multiple of 10 cents.

(2) *Drug Premium for Part B Only Individuals.*—Provides that for individuals enrolled under Part B but not entitled to benefits under Part A, the monthly Part B premium will be increased by 133⅓ percent of the basic monthly drug premium increase for that year.

(g) *Transfers to Catastrophic Health Insurance Trust Fund.*—No provision.

Effective date.—Provides that the transitional adjustment described in (b), above, applies to monthly premiums for months beginning with January 1991; (c) (related to premiums for the prescription drug benefit) applies to monthly premiums for months beginning with January 1989; (d) (related to premiums for in-home care) applies to monthly premiums for months beginning with January 1989 and ending with December 1991; (e) (related to premiums for residents of commonwealths and territories) applies to monthly premiums for months beginning with January 1988; and (f) (related to premiums for Part B only individuals, and for the conforming amendments) applies to monthly premiums for months beginning with January 1989.

Senate amendment

(a) *In General.*—Provides for increases to the monthly Part B premium to finance the catastrophic coverage benefit (beginning in 1988) and the prescription drug benefit (beginning in 1990).

Provides that the Part B premium would be calculated as under current law, except that the monthly actuarial rate for aged enrollees and for disabled enrollees would be referred to as the monthly actuarial basic rate for each group, respectively, and that such rate would exclude the costs of comprehensive catastrophic coverage benefits (defined as those payable by Medicare as a result of the enactment of sections 2(a), 3(a), 7(b), 7A, and 11 of this bill) and related administrative costs.

Suspends hold harmless provision for 1988 and reimposes hold harmless for 1989 and thereafter.

(b) *Catastrophic Coverage Premium.*—

(1) *Premium Amount.*—Provides that the monthly catastrophic coverage premium amount for 1988 for individuals covered by Part A and Part B of Medicare is $4.

(2) *Indexing.*—Provides that the monthly coverage premium amount for succeeding calendar years is the previous year's amount, increased by the following percentage. The percentage equals:

(a) the percentage (if any) necessary to increase the estimated total revenues collectible from the monthly catastrophic coverage premiums and the supplemental premiums (determined without regard to the drug premium rate adjustment amount) for the succeeding year by the amount by which the estimated total catastrophic coverage benefits and related administrative costs (including administrative costs for outpatient drug coverage) for such succeeding year exceed such revenues, plus

(b) a percentage related to establishing and maintaining a contingency or a reserve fund.

Provides that the percentage increase for a contingency or a reserve fund for a calendar year before 1993 is the percentage the Secretary determines to be necessary to ensure that before 1993 there is established a contingency fund equal to 20 percent or (if greater) a reserve fund equal to 5 percent. For calendar years after 1992, the percentage is the percentage necessary to maintain either of such funds at such percentages.

Defines "contingency fund" for any calendar year as the percentage determined by dividing (1) the amount of unexpended catastrophic coverage premiums and supplemental premiums (without regard to the drug premium rate adjustment amount) as determined at the end of such year, by (2) the actuarial comprehensive catastrophic benefit amount for the succeeding calendar year.

Defines "reserve fund" for any calendar year as the percentage determined by dividing (1) the amount of unexpended and unobligated catastrophic coverage premiums and supplemental premiums (without regard to the drug premium rate adjustment amount) as determined at the end of such year, by (2) the actuarial comprehensive catastrophic benefit amount for the succeeding calendar year.

Provides that if any monthly premium amount is not a multiple of 10 cents, it will be rounded to the nearest multiple of 10 cents.

Defines "catastrophic coverage benefits" as the benefits payable by Medicare because of the enactment of the catastrophic coverage provisions in section 2(a), 3(a), 4 and 7(b) of this bill.

Defines "actuarial comprehensive catastrophic benefit amount" for any calendar year as the amount that the Secretary estimates will equal the total of the catastrophic coverage benefits (and related administrative costs) that will be payable from the Federal Catastrophic Health Insurance Trust Fund in that calendar year for Part B enrollees.

Provides that for calendar years after 1988, for enrollees who were entitled to Social Security benefits for November and December of the preceding year and who have the Part B premium deducted from their Social Security checks for December and January, their monthly Part B premium cannot be increased due to the catastrophic benefits if such increase would reduce their Social Security Benefits payable for that January below the benefits payable for that December (after the deduction of the Part B premium).

(c) Premium for Prescription Drug Benefit.—Amends Section 1839 (amount of the Part B premium) to provide that the Part B premium be increased by the monthly catastrophic drug benefit premium amount for the prescription drug benefit:

(1) Premium Amount.—Provides that the monthly catastrophic drug benefit premium amount for any calendar year after 1989 for individuals who are covered by Part B will be an amount equal to 50 percent (40 percent for calendar year 1990 and 45 percent for calendar year 1991, as provided in section 27 of the bill) of the per enrollee actuarial catastrophic drug benefit amount for such year, plus (a) in calendar year 1990, an amount necessary to cover 7.5 percent of the per enrollee

actuarial catastrophic drug benefit amount for 1991 (for a contingency fund), and (b) for calendar years after 1990, an amount (when added to any unexpended amount in the contingency fund for the previous year) necessary to cover 7.5 percent of the per enrollee actuarial catastrophic drug benefit amount for such calendar year.

Provides in section 27 of the bill that for calendar years after 1990, if the Secretary determines that (a) it is appropriate to increase the contingency fund to assure a smooth transition from cash outlays accounting to costs incurred accounting over a multiyear period, and (b) the monthly catastrophic drug benefit premium amount for that year is less than the drug premium limit, the Secretary is authorized to increase the drug premium by no greater than 15 percent, not to exceed the drug premium limits in the bill. Once the transition has been completed, requires the Secretary to maintain the drug benefit contingency fund on the basis of such cost incurred accounting method.

Provides that if the monthly drug benefit premium amount is not a multiple of 10 cents, if will be rounded to the nearest multiple of 10 cents.

(2) Limit on Drug Benefit Premium Amount.—Provides that in calendar years after 1991, the monthly catastrophic drug benefit premium amount cannot exceed $0.90 for 1990 (as provided in section 27 of the bill), $2.00 for 1991, $3.50 for 1992, $4.05 for 1993 (as provided in section 27 of the bill), and for any succeeding year, the amount for the preceding year increased by the percentage by which the Part B beneficiary drug expenditure amount for the 12-month period ending in August in that preceding year exceeds the Part B beneficiary drug expenditure amount for the 12-month period ending in August in the second preceding year.

(3) Definitions.—Defines "catastrophic drug coverage benefits" to mean benefits payable under Part B of Medicare because of the enactment of section 7A (coverage of home intravenous drug therapy) and section 11 (coverage of catastrophic expenses for prescription drugs) of this bill.

Defines "per enrollee actuarial catastrophic drug benefit amount" to mean, with respect to a year, an amount equal to the actuarial catastrophic drug benefit amount for the year divided by the total number of individuals that the Secretary estimates will be enrolled under Part B for the year.

Defines "actuarial catastrophic drug benefit amount" to mean, with respect to a calendar year, the amount that the Secretary estimates will equal the total of the catastrophic drug coverage benefits (and related administrative costs) that will be paid in cash outlays from the Federal Catastrophic Drug Insurance Trust Fund in such calendar year for Part B enrollees.

Defines "Part B beneficiary drug expenditure amount" to mean, with respect to a 12-month period, the average per capita amount expended for a period on outpatient prescription drugs by Part B enrollees (other than such enrolless enrolled in a health maintenance organization, a competitive medical plan, or a health care prepayment plan).

(4) Report on Projected Excess Premium Increases.—No provision. (See section 11 of the Senate amendment relating to Secretarial authority to institute cost control measures to assure that the drug premiums do not exceed the premium limits.)

(d) Premium for In-Home Care Benefit.—No provision.

(e) Monthly Premiums for Residents of U.S. Commonwealths and Territories.—No provision.

(f) Monthly Premiums for Individuals Enrolled Under Part B But Not Entitled to Benefits Under Part A.—

(1) Part B Premium.—Provides that the monthly castastrophic coverage premium amount (which is added to the monthly Part B premium otherwise determined) for individuals who are covered by Part B but not by Part A is an amount that bears the same ratio to the monthly catastrophic coverage premium amount for individuals covered by both Part A and Part B of Medicare, as the actuarial Part B catastrophic benefit amount for that year bears to the actuarial comprehensive catastrophic benefit amount for that year.

Defines the actuarial Part B catastrophic benefit amount for a calendar year as the amount the Secretary estimates will equal the catastrophic coverage benefits and related administrative costs payable from the Federal Catastrophic Health Insurance Trust Fund for that year with respect to such enrollees (excluding any amounts attributable to changes under Sections 2(a), 3(a), and 7(b) of this bill in services performed and related administrative costs incurred in that year for individuals covered under Part A).

Provides that if the monthly premium amount is not a multiple of 10 cents, it will be rounded to the nearest multiple of 10 cents.

(2) Drug Premium for Part B Only Individuals.—No provision. (The drug premium for Part B only individuals is calculated in the same manner as for Medicare beneficiaries covered by both Part A and Part B).

(g) Transfers to Catastrophic Health Insurance Trust Fund.—Provides that there will be transferred from time to time from the Part B trust fund to the Federal Catastrophic Health Insurance Trust Fund amounts from Part B premiums that are attributable to the catastrophic coverage changes in services performed and related administrative costs incurred in a calendar year (under sections 2(a), 3(a), and 7(b) of this bill).

Provides that there will be transferred from time to time from the Part B trust fund to the Federal Catastrophic Drug Insurance Trust Fund amounts from the catastrophic drug benefit premiums.

Effective date.—Applies to premiums for months beginning after December 31, 1987.

Conference agreement

(a) *In General.*—The conference agreement provides for increases to the monthly Part B premium otherwise determined to finance the catastrophic coverage benefit and the prescription drug benefit. For 1993, revenues from the additional flat Part B premium are estimated to provide approximately 37 percent of the financing for the catastrophic coverage and prescription drug benefits, with the supplemental premium (see section 7, above) providing an estimated 63 percent of revenues. After 1993, the conferees intend that the proportion contributed by the flat premium will be 37 percent; however, the proportion could vary as a result of limits on the allowable change in the supplemental premium.

The conference agreement requires the Secretary of Health and Human Services and the Secretary of the Treasury jointly to (1) publish in the Federal Register, by not later than July 1 of each year beginning with 1993, a notice of the proposed preliminary catastrophic coverage and prescription drug monthly premiums for the following year; (2) report to Congress by no later than September 1 of each year the final premiums for the following year; and (3) publish in the Federal Register during the last three days in September of each year the final premiums for the following year.

The flat premium is adjusted to account for any changes in the supplemental premium resulting from limits specified in this Act (see section 7 for a description of these limits). The adjustment to the flat rate premium is calculated in three steps. First, the current year actual supplemental premium rate is subtracted from what the supplemental premium rate would have been if it had not been adjusted by the limits. This difference is known as either the excess or the shortfall rate. Then, the total supplemental premiums imposed in the second preceding year are compared to the total supplemental premiums as adjusted by the excess or shortfall rate. Finally, this difference is adjusted by the percentage by which the per capita catastrophic coverage premium liability (see section 7) for the second preceding year exceeds or is less than such liability for the fourth preceding year. The resulting amount is then used to establish the new per person monthly flat premium.

The conference agreement provides that the sum of the additional monthly premiums for catastrophic coverage and prescription drug coverage for months after 1993 cannot be less than the sum of these additional premiums for months in the preceding year. If this combined monthly premium is affected by the application of this provision, the premium increase is allocated between the catastrophic coverage premiums and the prescription drug premiums in the same proportion as if this provision had not applied.

If any flat premium increase for a month is not a multiple of 10 cents, it will be rounded to the nearest multiple of 10 cents. If so rounded, premiums will be allocated between the catastrophic coverage monthly premium and the prescription drug monthly premium on the basis of their respective amounts determined without regard to any rounding.

The conference agreement includes the Senate amendment regarding the "hold harmless" provision with a modification that the provision applies to both social security benefits and Railroad Retirement benefits and that such benefits may not decrease due to an increase in the Part B premium in any year.

(b) *Catastrophic Coverage Premium.*—(1) Premium Amount.—The conference agreement provides that the monthly catastrophic coverage premium will be as follows for months occurring in 1989 through 1993:

1989	$4.00
1990	4.90
1991	5.46
1992	6.75
1993	7.18

(2) *Indexing.*—The conference agreement provides that for months in a year after 1993, the catastrophic coverage monthly premium will be the preceding year's premium (without regard to any increase in the premium because it was less than the previous years' premium or because of any adjustment due to limits on the supplemental premium), adjusted by a percentage representing the sum of: (i) the outlay premium percentage, and (ii) the reserve account percentage.

The outlay-premium percentage is the percent by which the per capita catastrophic outlays in the second preceding year exceed (or are less than) such outlays in the third preceding year. An adjustment is provided for changes in the Consumer Price Index (CPI) as follows:

If the CPI's inflation rate increased from the third to the second preceding year, the outlay-premium percentage is adjusted by adding 50 percent of the excess (if any) of (i) the excess of the CPI inflation rate in the second over the third preceding year, over (ii) one percentage point. If the CPI inflation rate decreased from the third to the second preceding year, the outlay-premium percentage is adjusted by subtracting 50 percent of the excess (if any) of (i) the excess of the CPI inflation rate in the third over the second preceding year, over (ii) one percentage point. For this purpose, the CPI inflation rate for any year is defined as the percentage by which the CPI for May of such year exceeds such index for May of the preceding year.

The reserve account percentage for any calendar year is the percentage change in the catastrophic coverage monthly premium for the second preceding year which the Secretary determines would have increased (or decreased) the flat premiums for such year by an amount equal to 37 percent of the shortfall (or surplus) in the Medicare Catastrophic Coverage Account (the "Account") in such year. The shortfall (or surplus) in the Account for any calendar year is determined as the amount by which 20 percent of the catastrophic outlays from the Account in the second preceding year exceed (or are less than) the Account balance at the end of such year (taking into account falt and supplemental premium increases attributable to reserve percentages in prior years that have not yet been credited to the Account).

(c) *Premium for Prescription Drug Benefit.*—The conference agreement provides that the monthly prescription drug premium will be as follows for months occurring in 1991 through 1993:

1991	$1.94
1992	2.45
1993	3.02

For months in a year after 1993, the prescription drug premium will be the preceding year's premium, (without regard to any increase because the premium was less than the previous year's premium or because of any adjustment due to the limits on the supplemental premium), adjusted by a percentage determined in a manner similar to that for the monthly catastrophic coverage premium, with the following changes: (1) in determining the outlay percentage, prescription drug outlays rather than catastrophic coverage outlays are used; (2) in determining the reserve percentage, the Federal Catastrophic Drug Insurance Trust Fund balance (see section 16, below) is used rather than the Account balance; (3) the reserve percentage is 75 percent for 1994, 50 percent for 1995, and 25 percent for 1996 and 1997, instead of 20 percent; and (4) the outlay percentage is deemed to be zero for calendar years before 1998.

(d) *Premium for In-Home Care Benefit.*—The conference agreement does not include the House provision. Revenues to fund the in-home (respite care) benefit are included in the monthly and supplemental catastrophic coverage premiums.

(e) *Monthly Premiums for Residents of U.S. Commonwealths and Territories.*—The conference agreement includes the House provision, with the following amendments. For individuals who are residents of Puerto Rico or of another U.S. commonwealth or territory (including the U.S. Virgin Islands, Guam, American Samoa, or the Northern Mariana Islands), the monthly Part B premium otherwise determined would be increased by a catastrophic coverage monthly premium and a prescription drug monthly premium.

For months in 1989, the catastrophic coverage monthly premium is $1.30 for a resident of Puerto Rico and $2.10 for a resident of another U.S. commonwealth or territory. For months in 1990, the catastrophic coverage monthly premium is $3.56 for a resident of Puerto Rico and $5.78 for a resident of another U.S. commonwealth or territory.

For months in a subsequent year, the catastrophic coverage monthly premium is the resident's preceding year's premium increased by the Secretary's estimate (in September of that preceding year) of the percentage increase in the per capita catastrophic outlays from the Catastrophic Account for the year over such outlays for the preceding year.

For months in 1990, the prescription drug monthly premium is $0.14 for a resident of Puerto Rico and $0.22 for a resident of another U.S. commonwealth or territory. For months in 1991, the prescription drug monthly premium is $1,21 for a resident of Puerto Rico and $1.93 for a resident of another U.S. commonwealth or territory.

For months in a subsequent year, the prescription drug monthly premium is the resident's preceding year's premium increased by the Secretary's estimate (in September of that preceding year) of the percentage increase in the per capita prescription drug outlays from the Federal Catastrophic Drug Insurance Trust Fund for the year over such outlays for the preceding year.

The Secretary is required to report to Congress, in 1993, on the appropriateness of the level of the Part M premium increases for residents of Puerto Rico and of other U.S. commonwealths and territories.

(f) *Monthly Premiums for Individuals Enrolled Under Part B But Not Entitled to Benefits Under Part A.*—The conference agreement includes the House provision, with amendments. The agreement provides that for individuals who are entitled to Part B of Medicare but are not entitled to Part A, or would not be entitled to Part A but for payment of the Part A premiums, and who are not residents of a commonwealth or territory, the monthly Part B premiums will be determined as follows. The monthly Part B premium otherwise determined will be increased by a catastrophic coverage monthly premium and a prescription drug monthly premium.

For months in 1990, the catastrophic coverage monthly premium is $8.57, and for months in a subsequent year the premium is one-twelfth of the average actuarial expenses that the Secretary estimates (during the previous September) will be incurred for benefits and administration costs attributable to Part B for which outlays may be made from the Medicare Catastrophic Coverage Account during the year.

The prescription drug monthly premium is $0.53 for months in 1990, $4.61 for months in 1991, and for months in a subsequent year the premium is one-twelfth of the average actuarial expenses that the Secretary estimates (during the previous September) will be incurred for benefits and administration costs attributable to Part B for which outlays may be made from the Federal Catastrophic Drug Insurance Trust Fund during the year.

(g) *Transfers to Catastrophic Health Insurance Trust Fund.*—The conference agreement does not include the Senate amendment. The catastrophic coverage monthly premium is credited to the Medicare Catastrophic Coverage Account and transferred to the SMI Trust Fund.

(h) *Conforming Amendments.*—The conference agreement provides for certain conforming amendments, including (1) those to disregard the receipts and outlays attributable to changes made by this Act when determining (i) the monthly actuarial rate used to establish the Part B premium for aged and disabled beneficiaries, and (ii) the appropriate contingency margin for the PART B trust fund; (2) a provision to disregard the flat and supplemental catastrophic coverage and prescription drug premiums when computing appropriations to the Part B trust fund from the Treasury; and (3) those authorizing payments from the Federal Catastrophic Drug Insurance Trust Fund to organizations with risk-sharing contracts and establishing a method for allocating payment to such organizations from the Part A, Part B, and the Federal Catastrophic Drug Insurance Trust Funds.

Effective Date.—The conference agreement applies (except as otherwise specified in such amendments) to monthly premiums for months beginning with January 1989.

16. Establishment of Federal Catastrophic Drug Insurance Trust Fund (Section 6A or Senate Amendment)

Present law

A separate trust fund exists in the Treasury of the United States for each part of the Medicare program: the Federal Hospital Insurance Trust Fund (Part A) and the Federal Supplementary Medical Insurance Trust Fund (Part B).

The Part A trust fund includes annual deposits of the hospital insurance taxes collected from employers, employees, and the self-employed, and the monthly Part A premiums from individuals not otherwise eligible for Part A. The Part B trust fund includes deposits of the monthly Part B premiums paid by or on behalf of Part B enrollees, and contributions by the Federal Government from general revenues.

Section 1841 of the Social Security Act applies to the Federal Supplementary Medical Insurance Trust Fund as follows: Section 1841(b) creates and specifies the duties of a board of trustees for the trust fund; section 1841(c) provides for the investment of certain trust fund funds; section 1841(d) authorizes the selling of certain obligations acquired by the trust fund; section 1841(e) provides for the crediting of interest on or proceeds from the sale or redemption of any obligations held by the trust fund; section 1841(f) provides for periodic transfers to the trust fund from the Federal Old-Age and Survivors Insurance Trust Fund, the Federal Disability Insurance Trust Fund, and the Railroad Retirement Account; section 1841(g) provides for payments from the trust fund for Part B benefit payments and related administrative costs; section 1841(h) provides for payment from the trust fund for costs incurred by the Office of Personnel Management in deducting Part B premiums from Federal annuities; and section 1841(i) provides for payment from the trust fund for certain costs incurred by the Railroad Retirement Board.

House bill

No provisions.

Senate amendment

Creates on the books of the Treasury of the United States a trust fund known as the Federal Catastrophic Drug Insurance Trust Fund.

Provides that such trust fund consists of (1) any gifts and bequests made to the trust fund or to the Department of Health and Human Services for the benefit of the trust fund or any activity financed by the trust fund, and (2) the following amounts transferred to such trust fund: (a) drug benefit premiums transferred from the Part B trust fund, and (b) the drug premium rate adjustment component of the Medicare supplemental premium transferred from the general fund of the Treasury.

Provides that subsections (b) through (i) of section 1841 of the Social Security Act apply to such trust fund in the same manner as they apply to the Part B trust fund.

Requires that all Medicare payments for the home intravenous drug therapy benefit and the prescription drug benefit be made from this trust fund.

Effective date.—Applies to items and services furnished after, and premiums for months beginning after, December 31, 1987.

Conference agreement

The Conference agreement generally follows the Senate amendment. All payments for benefits and administrative costs relating to covered outpatient drugs are to be made from the CDI Trust Fund. The CDI Trust Fund has no borrowing authority.

Receipts attributable to the supplemental prescription drug premium rate are appropriated to the CDI trust fund. The Secretary of the Treasury is to transfer these appropriated amounts from the general fund to the CDI trust fund not less frequently than monthly, and at the close of the calendar year, determined on the basis of estimates; adjustments are made in subsequent transfers to take account of estimating errors. For individuals paying the maximum supplemental premium, receipts are allocated between the supplemental prescription drug and catastrophic coverage premiums pro rata on the basis of the respective premium rates.

The Secretary of HHS shall transfer premiums attributable to the prescription drug monthly premium directly to the CDI trust fund rather than through the SMI Trust Fund.

The Secretaries of HHS and Treasury jointly shall: (1) not later than July 1 of 1993 and each year thereafter, announce the preliminary monthly and supplemental prescription drug premiums for the following year; (2) not later than July 1 of 1992 and each year thereafter, publish in the Federal Register the outlays from, and the year-end balance in the CDI trust fund for the preceding year; (3) during the last 3 days of September of 1993 and each year thereafter, publish in the Federal Register the monthly prescription drug premiums for the following year; and (4) not later than October of 1993 and end each year thereafter, announce the supplemental prescription drug premium rate for the following year. The Comptroller General shall report to Congress, not later than September 1 of 1992 and each year thereafter, on the completeness and accuracy of the July 1 Federal Register publication, and after 1992, on the July 1 premium announcement.

With respect to the CDI trust fund, "outlays" and "receipts" are defined as gross outlays and receipts within the meaning of the "Monthly Treasury Statement of Receipts and Outlays of the United States Government," as published by the Treasury Department.

Effective date.—The CDI trust fund provisions are effective after December 31, 1988.

17. Establishment of Federal Catastrophic Health Insurance Trust Fund (Section 6B of Senate Amendment)

Present law

A separate trust fund exists in the Treasury of the United States for each part of the Medicare program: the Federal Hospital Insurance Trust Fund (Part A) and the Federal Supplementary Medical Insurance Trust Fund (Part B).

The Part A trust fund includes annual deposits of the hospital insurance taxes collected from employers, employees, and the self-employed, and the monthly Part A premiums from individuals not otherwise eligible for Part A. The Part B trust fund includes deposits of the monthly Part B premiums paid by or on behalf of Part B enrollees, and contributions by the Federal Government from general revenues.

Section 1841 of the Social Security Act applies to the Federal Supplementary Medical Insurance Trust Fund as follows: Section 1841(b) creates and specifies the duties of a Board of Trustees for the trust fund; section 1841(c) provides for the investment of certain trust fund funds; section 1841(d) authorizes the selling of certain obligations acquired by the trust fund; section 1841(e) provides for the crediting of interest on or proceeds from the sale or redemption of any obligations held by the trust fund; section 1841(f) provides for periodic transfers to the trust fund from the Federal Old-Age and Survivors Insurance trust fund, the Federal Disability Insurance trust fund, and the Railroad Retirement Account; section 1841(g) provides for payments from the trust fund for Part B benefit payments and related administrative costs; section 1841(h) provides for payment from the trust fund for costs incurred by the Office of Personnel Management in deducting Part B premiums from Federal annuities; and section 1841(i) provides for payment from the trust fund for certain costs incurred by the Railroad Retirement Board.

House bill

No provision.

Senate amendment

Creates the books of the Treasury of the United States as a trust fund known as the Federal Catastrophic Health Insurance Trust Fund.

Provides that such trust fund consists of (1) any gifts and bequests made to the trust fund or to the Department of Health and Human Services for the benefit of the trust fund or any activity financed by the trust fund, and (2) the following amounts transferred to such trust fund: (a) amounts from the Part B premiums attributable to the catastrophic benefit changes (excluding the drug benefit) in this bill, transferred from the Part B trust fund, and (b) the aggregate monthly supplemental premiums (excluding the drug premium rate adjustment) plus the amount the Secretary of the Treasury estimates Federal outlays are reduced under Medicaid because of the catastrophic provisions of this bill (after taking into account the provisions of section 14 of the bill related to Medicaid savings and State requirements), transferred from the general fund of the Treasury.

Provides that subsections (b) through (i) of section 1841 of the Social Security Act apply to such trust fund in the same manner as they apply to the Part B trust fund.

Requires that all Medicare payments for the catastrophic benefits in sections 2(a), 3(a), 4, and 7(b) of this bill be made from this trust fund.

Effective date.—Applies to items and services furnished after, and premiums for months beginning after, December 31, 1987.

Conference agreement

(a) *Medicare Catastrophic Coverage Account.*—The conference agreement does not include the Senate amendment. A separate Medicare Catastrophic Coverage Account (the "Account") is established on the books of the Treasury of the United States, to be maintained by the Secretary of the Treasury.

No funds are transferred into or out of the account. The principal purpose of the Account is to index the monthly and supplemental catastrophic coverage premium rates and to assure that over time revenue from these premiums are at least as large as the outlays from the Parts A and B trust funds attributable to the Medicare Catastrophic Coverage Act of 1988. (See discussion of premium indexing under section 7 above.)

Under rules prescribed by the Secretary of HHS, the Account is to be debited for catastrophic outlays. Catastrophic outlays are defined as outlays from the HI and SMI trust funds estimated to be attributable to the Catastrophic Coverage Act of 1988; HI and SMI outlays are to be separately debited from the Account. The Account is to be credited for monthly catastrophic coverage premiums received in the SMI trust fund and supplemental catastrophic coverage premiums received in the SMI trust fund and the Reserve Fund. Such credits and debits shall be made as of the last date of each month based upon receipts and outlays occurring during such month, as estimated by the Secretaries of HHS and Treasury. Interest (at the rate used for purposes of the SMI trust fund) is credited on any positive average Account balance in a calendar quarter and debited on any negative average Account balance in a calendar quarter. Thus, if the Account balance is negative, the Account is debited for principal and interest deemed to be owed to the SMI trust fund.

The Secretaries of HHS and Treasury jointly shall: (1) not later than July 1 of 1993 and each year thereafter, announce the preliminary monthly and supplemental catastrophic coverage premiums for the following year; (2) not later than July 1 of 1990 and each year thereafter, publish in the Federal Register the outlays debited from, and the year-end balance in the Account for the preceding year; (3) during the last 3 days of October of 1993 and each year thereafter, publish in the Federal Register the monthly and catastrophic coverage premiums for the following year; and (4) not later than October 1 of 1993 and each subsequent year, announce the supplemental catastrophic coverage premium rate for the following year. The Comptroller General shall report to Congress, not later than September 1 of 1990 and each year thereafter, on the completeness and accuracy of the July 1 Federal Register publication and, after 1992, and July 1 premium announcement.

Catastrophic health insurance benefits, other than prescription drug and home intravenous therapy benefits, are paid out of the existing medicare Parts A and B trust funds.

Receipts attributable to the supplemental catastrophic coverage premium rate, which are not otherwise appropriated to the Federal Hospital Insurance Catastrophic Coverage Reserve Fund (the "Reserve Fund"), are appropriated to the SMI trust fund. The Secretary of the Treasury is to transfer these appropriated amounts from the general fund to the SMI trust fund not less frequently than monthly, and at the close of the calendar year, determined on the basis of estimates; adjustments are made in subsequent transfers to take account of estimating errors. For individuals paying the maximum supplemental premium, receipts are allocated between the supplemental prescription drug and catastrophic coverage premiums pro rata on the basis of the respective premium rates.

The Secretary of HHS shall transfer receipts from the monthly catastrophic coverage premium to the SMI trust fund in the same manner as the existing Part B monthly premium.

These supplemental and monthly catastrophic coverage premiums are intended to increase Federal government receipts by the cost of catastrophic coverage benefits (plus a contingency margin).

No additional revenues are transferred to the Part A trust fund.

Effective date.—The Account is effective after December 31, 1988.

(b) *Federal Hospital Insurance Catastrophic Coverage Reserve Fund.*—To prevent an adverse effect on the HI trust fund balance, a new trust fund, to be known as the "Federal Hospital Insurance Catastrophic Coverage Reserve Fund," (the "Reserve Fund") is established on the books of the Treasury of the United States. The Conferees anticipate that Congress may at some future time transfer funds from the Reserve Fund to the HI trust fund to bolster the solvency of the trust fund. No expenditures from the Reserve Fund are permitted.

The rules for managing the Reserve Fund generally are similar to the rules that apply to the SMI trust fund.

Beginning in 1989, supplemental catastrophic coverage premiums are appropriated to the Reserve Fund, but not exceeding the amount of outlays from the HI trust fund that are debited against the Account. The Secretary of the Treasury is to transfer these appropriated amounts from the general fund to the Reserve Fund not less frequently than monthly, and at the close of the calendar year, determined on the basis of estimates; adjustments are made in subsequent transfers to take account of estimating errors. For individuals paying the maximum supplemental premium, receipts are allocated between the supplemental prescription drug and catastrophic coverage premiums pro rata on the basis of the respective premium rates.

The Secretary shall in July 1990 transfer an amount of supplemental catastrophic coverage premiums to the Reserve Fund equal to interest deemed to accrue (at the rate used for purposes of the SMI trust fund) from the time HI outlays are debited from the Account in 1989, until the time an equal amount of supplemenal catastrophic coverage premiums are transferred to the Reserve Fund.

Receipts attributable to the supplemental catastrophic coverage premium are first transferred to the Reserve Fund and then, to the extent available, transferred to the SMI trust fund, as described in section 17, above. (Such premium receipts are credited to the Account, whether transferred to the Reserve Fund or the SMI trust fund.)

With respect to the Reserve Fund, "outlays" and "receipts" are defined as gross outlays and receipts within the meaning of the "Monthly Treasury Statement of Receipts and Outlays of the United States Government," as published by the Treasury Department.

Effective date.—The Federal Health Insurance Reserve Fund provisions are effective after December 31, 1988.

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18. Trustee Comments on Actuarial Soundness of Basic and Supplemental Catastrophic Benefit Premiums (Section 18 of Senate amendment)

Present law

The Social Security Act currently requires that the Trustees of the Hospital Insurance (HI) and Supplementary Medical Insurance (SI) trust funds report to the Congress not later than April 1 of each year on the operation and status of the trust funds during the preceding fiscal year and on their expected operation and status during the current fiscal year and the next 2 fiscal years.

House bill

No provision.

Senate amendment

Amends section 1817(b) relating to the HI trust fund and 1841(b) relating to the SMI trust fund by inserting a requirement that the Trustees comment in their annual reports with respect to the extent to which the monthly catastrophic coverage premium and the supplemental premium cover the cost of the catastrophic benefits (as defined in section 1839(g)(2)(C)(i) added by this Act) and related administrative expenses payable from the trust funds.

Effective date.—Effective for trustees' annual reports beginning with those issued for fiscal year 1988.

Conference agreement

Under the Conference agreement, the Trustees annual reports on the HI and SMI trust funds are to identify those receipts and outlays in each trust fund which are deemed to be receipts and outlays in the Medicare Catastrophic Coverage Account (see section 17, above). In addition, the HI report is to include information pertaining to the Federal Hospital Insurance Catastrophic Coverage Reserve Fund.

The trustees of the CDI trust fund and the Account are to report to the Congress, not later than April 1 of each year, on the operation and status of the CDI trust fund and Account during the preceding fiscal year and on their expected operation and status during the current fiscal year and the next two fiscal years.

Effective date.—Effective for Trustees' annual reports beginning with those issued for fiscal year 1989.

19. Treatment of Prepaid Health Plans (Section 207 of House bill; Section 10 of Senate amendment).

Present law

Section 1876 of the Social Security Act, as amended by the Tax Equity and Fiscal Responsibility Act of 1982, provides for Medicare payments to Health Maintenance Organizations (HMOs) and Competitive Medical Plans (CMPs) on either a risk or a cost contracting basis. In general, risk contracting plans are financially responsible for the cost of all benefits their enrollees would otherwise be eligible for under Medicare. Reimbursement of HMOs and CMPs is determined based on estimates of the average adjusted per capita cost (AAPCC) and the adjusted community rate (ACR).

House bill

(a) Adjustment of AAPCC's and Contracts for Risk-Based Eligible Organizations.—Requires the Secretary to: (1) take into account amendments made by this act in estimating the AAPCC under section 1876(a) for eligible organizations with risk sharing contracts under section 1876(a) for portions of contract years occurring after December 31, 1987; (2) modify such contracts, for such portions of contract years, to reflect any adjustments made to the AAPCCs (as required above); and (3) require such organizations to make appropriate adjustments (including adjustments in premiums and benefits) in terms of their agreements with Medicare beneficiaries to take into account the changes in law required by this act.

(b) Provisions Applicable to Organizations Receiving Reasonable Cost Reimbursement.—Specifics that the following new provisions of this act apply to organizations reimbursed on the basis of reasonable costs: Section 201(a)(1) relating to payment for catastrophic benefits; section 202(b)(1)(C) relating to payment for covered out-patient drugs; section 203(c)(3) relating to payment for in-home care.

Requires the Secretary to provide for an appropriate adjustment in Medicare payment amounts to cost-based HMOs for added benefits.

Requires such organizations to assure the Secretary that they will not charge individuals eligible for:

Medicare catastrophic coverage for covered services after the individual has incurred out-of-pocket expenses equal to the catastrophic limit; or

More than 20 percent of reasonable cost of covered drugs plus amounts payable due to deductibile; or

More than 20 percent of reasonable costs of respite services plus an amount payable due to the deductible.

Effective date.—Enactment.

Senate amendment

(a) Adjustment of AAPCC's and Contracts for Risk-Based Eligible Organizations.—Similar provision except requires the Secretay to: (1) modify any AAPCC under section 1876(a) for an eligible organization with a risk-sharing contract to take into account the amendments made by section 2(a) of this bill relating to benefits for hospital inpatient services, section 3(a) relating to deductibles and coinsurance for individuals under parts A and B, section 4 relating to limitations on out-of-pocket expenses, section 7(b) relating to payment for in-home care, section 7A relating to home intravenous drug therapy, and section 11 relating to prescription drugs; (2) modify each such contract for portions of contract years occurring after December 31, 1987 to reflect the modifications made (as required above); and (3) require such organizations to make appropriate adjustments in terms of its agreements with Medicare beneficiaries to take into account such amendments.

(b) Provisions Applicable to Organizations Receiving Reasonable Cost Reimbursement.—No provision. See section 4 of the Senate amendment (Item 9e) relating to limitations on cost sharing.

Effective date.—Enactment.

Conference agreement

(a) *Adjustment of AAPCCs and Contracts for Risk-Based eligible Organizations.*—The conference agreement requires the Secretary to modify contracts under sections 1833 and 1976 for portions of contract years occurring after December 31, 1988. Prepaid plans are required to adjust their benefit packages to take the new benefits into account. The AAPCC will be adjusted to take the new beenfits into account under current authority. For provisions describing the treatment of copayments and deductibles when a beneficiary is enrolled in a pre-paid plan reimbursed on a risk basis, see item 9(e).

In assessing the value of benefits under prepaid plans paid on a risk basis the Secretary is required to make a separate actuarial determination for drug benefits and for all other covered benefits.

(b) *Provisions Applicable to Organizations Receiving Reasonable Cost Reimbursement.*—The conference agreement does not include the House provision. For provisions applicable to organizations reimbursed on a reasonable cost basis, see items 9(e), 10(f), and 12(c).

Effective date.—The conference agreement is effective on enactment.

20. Mailing of Notice of Medicare Benefits and Participating Physician Directories (Section 208 of the House bill; Section 9 of Senate amendment)

Present law

Under existing law, there is no requirement for an annual notice to Medicare beneficiaries about the scope of benefits available to them under the Medicare program. Information on Medicare coverage is generally available through the Social Security Administration district offices. As part of the participating physician program created by Public Law 98-369, the Deficit Reduction Act (DEFRA), HHS prepares directories of participating physicians, by area and specialty. These directories are made available in local Social Security offices, through hospitals, and through aging and consumer groups. Also, enrollees are informed by a notice in their Social Security check envelopes that they can obtain a copy free from their Medicare carrier. As of October 1, 1986, all "Explanation of Medicare Benefits" notices sent to beneficiaries on unassigned claims have to include a reminder of the participating physician and supplier program.

House bill

(a) Distribution of Notice of Medicare Benefits.—Amends the Medicare statute by adding new section 1804. Section 1804(a) requires the Secretary to distribute annually a notice containing: (1) a clear, simple explanation of the benefits available under Medicare and health care services for which benefits are not available under Medicare; and (2) a description of the limited benefits for

long-term care services available under this title and generally available under State plans approved under Medicaid. Requires the notice to be mailed annually to individuals entitled to Medicare Part A or Part B benefits.

(b) Authorization of Funds.—Amends the Medicare statute by adding a new provision (1804(b)) which authorizes, to be appropriated in equal portions from the HI and SMI trust funds, such sums as may be required to provide for the annual publication and distribution of the notice described in (a).

(c) Distribution of Participating Physician Directories.—Amends section 1842(h)(6) of the Medicare law relating to participating physician directories to require that an area directory of participating physicians be sent to each individual enrolled under Part B and residing in that area.

(d) Timing.—Requires the Secretary to provide notice annually.

(e) Consultation Required.—No provision.

Effective date.—First applies to annual rates and directories for 1988. The annual notice would be sent by January 31, 1988, or 3 months after the date of enactment of this legislation.

Senate amendment

(a) Distribution of Notice of Medicare Benefits.—Requires the Secretary to notify each individual who is entitled to benefits under Medicare of: (1) the benefits that are available under the insurance programs established under Medicare (and the major categories of health care that are not covered under those programs); (2) the limitations on payment (including deductibles and coinsurance amounts) that are imposed under such programs; and (3) the ways in which such limitations differ for individuals who are covered under the program established under Part B and individuals who are not covered under Part B.

(b) Authorization of Funds.—No provision.

(c) Distribution of Participating Physician Directories.—No provision.

(d) Timing.—Requires the Secretary to provide the notice described in (a) when an individual applies for benefits under Part A or enrolls under Part B, and annually thereafter.

(e) Consultation Required.—Requires the notices to be prepared in consultation with groups representing the elderly and with health insurers.

Effective date.—The requirement for notices for new beneficiaries is effective January 1, 1988. The notice to all beneficiaries applies to annual notices beginning for 1988.

Conference agreement

(a) *Distribution of Notice of Medicare Benefits.*—The conference agreement includes the House provision with modifications. The notice must include, in addition, information on Medicare's limitations on payment (including deductible and coinsurance amounts).

(b) *Authorization of Funds.*—The conference agreement does not include the House provision. General authority already exists in Section 201(g)(1)(A) of the Social Security Act to use Part A and Part B Trust Fund amounts for administrative expenses of the Medicare program.

(c) *Notice Concerning Participating Physicians.*—The conference agreement does not include the House provision requiring distribution of participating physicians directories, but instead modifies current law requirements for notice to beneficiaries regarding the participation program.

The agreement revised the reminder of the participation program currently required on the explanation of medical benefit (EOMB) notices for unassigned claims. The revised reminder would include: (i) a clear statement of the extra amounts (if any) charged by the physician above the Medicare approved charge; (ii) a brief statement of the advantages of receiving services from a participating physician; and (iii) the carrier's toll-free number with an offer of assistance in obtaining names of participating physicians of appropriate specialty and an offer of a free copy of the appropriate participating physician directory.

The conferees expect that the Secretary will consult closely with groups representing beneficiaries and physicians in developing the notice to assure that it can be easily understood by the elderly and conveys an accurate understanding of program policies.

The conferees expect that the revised reminder would be printed in a prominent type face (where possible) near the beginning of the explanation of medical benefits.

The conference agreement also modifies current requirements for an annual notice to beneficiaries concerning the participating physician program. The revised notice (which would be in the form of a brochure) would be mailed to each beneficiary each year and would contain: (i) a description of the participation program; and explanation of the advantages of obtaining services from a participating physician or supplier; (ii) an explanation of the assistance offered by carriers in obtaining the names of participating physicians and suppliers; and (iii) the local carrier's toll free number for inquiries concerning the program and for requests for free copies of appropriate directories.

The conferees note that the provisions are based on options developed by the Physician Payment Review Commission in its March 1988 report to Congress and are similar to measures used by private insurers to publicize and facilitate the use of their participating physician networks.

(d) *Timing.*—The conference agreement includes the House provision regarding distribution of the annual notice required under subparagraph (a) with an amendment that such notices must also be mailed annually when an individual applies for benefits under Part A or enrolls under Part B.

(e) *Consultation Required.*—The conference agreement specifies that the Secretary must first distribute the notice required under subparagraph (a) to beneficiaries not later than January 31, 1989. The revised EOMB notice applies to services furnished on or after January 1, 1989. The revised annual notice regarding the participation program would apply to annual notices beginning with 1989.

21. Benefits Counseling and Assistance for Certain Medicare and Medicaid Beneficiaries (Section 9A of Senate amendment)

Present law

No provision.

House bill

No provision.

Senate amendment

(a) Training and Technical Assistance.—Authorizes the Secretary to enter into agreements with private or public nonprofit agencies or organizations for the purpose of training volunteers. These volunteers are to provide counseling to elderly individuals, ages 60 and above, receiving benefits under Medicare or Medicaid with respect to eligibility for such benefits and are to provide assistance in preparing documentation that may be required to receive such benefits. In addition to other specified forms of technical assistance, the Secretary may provide material to be used in making elderly persons aware of the availability of assistance under volunteer assistance programs. The Secretary may also provide technical publications and materials to be used by the volunteers.

(b) Powers of the Secretary.—Authorizes the Secretary: (1) to provide assistance to organizations which demonstrate that their volunteers are adequately trained and competent to render effective benefits counseling and assistance to the elderly; (2) to provide for and assist in the training of such volunteers; (3) to provide reimbursement to volunteers for transportation, meals, and other expenses incurred by them during training or in providing counseling and assistance, and to provide such other support as the Secretary deems appropriate; (4) to provide for the use of services, personnel and facilities of the Federal executive agencies and of State and local public agencies with their consent, with or without reimbursement; and (5) to prescribe such rules and regulations as the Secretary deems necessary.

(c) Employment of Volunteers.—Provides that service as a volunteer under this section shall not be considered Federal employment. Volunteers are not subject to provisions of law relating to Federal employment, except that the volunteers are subject to the prohibition against the unauthorized disclosure of confidential information as if they were Federal employees. Reimbursement for expenses received by the volunteers are exempt from taxation.

(d) Authorization of Appropriations.—Authorizes to be appropriated $2.5 million for fiscal years after 1987.

Effective date.—Enactment.

Conference agreement

(a) *Training and Technical Assistance.*—The conference agreement includes the Senate amendment, with an amendment requiring the Secretary to establish a 3-year demonstration project with a private or public nonprofit agency or organization for the purpose of training volunteers.

(b) *Powers of the Secretary.*—The conference agreement includes the Senate amendment, with a modification that deletes the authority of the Secretary to prescribe rules and regulations deemed necessary to carry out the provisions of this section.

(c) *Employment of Volunteers.*—The conference agreement includes the Senate amendment.

(d) *Authorization of Appropiations.*—The conference agreement includes the Senate amendment, with an amendment authorizing appropriations, in appropriate parts from the HI and the SMI trust funds for fiscal years 1989, 1990, and 1991, such sums as may be necessary to conduct the demonstration project.

Effective date.—The conference agreement is effective for calendar years 1989, 1990 and 1991.

22. Case Management Demonstration Projects (Section 16 of Senate amendment)

Present law

"Case management" is a system under which a designated person or organization has responsibility for overseeing health care services for individuals assigned to the person or organization. Where case management is used, an insurer usually will not pay (or will pay less) for those services that are provided without permission of the case manager. Under current law, there are no requirements for Medicare beneficiaries to receive case management services, and case management is not a covered service under Medicare. Utilization and quality control peer review organizations (PROs) are responsible for reviewing the necessity and quality of services for Medicare beneficiaries.

House bill

No provision.

Senate amendment

(a) Description of Projects.—Requires HHS to establish not less than six demonstration projects under which a PRO agrees to provide case management services to Medicare beneficiaries with selected catastrophic illnesses.

(b) Purpose of Projects.—Specifies that the purpose of the demonstrations is to provide the Secretary and Congress with the information necessary (1) to evaluate the appropriateness of providing case management services under Medicare for individuals with catastrophic illnesses, and (2) to determine the most effective approach to implementing a case management system under the program for such individuals.

(c) Agreement.—Requires the agreement with the PRO to specify (1) the catastrophic illnesses for which case management services will be provided, (2) the payments to be made to the PRO for carrying out the project, and (3) such other terms and conditions as the Secretary and the PRO may agree to.

(d) Waivers.—Requires the Secretary to waive any provisions of Part B of title XI (relating to general provisions and Peer Review) and title XVIII of the Social Security Act (relating to Medicare) that the Secretary determines would prevent the establishment of a demonstration project under this provision.

(e) Duration.—Provides that the demonstration projects shall be conducted for a 1-year period. The Secretary may terminate the project before the end of the year if he determines that the State conducting the project is not in substantial compliance with the terms of the agreement with the PRO.

(f) Information and Reports.—(A) Requires a PRO with an agreement under section (a) to provide the Secretary with such information as the Secretary determines to be needed to evaluate the results of the project conducted by the PRO. (B) Requires the Secretary to submit an interim report based on information derived from the first 6 months of project operations, containing the findings, recommendations and conclusions of the evaluation of the project as described above.

(g) Authorization to Use Certain Funds.—Requires the Secretary to transfer from the HI and SMI trust funds amounts not to exceed $2 million to carry out the demonstration projects. Provides that amounts are to be transferred without regard to amounts appropriated in advance in appropriation acts. Requires payments from the trust funds to be made in such amounts as the Secretary determines to be fair and equitable.

Effective date.—Requires the Secretary to have the demonstrations in place 12 months after enactment. The interim reports are due 6 months from the date on which the demonstrations are initiated.

Conference agreement

(a) *Description of Projects.*—The conference agreement includes the Senate amendment, with an amendment requiring the Secretary to establish 4 demonstration projects under which an appropriate entity agrees to provide case management services to Medicare beneficiaries with selected catastrophic illnesses, particularly those with high costs of health care services. A further amendment requires that at least one of the demonstration projects be conducted by a peer review organization (PRO).

(b) *Purpose of Projects.*—The conference agreement includes the Senate amendment, with an amendment that the demonstration projects are to evaluate the appropriateness of, and determine the most effective approach of, providing case management services for Medicare beneficiaries with high costs of medical care.

(c) *Agreement.*—The conference agreement includes the Senate amendment, with an amendment that the demonstration project agreements must specify the high cost cases to which case management services will be provided.

(d) *Waivers.*—The conference agreeement includes the Senate amendment, with an amendment requiring the Secretary to waive (in addition to provisions of Part B of Title XI of the Social Security Act) any of Medicare's limitations or restrictions on benefits necessary to conduct the demonstration projects.

(e) *Duration.*—The conference agreement includes the Senate amendment, with an amendment that the data collection phase of the demonstration projects will be conducted for a 2-year period, with an additional period of time to write the report and submit it to Congress.

(f) *Information and Reports.*—The conference agreement includes the Senate amendment, with an amendment that the interim report will be based on information derived from the first year of project operations, and the final report will be based on data derived from the projects.

(g) *Authorization to Use Certain Funds.*—The conference agreement includes the Senate amendment, with an amendment requiring the Secretary to transfer, from the HI and the SMI trust funds in proportions the Secretary determines are appropriate, an amount not to exceed $2,000,000 in each of 2 years for administrative costs to carry out the demonstration projects.

Effective date.—The conference agreement requires the Secretary of HHS to establish the demonstration projects within 12 months after the date of enactment.

23. Changes in Certification of Medicare Supplemental Health Insurance Policies (Section 209 of House bill; Section 13 of Senate amendment)

Present law

(a) Establishment of New Medigap Standards.—Under section 1882 of the Social Security Act, insurers who market private insurance policies to fill the gaps in Medicare's coverage may have the policies certified as Medicare supplemental health insurance policies by the Secretary if the policies meet minimum standards. These standards were developed and approved by the National Association of Insurance Commissioners (NAIC) on June 6, 1979, and are incorporated by reference in section 1882 of the Social Security Act. Policies that are certified by the Secretary may be marketed as Medicare supplemental policies. However, if a State has adopted laws and/or regulations at least as stringent as those of the NAIC, policies regulated by the State are deemed to meet Federal requirements.

(b) Required Mailing of Notice.—Section 1882 (e) requires the Secretary to provide to individual Medicare beneficiaries information that will permit them to assess the value of the Medicare supplement policies to them and the relationship of any such policies to benefits under the Medicare program.

(c) Required Submission of Advertising.—There is currently no Federal requirement that insurance companies submit their Medigap advertisements for review to the State Commissioners of Insurance.

(d) Transition for Current Policies.—There is no present law relating to transition periods for current Medigap policies.

(e) Free Look Period.—Under the existing NAIC standards, Medigap policies are required to provide a "free look" period of 10 days for policies sold by mail, during which a policyholder may return the policy and get a full refund of any premium paid.

(f) Reporting of Information Relating to Loss Ratios.—Section 1882(b)(1) provides for loss ratio targets for Medicare supplemental policies that set a goal for the percentage of insurance premiums that must be returned to policyholders in the form of benefits. Medigap policies must be expected to pay benefits at least equal to 60

percent of the earned premiums for individual policies and 75 percent for group policies.

House Bill

(a) Establishment of New Medigap Standards.—

(1) Requires the Secretary to report to Congress not later than 150 days after the date of enactment of this act, on changes that should be made in the requirements of section 1882(c) of the Social Security Act for certification of Medicare supplemental policies to take into account the changes made by this act, and by any other pertinent acts enacted by the first session of the 100th Congress, and by any recommendations developed by the NAIC;

(2) Expresses the sense of Congress that: (A) Congress will promptly act on such recommendations and provide for appropriate changes in the requirements of 1882(c), and (B) States will be expected to adjust their laws in a timely manner to comply with changes in such requirements.

(b) Required Mailing of Notice.—Adds a new provision to section 1882 requiring that in order to meet the requirements for certification as a Medicare supplementary insurance policy, a policy offered in a State and in effect on January 1, 1988 must send a letter by January 31, 1988 to its policyholders who are entitled to Medicare, explaining: (a) the improved benefits resulting from this and other legislation enacted by the first session of the 100th Congress and (b) how these improvements affect the benefits contained in these policies and the premiums for these policies. Applies to Medicare supplemental policies as of February 1, 1988.

(c) Required Submission of Advertising.—Amends section 1882(b) to require that entities issuing Medigap policies submit their advertisements (whether through written, radio or television medium) used (or, at the option of the State, to be used) for the policy in the State, to the State Commissioner of Insurance for his or her review in accordance with State law.

(d) Transition for Current Policies.—

(1) Suspends (with the exception of Medigap policies sold in States described in (2) below) from January 1, 1988 through December 31, 1988, current Federal penalties under section 1882 for selling policies to Medicare beneficiaries which (a) were sold before the date of the enactment of this act, and (b) would not substantially duplicate health benefits to which they are otherwise entitled under Medicare but for the changes made by this act.

(2) Gives additional time to certain States (to be identified by the Secretary) in which penalties will be suspended. These are States which require legislation (other than legislation appropriating funds) in order for Medicare supplemental policies to be changed to avoid a penalty under section 1882, but the legislature of the State is not scheduled to meet in the 1988 legislative session in which such legislation may be considered. The exception in these States extends to the first day of the first calendar quarter beginning after the close of the first legislative session of the State legislature that begins on or after Jan-

uary 1, 1989, for which legislation described above may be considered.

(e) Free Look Period.—No provision.

(f) Reporting of Information Relating to Loss Ratios.—No provision.

Effective dates.—Enactment, except that (b) regarding notices to beneficiaries applies to Medicare supplemental policies as of February 1, 1988, and (c) applies to such policies with respect to advertising used on or after January 1, 1988.

Senate amendment

(a) Establishment of New Medigap Standards.—Amends section 1882 by making conforming changes and adding a new provision relating to NAIC amendments of its model regulation of Medicare supplemental (Medigap) policies to reflect the changes in law made by this Act:

(1) Provides that if the NAIC revises the existing model standards for Medigap policies within 90 days after enactment, then those standards will apply as the standard for certification, beginning 1 year later.

(2) Specifies that if the NAIC does not amend the standards within 90 days, the Secretary is required to issue Federal model standards for Medigap policies reflecting the changes in law made by this act, within 90 days, to become effective 1 year later.

(3) Specifies that no Medigap policy may be certified by the Secretary, no certification shall remain in effect and no State regulatory program will be found in compliance with Section 1882, unless such policy meets (or such program provides for the application of standards equal to or more stringent than) the standards set forth in the amended NAIC Model Regulation or the Federal model standards (as the case may be).

(b) Required Mailing of Notice.—Amends Section 1882(e) to require the Secretary to: (a) inform Medicare beneficiaries (and, to the extent feasible, individuals about to become entitled to Medicare) about current laws that prohibit certain marketing and sales abuses and the manner in which they may report any such action or practice to an appropriate official of HHS and (b) establish a toll-free telephone number for individuals to report suspected violations of the laws relating to Medigap standards. Also requires the Secretary to provide Medicare beneficiaries with a listing of the addresses and telephone numbers of State and Federal agencies and offices where information and assistance relating to Medicare supplemental policies may be obtained.

(c) Required Submission of Advertising.—No provision.

(d) Transition for Current Policies.—No provision.

(e) Free Look Period.—Section 1882(b)(1) is amended to require a uniform 30-day free look period for all Medicare supplemental policies, without regard to the manner in which the purchase of the policy was solicited.

(f) Reporting of Information Relating to Loss Ratios.—Amends section 1882(b)(1) to provide that information with respect to the actual ratio of benefits provided to premiums collected under Medigap policies will be reported to the State on forms conforming to

those developed by the NAIC for such purpose, or such ratios will be monitored under the program in an alternative manner approved by the Secretary.

Effective dates.—(a) is effective as provided in the amendment; (b) enactment; changes made by (e) and (f) are effective on the date on which the amended NAIC Model Standards (or Federal Model Standards) become effective under section 1882.

Conference agreement

(a) *Establishment of New Medigap Standards.*—The conference agreement includes the Senate amendment with amendments. The agreement provides for a procedure whereby the current National Association of Insurance Commissioner's (NAIC) model regulation would be amended or replaced as a standard for certification of Medicare Supplemental Insurance Policies. If the NAIC amends the model regulations within 90 days of enactment of this bill, in accordance with requirements in this section then the amended standards would apply as a standard for certification.

The NAIC has made available to the conferees both a model transition regulation, adopted in September 1987 in anticipation of the passage of this bill, and a draft of a new model minimum standards regulation. The conferees believe the transition regulation deals appropriately with the matter of adapting existing, certified policies to the amendments in Medicare made under this Act. The conferees also believe the draft model minimum standards regulation includes many appropriate provisions. The conferees intend and understand that the revised standards will continue to incorporate such provisions, including rules governing matters covered in the existing and draft model standards, such as minimum benefit standards, loss ratios, disclosure requirements and replacement requirements.

The conferees note that the NAIC model transition regulation contains an explicit prohibition on the inclusion of provisions in Medicare supplemental policies which duplicate the benefits covered under Medicare. The conferees believe such an explicit prohibition clarifies the meaning of the current requirements of Section 1882 that supplemental policies may not duplicate Medicare coverage. This amendment requires that the model standards include provisions otherwise necessary to reflect changes in law made by this Act. In enacting this provision, the conferees intend and understand that NAIC will include a similar provision precluding insurers from selling or maintaining Medicare supplemental policies which provide benefits covered by this Act in its final version of the model minimum standards regulation.

The conferees note in particular that Section 5B of the NAIC Transition Regulations provides for (1) a notice to the beneficiary, (2) the filing by the insurer of riders to the policy to eliminate duplication, and (3) the making of an appropriate refund or appropriate premium adjustment for duplicative coverage. The conferees intend and understand that such provisions will be included in the final model regulations. The conferees intend and understand that such appropriate refund or premium adjustments are to be made retroactive to the effective date of the new Medicare benefits enacted in this bill.

The conferees are particularly concerned about beneficiaries not paying for benefits under Medicare supplemental insurance policies that duplicate benefits covered under this Act. The conferees intend not merely to prevent such duplicative coverage from occurring, but also that beneficiaries receive appropriate premium adjustments where this has occurred.

If NAIC does not amend the regulations within 90 days, then the Secretary is directed to promulgate Federal model standards for certification of Medicare supplemental policies to reflect the changes in law made by this Act. Such Federal standards would then be the standards for certification. The conferees intend that such standards would incorporate all matters provided for in the bill and discussed above in this report with respect to the NAIC model standards.

The NAIC model standards (or the Federal model standards, as the case may be) would apply in a State effective on the earlier of (1) the date the State adopts standards equal to or more stringent than the amended NAIC standards (or the Federal standards), or (2) one year after the NAIC (or the Secretary, in the case of Federal standards) first adopts the standards.

The conference agreement also provides that the Secretary, rather than the President, will appoint the four State Commissioners or superintendents of insurance who, together with the Secretary, form the Supplemental Health Insurance Panel.

The conferees note that under this legislation, Medicare coverage of outpatient prescription drugs will begin in January 1991. The conferees do not intend for the enactment of this drug benefit to be construed as requiring current Medicare supplemental policies, which do not otherwise provide coverage for drugs to begin doing so upon enactment. Under the conference agreement, the NAIC (or the Secretary, as the case may be) will determine whether coverage of the drug deductible should be required for certification as a Medicare-certified policy.

(b) *Required Mailing of Notice.*—The conference agreement includes both the House provision and the Senate amendment, with modifications. In States which have enacted the NAIC Transition Regulations, beneficiaries will receive notices from insurers pursuant to the requirements of those regulations. In States which have enacted the final model standards, but not the transition regulations, insurers must send notices to beneficiaries in accordance with the requirements of this provision in order to remain certified. In States which have enacted neither the final model nor the transition regulations, insureers must follow the requirements described in (d) below. The House provision is modified to change each 1988 date to 1989. The Senate amendment is modified to require the Secretary (1) to inform Medicare beneficiaries of how they may report any marketing or sales abuses to HHS or to an appropriate State official, and (2) to publish the toll-free HHS telephone number for individuals to report suspected violations.

(c) *Required Submission of Advertising.*—The conference agreement includes the House provision, with a modification clarifying that the submission of advertisements to the State Commissioner of Insurance (or comparable officer identified by the Secretary) should be in accordance with review or approval as required under State law.

(d) *Transition for Current Policies.*—The conference agreement includes the House provision with amendments. The agreement does not include the provision which waives Federal penalties for knowingly selling policies with duplicative coverage. The agreement provides for the opportunity to sell or maintain certified Medicare supplemental health insurance policies during the period after enactment of the bill in those States which have not adopted standards by January 1, 1989 to reflect the changes in law made by this Act. The agreement provides that for policies sold prior to enactment (but in effect after enactment), a policy is deemed non-duplicative and may be deemed certified in the insurer selling the policy complies with the NAIC Model Transition Regulation by January 1, 1989, as discussed below. For policies sold after the date of enactment, such compliance would be required before the date of sale of the policy.

The conferees specifically intend that as a matter of Federal law, effective January 1, 1989 (for existing policies) or prior to sale (for policies later sold), Medicare supplemental insurance policies no longer include benefits that are provided for under this Act. Further, the conferees intend, that as a matter of Federal law, effective January 1, 1989, insurers whose policies would contain duplicate coverage but for such provision, notify the insured of such change in coverage, of any resulting premium refunds or adjustments, and when such refunds or adjustments will be made. The notice shall include the matters contained in Section 5(B)(1)(a), (b), and (c) of the NAIC model transition regulations and shall be mailed on the later of January 1, 1989 or the date the policy is sold. For this purpose, the insurer would not have to comply with the requirement of Section 5(B) that the notices be in a form approved by the State Insurance Commissioner.

Further, the conferees intend that insurers are required to take all necessary steps to effectuate such refunds or premium adjustments in the most expeditious possible manner, including immediately filing any appropriate riders to insurance policies. The conferees specifically intend and understand that all such appropriate refunds or premium adjustments will be made retroactive to January 1, 1989 or the date on which the policy is sold, whichever is earlier.

The conferees understand that insurers offering policies which are guaranteed renewable will conform their policies to prevent duplication of coverage in accordance with the provisions in this Act.

The conference agreement also requires the Secretary to report to Congress in March 1989 and in July 1990 on actions States have taken in adopting standards equal to or more stringent than the NAIC Model Transition Regulation or the amended NAIC model regulation (or Federal model standards).

(e) *Free Look Period.*—The conference agreement includes the Senate amendment.

(f) *Reporting of Information Relating to Loss Ratios.*—The conference agreement includes the Senate amendment.

(g) Prohibiting Misuse of Social Security or Medicare References.—The Conference agreement prohibits the use of the word "Social Security", "Social Security Account", "Social Security

System", "Social Security Administration", "Medicare", "Health Care Financing Administration", or any acronym, combination, or variation of such words, and any symbols or emblems of such agencies, in a manner which a person or an organization knew or should have known would convey the false impression that any advertisement or other item is authorized by the Social Security Administration, the Health Care Financing Administration or the Department of Health and Human Services.

The conference agreement authorizes the Secretary to impose civil money penalties of not more than $5,000, or $25,000 in the case of a broadcast or telecast, for violations of this prohibition. The total amount of penalties imposed for multiple violations consisting of substantially identical communications or productions could not exceed $100,000 a year. Those who are assessed penalties would be permitted to request a hearing before an Administrative Law Judge and to appeal thereafter to the U.S. District Court of Appeals. In assessing fines and pursuing violators, the Secretary would be required to coordinate his actions with the Justice Department.

The conferees intent that, to the extent feasible, the Secretary would use informal methods to deal with potential violations prior to initiating action under this provision. Such methods might include a letter which identifies a violation or which points out that the addition of a conspicuously-placed disclaimer of affiliation with the Social Security Administration could avoid the need for action under this provision.

The conferees also intend that the authorities established by this provision should supplement, not substitute for, existing authority of the U.S. Postal Service to take action against misleading and fraudulent references to the Social Security Administration in materials which re mailed.

(h) *Civil Money Penalties for Medigap Violations.*—The conference agreement authorizes civil montary penalties, in every case where only criminal penalties currently apply, for deceptive selling practices relating to Medicare supplemental health insurance (medigap) policies. Violations would be subject to a civil monetary penalty of up to $5,000 per violation.

Effective date.—The conference agreement provides that (a) applies as provided in the section and the Secretary is required to provide for the reappointment of members of the Supplemental Health Insurance Panel by not later than 90 days after the date of enactment. The provisions of (b) requiring the Secretary to provide consumer information apply on enactment; and the provision of (b) requiring health insurers to send informational letters to their policy holders apply to Medicare supplemental policies as of January 31, 1989. (c) applies to Medicare supplemental insurance policies as of Janaury 1, 1989, with respect to advertising used on or after such date. (d) applies as provided in the section. (e) and (f) apply on the date the amended NAIC Model Standards (or Federal model standards) become effective under Section 1882 of the Social Security Act. (g) and (h) are effective on enactment and apply only with respect to violations occurring after enactment.

24. Research on Long-Term Care Services for Medicare Beneficiaries (Section 211 of House bill; Section 15 of Senate amendment)

Present law

(a)-(b) Long-Term Care Services.—Medicare does not cover services required for individuals whose chronic conditions require long-term nursing home or home and community-based services. There is no current requirement that the Secretary provide for research relating to long-term care services nor is there any specific authorization for appropriations for such research.

(c) Institute of Medicine Study.—There is no current requirement that the IOM conduct a study on the financing of long-term care.

(d) Treasury Department Study of Tax Incentives for Long-Term Care.—There is no current requirement that the Secretary of Treasury conduct a study on the financing of long-term care. The President has asked the Department of Treasury to review tax policy as it affects the provision of catastrophic and long-term care health insurance.

House bill

(a) Health and Human Services Study.—Requires the Secretary to provide for research relating to the delivery and financing of long-term care services for Medicare beneficiaries. It shall include at least the following: (1) the financial characteristics of Medicare beneficiaries who receive or need long-term care services, including whether beneficiaries are eligible for Medicaid benefits for such services; (2) how financial and other characteristics of Medicare beneficiaries affect their utilization of institutional and noninstitutional services; (3) how relatives and Medicare beneficiaries are affected financially and in other ways because the beneficiaries require or receive long-term care services; (4) the quality of long-term care services (in community-based and custodial settings) and how the provision of such services may reduce expenditures for acute health care services; (5) the effectiveness of, and need for, State and Federal consumer protections which assure adequate access to and protect the rights of beneficiaries provided long-term care (other than in a nursing facility).

Defines long-term care services to include nursing home care, home care, community-based services, and custodial care.

(b) Authorization of Appropriations.—Authorizes to be appropriated, in equal parts from the HI and SMI trust funds, $5 million for each of fiscal years 1988, 1989, 1990, 1991, and 1992, to carry out the research described in (a).

(c) Institute of Medicine Study.—No provision.

(d) Treasury Department Study of Tax Incentives for Long-Term Care.—No provision.

Effective date.—Enactment.

Senate amendment

(a) Health and Human Services Study.—No provision.

(b) Authorization of Appropriations.—No provision.

(c) Institute of Medicine Study.—

(1) Requires the Secretary to request the National Academy of Sciences, through the Institute of Medicine (IOM), to contract for an IOM study to (a) explore options for private funding of a portion of long-term care (including methods by which changes in Federal laws, including tax laws, could facilitate such funding) and determine whether such options would be effective as compared to public financing alternatives and would be beneficial to the broad spectrum of populations (including children and adults who have attained and have not attained retirement age) requiring protection; (b) analyze the effect that provision of types of private funding of long-term care would have on public funding of such care; (c) review options for public sector coverage, both means-tested and universal, with respect to their effects on current and future Federal spending for health care; (d) review the effectiveness, quality of life provided, effect on family caregivers, and cost-implications of community-based long-term care, including types of limits necessary to assist beneficiaries and providers in preventing overutilization; (e) analyze, for each approach to provision of care, relative payments derived from users, non-utilizing elderly and employed persons (including both pre-funding and pay-as-you-go); and (f) review sources of financing and coverage of long-term care services in other developed nations and the implications of these findings on the development of similar policies in the United States.

(2) Requires the IOM study to take into account (a) the effect that impending demographic changes (near and long-term) will have on various approaches to service utilization and funding: (b) the impact of the various approaches to funding, both public and private, on access to long-term care services by individuals of all age groups (including children and adults who have attained and not attained retirement age), individuals of different socioeconomic and minority groups, and women; and (c) the effect that membership in these different groups has on the need, the ability to pay, and access to quality long-term care.

(3) Requires the Secretary to enter into appropriate arrangements with the Academy under which the Secretary will be responsible for expenses incurred for the study. Requires the Secretary to transfer from the HI and SMI trust funds amounts necessary to fund the study.

(4) Requires IOM to submit, by October 1, 1989 to the Secretary, the Senate Finance Committee and the House Energy and Commerce and Ways and Means Committees, a report that describes the study, includes a statement of the data obtained, and specifies administrative actions and changes in law that IOM considers to be appropriate to implement the study findings.

(d) Treasury Department Study of Tax Incentives for Long-Term Care.—Requires the Secretary of Treasury to conduct a study of Federal tax policies to promote the financing of long-term care. The study shall identify alternative methods of creating tax incentives to encourage individuals to purchase insurance for long-term care. Requires the study to consider also the cost to the U.S. Treas-

ury and the potential benefits to consumers, including whether the incentives would benefit all or most of the population requiring protection. Requires Secretary to consult with representatives of the insurance industry, providers of long-term care, and consumers. Requires the Secretary to report the results of the study and make recommendations to the Congress prior to April 1, 1988 of any changes in Federal law that the Secretary determines to be appropriate to promote financing of long-term care. Defines long-term care to include care and services provided by nursing homes, home health agencies and other mechanisms for long-term care delivery.

Effective date.—Enactment.

Conference agreement

(a) *Health and Human Services Study.*—The conference agreement includes the House provision with amendments. To the extent possible, the Secretary is to rely on research that has already been conducted or is underway by the Health Care Financing Administration or the National Center for Health Services Research and Health Care Technology (in their National Medical Expenditures Survey). The Secretary is required to submit interim reports by December 1990 and December 1992, and a final report by June 1994 to the House Committees on Energy and Commerce and Ways and Means, and the Senate Finance Committee describing the findings of the long-term care research required by this provision.

(b) *Authorization of Appropriations.*—The conference agreement includes the House provision.

(c) *Institute of Medicine Study.*—The conference agreement does not include the Senate amendment. The conferees note that the Secretary may contract with the Institute of Medicine to conduct the research required by Section 211(a) of the House provision.

(d) *Treasury Department Study of Tax Incentives for Long-Term Care.*—The conference agreement includes the Senate amendment, with an amendment that reporting date be changed to November 31, 1988.

Effective date.—The conference agreement is effective on enactment.

25. Study of Adult Day Care Services (Section 212 of House bill; Section 24 of Senate amendment)

Present law

Medicare does not provide coverage for adult day care services.

House bill

(a) Survey of Current Adult Day Care Services.—Requires the Secretary to survey adult day care services to collect information on (1) the scope of such services and the extent of their availability; (2) the characteristics of entities providing such services; (3) licensure, certification and other quality standards that are applied to those providing such services; (4) the cost and financing of such services; and (5) the characteristics of the people who use such services.

Defines adult day care services as medical or special services provided in an organized nonresidential setting to chronically impaired persons who are not inpatients in a medical institution.

(b) Report.—Requires the Secretary to report to Congress, within one year after enactment, on the information collected in the survey. Requires the report to include recommendations concerning appropriate standards for adult day care services under Medicare, including definitions of chronically dependent individuals and services in adult day care, establishing qualifications of providers of adult day care services, and establishing a reimbursement mechanism.

Effective date.—Enactment.

Senate amendment

(a) Survey of Current Adult Day Care Services.—Identical provision.

(b) Report.—Identical provision.

Effective date.—Enactment.

Conference agreement

(a) *Survey of Current Adult Day Care Services.*—Identical provision.

(b) *Report.*—Identical provision.

Effective date.—The conference agreement is effective on enactment.

26. U.S. Bipartisan Commission on Comprehensive Health Care (Sections 401-408 of House bill; Section 30 of Senate amendment)

Present law

No provision.

House bill

(a) Establishment/Duties.—Establishes a commission to be known as the U.S. Bipartisan Commission on Comprehensive Health Care. Requires that the Commission: (1) examine short-comings in the current health care delivery and financing mechanisms that limit or prevent access of all individuals to comprehensive health care; and (2) make specific recommendations to Congress on Federal programs, policies, and financing needed to assure the availability of comprehensive long-term care services for the elderly and disabled, comprehensive health care services for the elderly and disabled, and comprehensive health care services for all individuals in the United States. Requires the Commission to consider as it makes its recommendations: (1) the amount and sources (consistent with principles of social insurance) of Federal funds to finance the needed services, including reallocations of existing Federal program funds; and (2) the most efficient and effective manner of administering these programs.

Defines "comprehensive health care services" as including: (1) inpatient hospital services (including mental health services); (2) skilled nursing facility services, intermediate care facility services, home health services, and other long-term care services; (3) physician services and other outpatient health care services (including mental health services); (4) periodic general physical examinations; eye, hearing, dental, and foot examinations; and other preventive health care services; and (5) prescription drugs, eye-glasses, hearing aids, orthopedic equipment, and dentures (both complete and partial).

Defines "comprehensive long-term care services" as including custodial and noncustodial services in facilities, as well as home and community-based services.

(b) Membership.—Requires that the Commission be composed of 15 members appointed as follows: (1) the President will appoint 3 members; (2) the President Pro Tempore of the Senate will appoint, after consultation with the minority leader of the Senate, 6 Members of the Senate, of whom not more than 4 may be of the same political party; and (3) the Speaker of the House will appoint, after consultation with the minority leader of the House, 6 Members of the House, of whom not more than 4 may be of the same political party. The Commission will elect a chairman and vice chairman from among its members. Any vacancy in the membership of the Commission will be filled in the manner in which the original appointment was made and will not affect the power of the remaining members to execute the duties of the Commission.

(c) Meetings.—Specifies that the Commission will meet at the call of its chairman or a majority of its members; a quorum will consist of 8 members, except that 4 members may conduct a hearing. Members of the Commission may not receive compensation but may be reimbursed for travel, subsistence, and other necessary expenses incurred in carrying out the duties of the Commission.

(d) Staff.—Provides that the Commission may appoint and determine the compensation of staff, and may procure the temporary and intermittent services of consultants necessary to carry out the duties of the Commission.

(e) Powers.—Provides that the Commission may hold hearings and undertake such other activities as the Commission determines to be necessary to carry out its duties. The provision requires, upon request of the Commission: (1) the Comptroller General to conduct studies or investigations; (2) the Director of the Congressional Budget Office to provide cost estimates; (3) the head of a Federal agency to provide technical assistance; and (4) the Administrator of General Services to provide on a reimbursable basis administrative support services, which the Commission determines to be necessary to carry out its duties. The head of any Federal agency may detail to the Commission, without reimbursement, any personnel to assist the Commission in carrying out its duties. The Commission is authorized: (1) to use the U.S. mails; (2) to secure directly from any Federal agency information that may be disclosed to enable the commission to carry out its duties; and (3) to accept, use and dispose of gifts or donations of services or property.

(f) Reports.—

(1) Requires the Commission to submit not later than 6 months after enactment a report to Congress on its findings and recommendations regarding comprehensive long-term care services for the elderly and disabled. The report is to include detailed recommendations for appropriate legislative initiatives.

(2) Requires the Commission to submit not later than 1 year after enactment a report to Congress on its findings and recommendations regarding comprehensive health care services for the elderly and disabled and for all individuals in the United States. The report is to include detailed recommendations for appropriate legislative initiatives.

(g) Termination.—Specifies that the Commission shall terminate 30 days after the date it submits its report on comprehensive health care services.

(h) Authorization.—Authorizes $1.5 million for the Commission.

Effective date.—Enactment.

Senate amendment

(a) Establishment/Duties.—Identical provision.
(b) Membership.—Identical provision.
(c) Meetings.—Identical provision.
(d) Staff.—Identical provision.
(e) Powers.—Identical provision.
(f) Reports.—Identical provision.
(g) Termination.—Identical provision.
(h) Authorization.—Identical provision.
Effective date.—Enactment.

Conference agreement

Identical provision.

Effective date.—The conference agreement is effective on enactment.

27. Extension of Social HMO Demonstration Project (Section 210 of House bill)

Present Law

Section 2355 of DEFRA of 1984 (P.L. 99-369) required the Secretary to approve Medicare and Medicaid waivers needed to implement a demonstration project for social health maintenance organizations (SHMOS). These organizations are to provide an integrated package of health, long-term care, and social services on a prepaid capitation basis for persons who voluntarily enroll with the organization. There are currently four demonstration projects.

There is a comparable provision in section 4079 of Public Law 100-203.

House bill

Requires the Secretary to extend, without interruption, through September 30, 1992, the approval of waivers granted under Section 2355 of DEFRA of 1984 for the SHMO demonstration projects described in that provision, subject to the same terms and conditions (other than the duration of the project) established under that provision. It amends section 2355(b)(5) of DEFRA relating to Medicare's risk contract with the HMO to state that all payors will share risk for no more than 2 years, with the organization being at full risk in the 3rd year and in succeeding years. It requires the Secretary to send an interim report to Congress by December 1988 (rather than a final report, as in current law), and it requires the Secretary to submit a final report not later than March 31, 1993.

Effective date.—Enactment.

Senate amendment

No provision.

Conference agreement

The conference agreement does not include the House provision. A comparable provision was enacted in Section 4079 of P.L. 100-203.

28. Protection of Medicare Beneficiaries Enrolled in an Eligible Organization With a Risk-Sharing Contract Against Certain Practices (Section 10A of Senate amendment)

Present law

(a) Notice to Medicare Beneficiaries.—No provision.

(b) Civil Monetary Penalties and Intermediate Sanctions Against HMOs/CMPs.—HMOs/CMPs must provide assurances to the Secretary that they will not expel or refuse to reenroll any individual on the basis of health status or need for health services.

For each instance in which an HMO/CMP fails substantially to provide medically necessary items and services to a beneficiary, the Secretary may impose a $10,000 civil monetary penalty. No other sanctions short of contract termination are available for most other kinds of possible HMO/CMP contract or legal violations.

(Similar provision included in Omnibus Budget Reconciliation Act of 1987, except does not provide for refund to enrollee of excess charge and does not include extra $15,000 penalty for each individual not enrolled as a result of improper marketing practices.)

House bill

No provison.

Senate amendment

(a) Notice to Medicare Beneficiaries.—Requires an HMO or CMP with a Medicare risk-sharing contract to notify enrolled beneficiaries and potential enrollees that the organization may legally terminate or refuse to renew the contract, and that beneficiaries' enrollments may be terminated if this should occur. The notice would be included in any promotional materials furnished to potential enrollees and in information provided to all enrollees at the time of enrollment and annually thereafter. (Identical provision included in Omnibus Budget Reconciliation Act of 1987).

(b) Civil Monetary Penalties and Intermediate Sanctions Against HMOs/CMPs.—Increases the civil monetary penalty for failure to furnish medically necessary services to $25,000 for each failure. Provides for additional civil monetary penalties as follows:

(a) For each case in which an enrollee is charged a premium greater than permitted by law, $2,000 plus double the amount of the excess charge. The excess charge would be deducted from the penalty and returned to the enrollee.

(b) For each case in which the HMO/CMP expels or refuses to reenroll a beneficiary on the basis of health status, $15,000.

(c) For engaging in any practice which could reasonably be expected to result in denying or discouraging enrollment on the basis of health status, $100,000, plus $15,000 for each individual not enrolled as a result.

(d) For each case in which the HMO/CMP falsifies or misrepresents enrollment information furnished to the Secretary, any individual, or any other entity, or enrolls an individual without consent, or gives an individual a material inducement to enroll, $15,000. The penalty for each instance of false enrollment information furnished to the Secretary would be $100,000.

Provides that, in addition to or instead of imposing civil penalties, the Secretary may after notice to the organization suspend new enrollments or suspend payments to the HMO/CMP on behalf of new enrollees. Incorporates existing provisions on administration of civil monetary penalties.

Effective date.—(a) Applies to contracts entered into or renewed on or after the date of enactment.

(b) Becomes effective at the end of the 14 day period beginning on the date of enactment and does not apply to administrative proceedings commenced before the end of such period.

Conference agreement

The conference agreement includes the Senate amendment, with modifications. Only provisions not already enacted in the Omnibus Budget Reconciliation Act of 1987 (P.L. 100-203) are included. Excess premium charges collected from enrolleees are to be refunded, and an organization may be subject to a $15,000 civil monetary penalty for each case in which it expels or refuses to reenroll a beneficiary on the basis of health status.

29. Repeal of Authority to Administer Proficiency Examinations (Section 17 of Senate amendment)

Present law

Section 1123 of the Social Security Act allows the use of a testing program to determine the proficiency of individuals who desire to become skilled medical technicians. In the conduct of such tests, no individual who otherwise meets the proficiency requirements for the health care specialty can be denied a satisfactory proficiency rating solely because of his failure to meet formal educational or professional membership requirements. Currently, persons who are judged proficient as a result of this test may avoid going through an accredited education program designed to train such personnel.

House bill

No provision.

Senate amendment

Repeals section 1123, effective October 1, 1987. Provides that the repeal would not affect the authority of the Secretary to conduct the program established under 1123 prior to October 1, 1987 or the qualification of individuals to perform their duties and responsibilities who were certified by reason of previously administered exams.

Effective date.—October 1, 1987.

Conference agreement

The conference agreement includes the Senate amendment. The conferees note that this authority had already expired on September 30, 1987.

Although the authority would have allowed the Secretary to develop proficiency examinations for a variety of health personnel, the only examinations ever administered were those for clinical laboratory personnel. The conferees have been advised that there may develop a shortage of such personnel in the future. If this occurrs, the conferees anticipate that consideration could be given to the appropriateness of authorizing a new examination for such personnel.

Effective date.—The conference agreement is effective October 1, 1987.

30. Study and Reports by the Office of Personnel Management on Offering Medicare Supplemental Plans to Federal Medicare Eligible Individuals, and Other Program Changes (Section 23 of Senate amendment)

Present law

(a) Study and Report.—Under the Federal Employees Health Benefits (FEHB) Program, Federal employees and annuitants and their dependents are offered health benefits coverage from a range of participating health benefit plans. Since the FEHB program offers no plans that only supplement Medicare's coverage, the benefits available under the plans in the FEHB program duplicate certain benefits under the Medicare program.

(b) Feasibility Study and Report.—Under Section 1882 of the Social Security Act, the Secretary is required to establish a procedure by which Medicare supplemental policies may be certified by the Secretary as meeting minimum standards and requirements if they meet or exceed certain model standards developed and adopted by the National Association of Insurance Commissioners and meet certain loss ratio requirements. If a State establishes a regulatory program that provides for the application of these same minimum standards and requirements to Medicare supplemental policies, then such policies issued in that State are deemed to have met the requirements under the Secretary's certification program.

Section 1882 defines Medicare supplemental policies as health insurance policies or other health benefits plans offered by a private entity to individuals covered by Medicare that supplement Medicare's coverage; policies or plans of one or more employers or labor organizations are not included in this definition.

House bill

No provision.

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Senate amendment

(a) Study and Report.—Requires the Director of the Office of Personnel Management (OPM), no later than April 1, 1989, to conduct a study and submit a report to the Senate Committee on Governmental Affairs and the House Committee on Post Office and Civil Service regarding changes to the Federal Employees Health Benefits Program that may be required to incorporate plans designed specifically for Medicare eligible individuals and to improve the efficiency and effectiveness of the program.

Prohibits any Medicare supplemental plan recommended by the Director of OPM from duplicating benefits for which payment is made under Medicare. However, any such recommended plan (1) must cover expenses that are not payable by Medicare because of deductible and coinsurance amounts, and (2) may offer additional reimbursement where Medicare benefits are limited by fee schedule and for benefits not covered by Medicare which may be of value to Medicare eligible individuals.

(b) Feasibility Study and Report.—Requires the Director of the Office of Personnel Management, no later than April 1, 1989, to report to the appropriate committees of Congress whether it is feasible to adopt such standards as issued by the National Association of Insurance Commissioners as required by section 1882 of the Social Security Act for Medicare supplemental policies, when providing Medicare supplemental plans as a type of health benefits plan available under the Federal Employees Health Benefits Program.

Effective date.—The reports required by (a) and (b) are due no later than April 1, 1989.

Conference agreement

(a) *Study and Report.*—The conference agreement includes the Senate amendment.

(b) *Feasibility Study and Report.*—The conference agreement includes the Senate amendment.

Effective date.—The conference agreement is effective upon enactment.

31. Rate Reduction For Medicare Eligible Federal Employees (Section 22 of Senate amendment)

Present law

Under the Federal Employees Health Benefits (FEHB) Program, Federal employees and annuitants and their dependents are offered health benefits coverage from a range of participating health benefit plans. The premiums for such coverage are shared by the Federal Government and by the enrollees. Premium payments are deposited in the Employees Health Benefits Fund, from which benefit and administrative costs are paid.

Since the FEHB Program offers no plans that only supplement Medicare's coverage, the benefits available under the plans in the FEHB Program duplicate certain benefits under the Medicare program.

House bill

No provision.

Senate amendment

Requires the Office of Personnel Management, in consultation with carriers offering health benefits plans under the Federal Employees Health Benefits Program, to reduce the rates charged to Medicare eligible individuals participating in such health plans by the amount, prorated for each covered Medicare eligible individual, of the estimated cost of medical services and supplies which would have been payable by such plans if the catastrophic coverage benefits (those in sections 2(a), 3(a), 4, and 7(b) of this bill) had not been enacted.

Defines "Medicare eligible individual" as any annuitant, survivor of an annuitant, or former spouse of an annuitant (1) who is otherwise eligible for benefits under the Federal Employees Health Benefits Program, eligible for benefits under Part A of Medicare, and covered by Part B of Medicare, and (2) for whom benefits paid under Medicare are the primary source of health care benefits.

Provides that funds in the Employees Health Benefits Fund for the Federal Employees Health Benefits Program are available without fiscal year limitation for costs incurred by the Office of Personnel Management in making such rate reductions.

Effective date.—Provides that the reduced rates apply as of the effective date of the Medicare catastrophic coverage (items and services furnished after, and premiums for months beginning after, December 31, 1987).

Conference agreement

The conference agreement includes the Senate amendment, with technical amendments to insure that all catastrophic benefits would be included in determining the rate reduction.

Effective date.—The conference agreement is for health benefit plans beginning January 1, 1989.

32. Maintenance of Effort (Section 21 of Senate amendment)

Present law

Many older, disabled and retired workers participate in employer-sponsor group health insurance plans. There are no current Federal requirements that employer-sponsored health plans provide specific benefits to plan participants. For those employer group plans who are also covered by Medicare, employer plans are generally coordinated to supplement Medicare benefits or provide benefits that Medicare does not cover.

The proposed Medicare catastrophic legislation would result in duplicative coverage for many of those individuals receiving both Medicare and employer-sponsored health benefits.

House bill

No provision.

Senate amendment

(a) In General.—Provides that for the 1-year period beginning on the date of enactment of this act, if an employer provides health benefits to an employee or retired former employee (including a Federal employee or retired Federal employee) that are duplicative of new or improved health care benefits provided under this act or the amendments made by this act, the employer shall: (1) provide additional benefits to the employee or retired former employee that are at least equal in value to the duplicative benefits; or (2) refund to the employee or retired former employee an amount equal to the actuarial present value of the duplicative benefits.

(b) Regulations.—Requires the Secretary of Labor to issue such regulations as are necessary to carry out this provision.

Effective date.—Effective (1) during the 1-year period beginning on the date of enactment of this act; or (2) in the case of an employer who is providing duplicative health care benefits to employees or retired former employees under a collective bargaining agreement that is in effect on the date of enactment, until the expiration of the agreement.

Conference agreement

(a) *In General.*—The conference agreement includes the Senate amendment with the following amendments. Employers who, on enactment, provide health care benefits to employees or retired former employees that duplicate Part A benefits or Part B benefits (excluding covered outpatient drugs) as amended by this Act must provide to the employees or retired former employees an amount of additional benefits (which could include payment of the part B premium) or refunds, or both, that total at least the actuarial value of the duplicative Part A benefits or Part B benefits (excluding covered outpatient drugs). Duplicative benefits are determined net of any premiums paid employees or retired former employees that are attributable to the duplicative benefits.

(b) *Employers Covered.*—Employers (including public employers other than the Federal government) affected by this provision include those who provide duplicative Part A benefits whose actuarial value is at least 50 percent of the actuarial value (discounted to the value as of the date of enactment) of the average Part A benefits provided under this bill.

Also, employers (including public employers other than the Federal government) affected by this provision include those who provide duplicative Part B benefits whose actuarial value is at least 50 percent of the actuarial value (discounted to the value as of the date of the enactment) of the average Part B benefits that will be provided under this bill.

The conferees intend that employers contributing to a multiemployer plan would be required to continue their contributions under their collective bargaining agreements.

Employers may elect to compute the actuarial value of duplicative Part A or Part B benefits on the basis of: (1) national average actuarial values, or (2) the actuarial value (net of employee premiums) with respect to that employer. The Secretary of Health and Human Services must calculate and publish for four years beginning with 1989 for duplicative Part A benefits, and 1990 for duplicative Part B benefits, the national average actuarial value of the duplicative benefits for 1988 and the year involved, and the employer guidelines for computing the actuarial value of duplicative benefits for such years.

(c) *Effective Period.*—The conference agreement includes the Senate amendment, with a modification that the maintenance of effort requirements with respect to duplicative Part A benefits are effective during 1989, and the maintenance of effort requirements with respect to duplicative Part B benefits are effective during 1990. However, where there is a collective bargaining agreement in effect of the date of enactment, the maintenance of effort requirements are in effect until the later of 1989 for Part A benefits and 1990 for Part B benefits or the expiration of the agreement, determined without regard to any extensions after enactment.

(d) *Effective date.*—The conference agreement is effective on enactment.

33. Medicaid Buy-In of Premiums and Cost-Sharing for Indigent Medicare Beneficiaries (Section 301 of House bill; Sections 14 and 14B of Senate amendment)

Present law

Most States have entered into a "buy-in" agreement under which they pay the Medicare Part B premiums on behalf of their Medicaid beneficiaries who are also eligible for Medicare.

The Omnibus Budget Reconciliation Act of 1986 (OBRA 86) permits States to cover Medicare premiums, deductibles, and coinsurance for aged and disabled persons with incomes up to a State-established level, which may be up to 100 percent of the Federal poverty line. A State choosing this option is required to use the resource standards of the Supplemental Security Income (SSI) program; except that if it has a medically needy program using higher standards it may use those standards. States electing this option are required to offer Medicaid coverage "to some or all" newly pregnant women and children below the Federal poverty line.

House bill

(a) In General.—Makes mandatory the current option for States to pay Medicare premiums, deductibles and coinsurance for all elderly and disabled persons with incomes at or below 100 percent of the Federal poverty level, except that resources would be set at or below twice the SSI standard. The requirement that States cover some newly eligible pregnant women and children is retained. A State which is providing medical assistance under a section 1115(a) waiver instead of under Medicaid is required to meet the mandatory coverage requirement. The coverage requirement is optional with the commonwealths and territories, and they may use an income level below 100 percent of the Federal poverty line.

(b) Drug Provisions.—(See Item 10, "Coverage of Catastrophic Prescription Drugs Under Medicare").

(1) Requires State Medicaid programs to cover incurred drug charges below the Medicare deductible for Medicare beneficiaries with incomes below poverty. Alternatively, a State may

provide the same drug coverage (up to the deductible) as is offered to categorically needy Medicaid beneficiaries in the State.

(2) No provision.

Effective date.—(a) Applies to calendar quarters beginning on or after July 1, 1988 (without regard to whether or not final regulations have been promulgated) with respect to medical assistance for monthly Medicare premiums beginning July 1, 1988, and items and services furnished on or after that date. Delay is permitted where State legislation is required.

(b) Applies for calendar quarters beginning on or after January 1, 1989 (without regard to whether or not final regulations have been promulgated) with respect to medical assistance for monthly Part B premiums beginning January 1, 1989, and covered outpatient drugs dispensed on or after that date; delay is permitted where State legislation required.

Senate amendment

(a) In General.—Requires the Secretary, before the beginning of each fiscal year, to estimate the amount that would have been expended from State funds that fiscal year for Medicaid in the absence of the catastrophic protection offered under the bill and to notify each State of the amount. Each State is required to use such estimated savings for one or more of the following:

(1) Paying for Medicare cost-sharing charges (other than those for covered outpatient drugs) for persons below the poverty line, pursuant to the provisions of OBRA 86 (except that requirements pertaining to additional coverage of pregnant women and children would not apply);

(2) Increasing the monthly maintenance needs allowance for community spouses of institutionalized individuals; or

(3) Increasing opportunities for elderly persons to participate in adult day health and other community-based services, if the State both: (A) has elected to provide coverage for Medicare cost-sharing charges for persons with incomes up to 100 percent of poverty, and (B) provides a minimum monthly income allowance for community spouses up to $500 per month.

The amounts expended by the State under this provision are in addition to any amounts that would have otherwise been expended for such purposes.

(b) Drug Provisions.—(See Item 10, "Coverage Catastrophic Drugs Under Medicare".)

(1) Similar provision.

(2) Permits States to cover Medicare prescription drug cost-sharing charges for persons whose income is between 100 and 200 percent of poverty. For persons with incomes up to 150 percent of poverty, the deductible can be up to $150 and the cost sharing amount up to 10 percent of any coinsurance amounts otherwise paid by the State. For persons with incomes above 150 percent of poverty, the deductible can be up to $300 and the coinsurance up to 15 percent.

Effective date.—(a) Applies for 12 successive calendar quarters beginning January 1, 1988, except delay is permitted where State legislation is required. In case of delay, the provision is also effective for 12 successive calendar quarters.

(b) Applies to Medicaid payments for calendar quarters beginning on or after January 1, 1990 (without regard to whether final regulations have been issued) with respect to monthly Medicare premiums and items and services furnished on and after January 1, 1990.

Conference agreement

(a) *In General.*—The conference agreement follows the House provision with modifications. Except with respect to certain "209(b)" States, the buy-in requirement would be phased in as follows: effective January 1, 1989, States would have to buy-in the elderly and disabled with incomes at or below 85 percent of the Federal poverty income guidelines ($5,770 per year in 1988 for an individual); effective January 1, 1990, at or below 90 percent; effective January 1, 1991, at or below 95 percent; and effective January 1, 1992, at or below 100 percent. With respect to those five "209(b)" States that, as of January, 1987, used more restrictive income eligibility standards with respect to the elderly than those applicable under SSI, the buy-in requirement would be phased in as follows: effective January 1, 1989, these States would be required to offer buy-in coverage to individuals with income at or below 80 percent of the Federal poverty income guidelines; effective January 1, 1990, at or below 85 percent; effective January 1, 1991, at or below 90 percent; effective January 1, 1992, at or below 95 percent; and effective January 1, 1993, at or below 100 percent. The conferees understand that five "209(b)" States qualify for this extended phase-in schedule: Hawaii, Illinois, North Carolina, Ohio, and Utah, (See CRS Report 87-986 EPW, Appendix B-2).

The conferees note that the current option to offer buy-in coverage would remain in effect during the phase-in period. Thus, States which currently offer buy-in coverage to the elderly or disabled with income at or below 100 percent of the Federal poverty guidelines but above the mandatory phase-in schedule (i.e., Florida, New Jersey, Rhode Island, and the District of Columbia) could continue to receive Federal matching payments for such coverage. Similarly, States that, over the next three years, wish to offer buy-in coverage to individuals with incomes above the mandatory phase-in schedule (but no higher than 100 percent of poverty) may do so.

The conference agreement clarifies the standard in the House bill that States cover "some or all" pregnant women and infants. Under the agreement, States are required, effective July 1, 1989, to extend coverage to pregnant women and infants up to age 1 with incomes at or below 75 percent of the Federal poverty income guidelines ($9,690 in 1988 for a family of 3); effective July 1, 1990, the requirement applies to all pregnant women and infants with incomes at or below 100 percent of poverty. In the case of pregnant women, coverage would be limited to pregnancy-related services; in the case of infants, coverage would extend to all Medicaid benefits offered be the State to cash assistance recipients. Those States that, as of enactment, offered overage to pregnant women and infants with incomes at or below 100 percent of the poverty level (or some lower income threshold higher than 75 percent) would be required to continue this coverage. This maintennance of effort requirement would also apply to States that, as of enactment, had enacted authorizing or appropriations legislation to establish such coverage but had not yet actually implemented the coverage. As under current law, States that elected to offer Medicaid coverage to pregnant women and infants above the mandatory income thresholds up to 185 percent of the Federal poverty level would not be permitted to reduce their cash assistance payment levels to families with dependent children below the levels in effect as of July 1, 1987. Similarly, to assure that the resources for mandatory coverage of pregnant women and infants up to 100 percent of poverty are not diverted from the Aid to Families with Dependent Children (AFDC) program, all States are prohibited from reducing their cash assistance payment levels to families with dependent children below the levels in effect on May 1, 1988.

The conference agreement also provides that states which impose durational limits on Medicaid payments for inpatient hospital services (e.g., 12 days per year, 14 days per admission, 30 days per spell of illness, 35 days for a particular diagnosis under a prospective payment system) must establish exceptions to any such limit for medically necessary inpatient services received by an infant (up to age 1) in a hospital designated as a disproportionate share hospital under the State's Medicaid plan. Thus, so long as the infant remains Medicaid-eligible and is receiving medically necessary inpatient services in a disproportionate share hospital, the State would be obligated to reimburse the hospital for such services without regard to any durational limit that might otherwise apply. The agreement further provides that, if a State pays for inpatient hospital services on a prospective basis (per diem, per case, or otherwise), the State must provide for an outlier adjustment for disproportionate share hospitals for medically necessary inpatient services delivered on or after July 1, 1989, involving exceptionally high cost or exceptionally long lengths of stay for infants up to age 1. States would have the discretion to define length of stay and cost outliers, and to determine the amount of adjustment to be paid for outlier cases; however, reimbursement to disproportionate share hospitals for these exceptionally high costs or exceptionally long length of stay infants would have to be reasonable and adequate. States are required to submit a plan amendment setting forth their outlier policy by April 1, 1989; the Secretary is required to review and approve or disapprove such amendment within 90 days. If the Secretary disapproves the amendment, the State is required to submit immediately a complying amendment. This requirement applies to all States, including those with "prudent buyer" contracting waivers under section 1915(b)(4) of the Social Security Act.

(b) *Drug Provisions.—*

(1) The conference agreement follows the House provision with a modification providing for a phase-in schedule corresponding to the schedule applicable to the general buy-in requirement described in (a), above. Thus, as of January 1, 1991, when the Medicare prescription drug benefit takes effect, most States will be required to buy-in the elderly and disabled with incomes at or below 95 percent of the Federal poverty level; in the five "209(b)" States for which a longer phase-in schedule is

specified, the 90 percent threshold will apply. The managers note that, if the State elects the option of providing its Medicaid drug benefits in order to satisfy the Medicare prescription drug deductible, the "charges for covered outpatient drugs" are the billed charges for the drugs that Medicaid covers, even though the beneficiary has not actually incurred the charge or paid the difference between the State's payment (plus any coinsurance requirement) and the pharmacist's charge.

(2) The conference agreement does not include the Senate provision.

Effective date.—Applies to calendar quarters beginning on or after January 1, 1989 (without regard to whether or not final regulations have been promulgated) with respect to medical assistance for monthly Medicare premiums beginning on that date, and items and services furnished on or after that date. Delay is permitted where specified State legislation is required. The disproportionate share hospital payment provision is effective on enactment.

34. Determination of Medicaid Drug Savings; State Plan Requirement (Section 14A of Senate amendment)

Present law

No provision.

House bill

No provision.

Senate amendment

Requires the Secretary before the beginning of each fiscal year (or portion thereof) to estimate and determine the amount that would have been spent in each State that fiscal year under Medicaid in the absence of the new outpatient drug coverage and intravenous drug coverage provisions, and to notify the State of the amount.

Requires each State plan to use any such savings for covering Medicare drug cost sharing charges for persons below the poverty line.

Effective date.—Applies with respect to any calendar quarter beginning on or after January 1, 1990.

Conference agreement

The conference agreement does not include the Senate provision.

35. Protection of Income and Resources of Couple for Maintenance of Community Spouse (Section 302 of House bill; Section 14C of Senate amendment)

Present law

(a) In General.—Eligibility of the aged and disabled for Medicaid is linked to actual or potential receipt of cash assistance under SSI. The SSI program employs certain criteria for the treatment of income and resources which are also used in States which cover all SSI recipients. ("209(b)" States which do not cover all SSI recipi-

ents, may employ more restrictive criteria, provided they are no more restrictive than those in effect in January 1972).

An institutionalized individual with a spouse in the community is permitted to keep an amount for the maintenance needs of his spouse; however this amount is set at welfare levels. As a result of Medicaid rules, both for determining eligibility and in the treatment of income after eligibility has been established, the spouse in the community may be left with income below the poverty level; this circumstance is referred to as spousal impoverishment.

(b) Rules for Treatment of Income.—Under SSI rules, if both spouses live together, their incomes and resources are considered available to each other whether or not they actually contributed to each other. Spouses are no longer considered to be living together if one is institutionalized for longer than one month in a facility certified to receive Medicaid payments. Only the income of the institutionalized spouse is considered for purposes of determining eligibility. In most states the "name on the instrument" rule applies in attributing income; i.e., income is considered to belong to the spouse whose name is on the check or other instrument conveying the funds. (In the case of Social Security checks, the amount attributable to each spouse is the individual's share of the couple's benefit.) A Federal Appeals Court has ruled that in California and Washington, community property principles, and not the "name on the instrument" rule, apply.

(c) Rules for Treatment of Resources.—Resources must be considered mutually available for 6 months following institutionalization if both spouses are SSI eligible and for 1 month if only one spouse is SSI eligible. Countable resources above specified amounts (including a minimum of $1,900 in liquid resources for an individual and $2,850 for a couple) must be applied to the costs of care. Excluded from the calculation is the couple's home and $2,000 in equity value of household goods or personal effects. If resources are held solely by the institutionalized spouse, they are attributed to him for eligibility purposes. If they are held jointly by the institutionalized spouse and the noninstitutionalized spouse, they are considered to belong entirely to the institutionalized spouse. If they are held solely by the spouse remaining in the community, none is considered available to the institutionalized spouse.

(d) Protecting Income for Community Spouse.—After an institutionalized individual has established eligibility, his income, after deduction of specified amounts known as "disregards," is applied to the cost of care. The disregards are applied to the resident's income in the following order:

(1) A monthly personal needs allowance (which must be at least $25) ($30 as of July 1, 1988);

(2) A monthly maintenance needs allowance for an individual with a spouse at home which may not exceed: (A) the SSI standard for an individual residing in his own home, (B) the highest income standard for State optional supplementary payments, or (C) the medically needy standard for one person. (A State not covering all SSI recipients cannot use a level higher than the more restrictive income standard or the medically needy standard);

(3) An additional allowance for an individual with a family at home.

(4) Amounts for medical expenses not covered by a third party, subject to reasonable limits. (The Health Care Financing Administration (HCFA) has issued a regulation that, effective April 8, 1988, makes this disregard optional with the State.

(e) Notice and Hearing.—No provision.

(f) Court Ordered Support.—In certain instances State or local courts have issued orders against institutionalized spouses requiring them to make monthly payments to the community spouse. However, notwithstanding such an order, the Health Care Financing Administration (HCFA) has determined that the income of the institutionalized spouse is available to him for purposes of determining his contribution to the cost of care.

(g) Transfer of Assets.—The fair market value of any resources (not including the individual's home) disposed of within the preceding 24 months must be taken into account in determining SSI eligibility (to which Medicaid eligibility is linked). States are permitted, but not required, to impose such a restriction for Medicaid provided it is not more restrictive than that for SSI, with one exception. In cases where the uncompensated value of disposed resources exceeds $12,000, the State may provide for a period of ineligibility exceeding 24 months, provided the period bears a reasonable relationship to the uncompensated value. States may waive the delay in Medicaid eligibility in cases of undue hardship.

States are also allowed to deny Medicaid eligibility for 24 months to institutionalized individuals who, within 24 months prior to application for Medicaid, disposed of their homes for less than fair market value even though such disposal would not make them ineligible for the SSI program. The provision does not apply if the individual intended to dispose of the home at fair market value or if title was transferred to a spouse or minor or handicapped child.

(h) Conforming Amendment.—Some States covering the aged and disabled medically needy use less restrictive income or resource methodologies than are applied under the SSI program. HCFA has interpreted current law to require that States use SSI income and resource methodologies. A moratorium on this interpretation enacted in section 2373(c) of P.L. 98-369, and clarified by section 9 of P.L. 100-93, is currently in effect.

(i) Study of Means of Recovering Costs of Nursing Facility Services From Estates of Beneficiaries.—Under certain circumstances, States may recover amounts paid on behalf of deceased beneficiaries who were nursing home residents or who were 65 or over when Medicaid payments were made.

House bill

(a) In General.—

(1) Adds a new Section 1921 to the Social Security Act entitled "Treatment of Income and Resources For Certain Institutionalized Spouses". The provisions of this section supersede other provisions of title XIX, to the extent they are inconsistent, for purposes of determining eligibility of an institutionalized spouse. Comparable treatment is not required for other groups of eligibles.

(2) Specifies that, except as specifically provided, the section does not apply to the determination of what constitutes income or resources or the methodology and standards for determining and evaluating them.

(3) Permits an institutionalized spouse to elect to be governed instead by the rules in effect in March 1987 in his State, except that the institutionalized spouse may not opt out of the new rules regarding treatment of resources at the time of initial eligibility determination.

(4) Specifies that the new section applies to a State operating under a section 1115 waiver but not to the commonwealths and territories.

(b) Rules for Treatment of Income.—

(1) Specifies that in any month in which a spouse is institutionalized, no income of the community spouse is considered available to the institutionalized spouse.

(2) Specifies that, regardless of State laws relating to community property or division of marital property, the following income attribution rules apply for non-trust property unless otherwise specifically provided on the instrument. Income paid solely to one spouse or another is considered to belong to that respective spouse. If the income is paid in both names, half is considered available to each spouse. If the income is paid in the name of either or both spouses and another person, an equal share of the income is considered available to each individual. The same principles apply for trust property unless the trust specifically provides otherwise. For non-trust property with no instrument, half of the income is considered available to each spouse.

(3) An institutionalized spouse can rebut the non-trust property attribution rules by establishing that ownership interests are otherwise.

(4) No provision.

(c) Rules for Treatment of Resources.—

(1) Provides for the computation, as of the beginning of a continuous period of institutionalization, of the spousal share which is equal to one-half the value of all the resources held by the institutionalized spouse, the community spouse, or both. The couple's house and all household goods and personal effects are to be excluded from the calculation.

(2) Provides that the determination of countable resources is to be made regardless of State laws relating to community property or division of marital property, at the time of application for benefits. All resources held by either spouse are considered available to the institutionalized spouse except that the resources held in the name of the community spouse are not considered available unless they exceed a community spouse resource allowance (as of the application date) or if greater, the amount retained under court order.

(3) No provision.

(4) Provides that after an institutionalized spouse has established eligibility, no resources of the community spouse shall be considered available to the institutionalized spouse.

(5) Specifies that if the spousal share is less than $12,000 (indexed to the CPI beginning in 1989), the institutionalized spouse is allowed to transfer an amount sufficient to enable the community spouse to hold $12,000 in his or her own name. If the spousal share is greater than $48,000 (indexed by the CPI beginning for 1989), the amounts in excess of $48,000 would be attributed to the institutionalized spouse.

(d) Protecting Income for Community Spouse.—Specifies that the following disregards are to be applied to the institutionalized individual's income in the following order:

(1) A monthly personal needs allowance as specified under current law;

(2) A minimum monthly maintenance needs allowance for the community spouse. The allowance is the amount needed to bring the community spouse's monthly income up to a minimum level (not to exceed $1,500, indexed to the CPI beginning for 1989) which is the sum of:

(A) 150 percent of the Federal poverty guidelines for a family of two;

(B) an excess shelter allowance (the amount by which mortgage expenses or rent, plus utility costs, exceed 30 percent of Item A); and

(C) one-half of the amount by which the income of the institutionalized spouse exceeds the sum of items A and B;

(3) A family allowance for each family member (minor or dependent child, dependent parent or dependent sibling residing with the community spouse) equal to at least one-third of the amount by which 150 percent of the Federal poverty line for a family of two exceeds the family income of that family member.

(4) Amounts for incurred medical expenses not subject to payments by a legally liable third party.

(e) Notice and Hearing.—

(1) Requires States to notify the institutionalized spouse of the community spouse monthly income allowance, the family allowance, the method for computing the amount of the community spouse resource allowance, and of the spouse's right to a fair hearing with respect to the determination of the community spouse monthly income allowance.

(2) Specifies that if the institutionalized spouse establishes that the minimum monthly maintenance needs allowance is inadequate to support the community spouse without financial duress, the amount is to be increased.

(f) Court Ordered Support.—

(1) Provides that if a court has entered an order against an institutionalized spouse for monthly income support for the community spouse, the community spouse monthly maintenance needs allowance must be at least as great as the court ordered amount.

(2) Provides that if a court has entered a support order against an institutionalized spouse requiring the spouse to transfer countable resources to the community spouse, such transfer will not be considered in violation of transfer of assets prohibitions.

(3) Provides that if a court has entered an order against an institutionalized spouse requiring the spouse to transfer resources, the community spouse resource allowance is the amount transferred up to the ceiling ($48,000 in 1988, indexed to the CPI in future years).

(g) Transfer of Assets.—

(1) Requires States to determine, at the time of application, whether an institutionalized individual has disposed, within the preceding 24 months, of resources for less than fair market value. If such a transfer has occurred, a period of ineligibility is established beginning with the month in which the resources were transferred. The number of months in such period equals the total uncompensated value at the time of transfer divided by the average cost of nursing home care to a private patient in the State or community.

(2) Specifies that the transfer prohibition does not apply if:

(A) the transfer was that of the applicant's home to his or her spouse, child under 21 or blind or disabled adult child;

(B) resources were transferred to the community spouse;

(C) a satisfactory showing is made that the individual intended to dispose of resources at fair market value or for other valuable consideration; or

(D) the State determines that denial of eligibility would work an undue hardship. States can only employ transfer of resources restrictions in accordance with these provisions.

(h) Conforming Amendment.—Provides that a State's methodology for determining eligibility for the medically needy may not be more restrictive than that under the appropriate cash assistance program. The methodology is considered to be no more restrictive if, in using the methodology, additional individuals may be eligible and no otherwise eligible individuals are made ineligible.

(i) Study of Means of Recovering Costs of Nursing Facility Services From Estates of Beneficiaries.—No provision.

Effective Date.—Applies to payments made for calendar quarters beginning on or after January 1, 1988, without regard to whether final regulations have been issued. Delay is permitted where State legislation required. The conforming amendment item (h) applies to medical assistance furnished on or after October 1, 1982.

Senate amendment

(a) In General.—Identical provision, except excludes item 3.

(b) Rules for Treatment of Income.—

(1) Identical provision.

(2) Similar provision except: (A) applies only to post-eligibility treatment of income; and (B) in the case of both trust and non-trust property where the income is paid in the name of either or both spouses and another person, the income is considered available to each spouse in proportion to the spouse's interest (or if payment is made with respect to both spouses and no such interest is specified, one-half of the joint interest shall be considered available to each spouse).

(3) Identical provision.

(4) Specifies that in the case of community property States that do not provide coverage for the medically needy, the amount of income considered available to each spouse, at the time of application for benefits, is equal to half of the combined income of the institutionalized and community spouse.

(c) Rules for Treatment of Resources.—

(1) Similar provision. Also excludes resources that are necessary to produce income that is available to the community spouse or the family allowance up to the limits established by this section (see (d) below).

Requires the State to provide an assessment and documentation of total joint resources at the request of either spouse, at the beginning of a continuous period of institutionalization. The assessment shall occur promptly on receipt of relevant documentation. A copy is to be provided to each spouse. A State may charge a reasonable fee for an assessment if it is not part of an application for Medicaid.

(2) Similar provision.

(3) Specifies that the institutionalized spouse is not considered ineligible by resources determined to be available where: (A) the institutionalized spouse has assigned to the State any rights to support from the community spouse; (B) the institutionalized spouse lacks the ability to excute an assignment due to physical or mental impairment but the State has a right to bring a support proceeding against a community spouse without such assignment; or (C) the State determines denial of eligibility could work an undue hardship.

(4) Identical provision.

(5) Similar provision, except: (A) a State, by law, practice, policy, or State plan (whether approved or not), may establish a higher amount than $12,000; and (B) specifies that a higher amount may be established by fair hearing or court order. Specifies that a transfer of resources to a community spouse must be made within 1 year after the date of the initial eligibility determination or such time as is necessary to obtain a court order (whichever is longer.)

(d) Protecting Income for Community Spouse.—Similar provision, except:

(1) The definition of personal needs allowance is tied to that specified under the bill.

(2) The minimum allowance for the community spouse may be increased by State law, policy, or State plan (whether approved or not):

(A) The minimum maintenance needs allowance is 122 percent of the poverty line;

(B) Similar provision.

(C) No provision.

(3) Similar provision, except family allowance linked to 122 percent of Federal poverty line.

(4) Similar provision.

(e) Notice and Hearing.—

(1) Similar provision, execpt requires specific notice to both spouses at the time of eligibility determination or to either spouse upon request. Also requires notification of the spouse's

right to a fair hearing respecting ownership or availability of income or resources, and respecting the community spouse monthly income or resource allowance.

(2) Specifies that if either spouse establishes that either the minimum monthly maintenance needs allowance or the community spouse resource allowance (in the relation to the amount of income generated by such allowance) is not adequate to support the community spouse without financial duress, the amount of either allowance is to be increased.

(f) Court Ordered Support.—

(1) Similar provision.

(2) Similar provision.

(3) Similar provision, except ceiling does not apply.

(g) Transfer of Assets.—Similar provision except that the State review covers the disposal of assets within the 26 months prior to application.

(2) Similar provision, except:

(A) specifies transfer prohibition does not apply (i) in the case of a sibling who has an equity interest in the home and was residing in the home for at least a year prior to the individual's admission to a nursing home, or

(ii) in the case of a son or daughter who was residing in the home for at least two years prior to the admission and was providing care which permitted the individual to reside at home.

(B) also permits transfer to the individual's child who is permanently or totally disabled.

(C) also permits a showing that resources were transferred exclusively for a purpose other than to qualify for medical assistance.

(D) Identical provisions.

(h) Conforming Amendment.—Identical provision.

(i) Study of Means of Recovering Costs of Nursing Facility Services From Estates of Beneficiaries.—Requires the Secretary to study the means for recovering the amounts from the estates of deceased beneficiaries (or the estates of spouses of deceased beneficiaries) to pay for SNF or ICF services furnished them under Medicaid. The Secretary is required to report to Congress, not later than December 31, 1988, on such means, and to include appropriate recommendations for changes.

Effective date.—Applies to payments made for calendar quarters beginning on or after January 1, 1988, without regard to whether final regulations have been issued. Delay is permitted where State legislation required. Provisions relating to treatment of resources, apply only to institutionalized individuals who begin continuous periods of institutionalization on or after January 1, 1988. Transfer of assets provisions, item (g) apply only to transfer of resources made on or after January 1, 1988.

Conference agreement.

(a) *In General.*—The conference agreement follows the Senate amendment.

(b) *Rules for Treatment of Income.*—The conference agreement follows the Senate amendment with a modification deleting the provision relating to community property States that do not offer coverage to the medically needy (item (4) of the Senate amendment).

(c) *Rules for Treatment of Resources.*—The conference agreement follows the Senate amendment with the following modifications. If the spousal share the couple's total resources is greater than $60,000 (indexed by CPI beginning in 1990), amounts in excess of $60,000 would be attributed to the institutionalized spouse. A level higher than $60,000 could be established by fair hearing or court order. The State, by amending its State plan, could raise the $12,000 minimum resource allowance for the community spouse to any level up to the $60,000 (subject to indexing) statutory maximum.

The agreement does not exclude from countable resources those assets necessary to produce income available to the community spouse or the family allowance. Instead, the agreement provides that either the institutionalized or the community spouse may request a fair hearing as to whether the community spouse resource allowance is adequate to generate sufficient income to raise the community spouse's income to the minimum monthly maintenance needs allowance. The State must grant such a hearing within 30 days of request. If the State, after such a hearing, determines that the community spouse resource allowance is inadequate, the State must allow the community spouse to retain an adequate amount of resources to provide the minimum monthly maintenance needs allowance (taking into account any other income attributable to the community spouse), notwithstanding the amount of the State-established resource allowance. If either spousel requests an assessment or resources at the time of institutionalization, the State must, in providing the assessment give notice to the requesting spouse of the right to a fair hearing with respect to the adequacy of the community spouse's resource allowance. The agreement also requires that nursing facilities inform newly-admitted residents of their right to request an assessment from the State agency.

The conference agreement specifies that a transfer of resources to a community spouse must be made as soon as practicable after the date of initial eligibility determination, with allowance for the time necessary to obtain a court order, where necessary. In determining what constitutes a "transfer" for this purpose, the conferees intend that State law govern. In addition, the agreement provides that the State of Missouri must not count as a resource the home (of any value) of an aged, blind, or disabled individual who applies for Medicaid on or after October 1, 1989. This requirement would apply only to the home; the State could, but would not be requird to, exclude the land that appertains to the house, as would be the case under SSI.

(d) *Protecting Income for Community Spouse.*—The conference agreement follows the Senate amendment with the following modifications. As under current law, the proposal needs allowance is $30, whether the resident is eligible for Medicaid on a categorically needy, optional categorically needy, or medically needy basis. The minimum monthly maintenance needs allowance is effective September 30, 1989, set at 122 percent of the monthly Federal poverty income guidelines for a 2-person household (which is 1988 would be $786). Effective July 1, 1991, the minimum allowance would be raised to 133 percent; effective July 1, 1992, to 150 percent. This schedule of percentage would also apply to the calculation of the family allowance. The community spouse monthly maintenance needs allowance may not exceed $1500, except where a higher level is determined to be necessary through a fair hearing or by a court order.

With respect to the deduction for incurred medical expenses, the conference agreement requires that, with respect to any Medicaid-eligible individual in an institution (regardless of whether the individual has a spouse in the community), States must take into account amounts for incurred expenses for medical or remedial care that are not subject to payment by a third party, including Medicare and other health insurance premiums, deductibles, or coinsurance, and, subject to reasonable limits a State may establish, necessary medical or remedial care recognized under State law but not covered under the State's Medicaid plan. The conferees note that, until recently, HCFA regulations required that Medicaid-eligible nursing home residents be allowed to deduct uncovered medical costs from their income before contributing toward the cost of nursing home care. However, a recent HCFA regulation, 53 *Fed. Reg.* 3586 (Feb. 8, 1988), altered this rule to allow States to limit this deduction substantially, or to eliminate it altogether. The conference agreement is intended to reinstate the previous rule, retroactive to the effective date of the recent change (April 8, 1988). As under the previous regulation, States will have the ability to place "reasonable limits" on a resident's expenditures for medical or remedial care. The conferees wish to emphasize that these limits must ensure that nursing home residents are able to use their own funds to purchase necessary medical or remedial care not covered by the State Medicaid program, while minimizing opportunities for providers to take financial advantage of either the program or the residents. For example, it would be reasonable for a State to provide that only uncovered services prescribed by a physician may be deducted. It would also be reasonable for States to impose specific dollar limits for specific services or items, provided that these limits reflect annual increases in the cost of medical care services and supplies. However, it would not be reasonable for States to set an overall dollar limit, such as $50 per month, for all noncovered services. Similarly, it would not be reasonable for States to impose a limit on the number of medically necessary services or items that an individual could deduct in any month. In providing these examples of "reasonable limits" for deductions of uncovered medical expenses incurred by nursing home residents, the conferees do not intend any approval of camparable limitations in the "spenddown" process for medically needy programs.

(e) *Notice and Hearing.*—The conference agreement follows the Senate amendment with the following modification. If either the community or institutionalized spouses establishes in a fair hearing that, due to exceptional circumstances resulting in significant financial duress, the community spouse needs income above the minimum monthly maintenance needs allowance, the State is required to increase the allowance to provide this amount, notwithstanding the $1500 statutory ceiling. Exceptional circumstances resulting in significant financial duress would include, but not be limited to, the financial burden of caring for a disabled child, sibling, or other immediate relative. If either spouse establishes in a fair hearing that the community spouse resource allowance (in relation to the income generated by such allowance) is inadequate to raise the income of the community spouse to the level of the minimum monthly maintenance needs allowance (taking into account any other income attributed to the community spouse), the State must provide for a resource allowance adequate in amount to generate that level of income for the community spouse.

(f) *Court-ordered Support.*—The conferences agreement follows the Senate amendment.

(g) *Transfer of Assets.*—The conference agreement follows the Senate amendment, with a modification. The transfer of assets prohibitions apply only with respect to individuals institutionalized in a medical institution or nursing facility. The term "medical institution" has the same meaning as under current regulations, 42 C.F.R. section 435.1009; the term "nursing facility" includes a skilled nursing facility or intermediate care facility (other than an ICF for the mentally retarded), until October 1, 1990, when these categories will be replaced by "nursing facility." States are required to determine whether these individuals made any prohibited resource transfers within 30 months prior to application for benefits. This requirement is effective with respect to applications for Medicaid eligibility occurring on or after July 1, 1988 and applies only with respect to resources transferred on or after July 1, 1988. Thus, in those States which do not have transfer or assets prohibitions in place prior to July 1, 1988, the State can look back only to transfers occurring on or after July 1, 1988. In those States that, prior to July 1, 1988, have exercised their option to penalize transfers of assets for less than fair market value, the State may continue to apply its pre-July 1 transfer policies and penalties with respect to resources transferred prior to July 1, 1988, even in cases where application for Medicaid benefits is made after on or after that date. However, with respect to resource transfers occurring on or after July 1, 1988, the rules set forth in the conference agreement regarding computation of the period of ineligibility and exceptions to the transfer prohibition will apply in all States, including the "209(b)" States which have elected the option to use more restrictive eligibility standards with respect to their aged, blind, and disabled beneficiaries than apply under SSI.

The conference agreement also repeals the provision in present SSI law which requires that the uncompensated value of resources transferred at less than fair market value within the preceding 24 months be counted toward the SSI resource limit. However, under the conference agreement, a transfer of resources at less than fair value by an SSI applicant or recipient will be considered in determining an individual's eligibility for Medicaid if and when the individual enters a medical institution or nursing facility. Such transfers may include, for example, the SSI applicant's or recipient's home even though at the time of the transfer the home was not a countable SSI resource. Therefore, the conference agreement will require that the Secretary inform SSI applicants in writing, at the time of application, and SSI recipients, at the time of redetermination of eligibility, of the provisions of Medicaid law with respect to transfer of assets. The Secretary will be required to request from the individual information about transfers and, at the time of such request, to inform the individual that such information may be shared with the State Medicaid agency. The Secretary will also be required to make this information available to a State Medicaid agency, upon request; the State may, at its option, use this information to determine whether and to what extent there will be a period of ineligibility for Medicaid because an individual transferred resources at less than fair market value.

(h) *Conforming Amendment.*—The conference agreement follows the House bill, which applies to States which cover the medically needy, with a modification extending its application to States which offer coverage to optional categorically needy individuals and to "209(b)" States as well. Under the moratorium imposed by section 2373(c) of P.L. 98-369, as clarified by section 9 of P.L. 100-93, States have flexibility to establish income and resource methodologies under medically needy programs, optional categorically needy programs, and under the "209(b)" option that are less restrictive, i.e. more generous, than those applied in the corresponding cash assistance programs. The conference agreement codifies this flexibility, retroactive to October 1, 1982.

(i) *Study of Means of Recovering Costs of Nursing Facility Services from Estates of Beneficiaries.*—The conference agreement includes a technical amendment reflecting the Senate amendment, the text of which had been agreed to in, but was inadvertently ommitted from, the Omnibus Budget Reconciliation Act of 1987, P.L. 100-203. The conference agreement includes additional OBRA '87 technical corrections and other miscellaneous provisions.

With respect to section 4112 of OBRA '87, relating to payment adjustments for disproportionate share hospitals, the conference agreement makes a number of technical corrections regarding the 3-year phase-in and other matters. It clarifies that the special rule in subsection 4112(e) applies only to New York, and adds a special rule providing that, for a 3-year period, Texas may use its own definition of disproportionate share hospital and its own payment adjustment rules so long as the aggregate amount payment adjustments to disproportionate share hospitals is not less than the amount that would be required by section 4112. During this 3-year period, in meeting the requirement that at least two obstetricians with staff privileges agree to provide obstetric services to Medicaid patients, a hospital in an urban area in Texas seeking disproportionate share status could substitute family practitioners, internists, or any other qualified physician with staff privileges.

The conference agreement clarifies that Federal Medicaid matching funds are available for the cost of health services, covered under a State's Medicaid plan, that are furnished to a handicapped child or a handicapped infant or toddler, even though such services are included in the child's individualized education program or individualized family service plan. Under the Education for All Handicapped Childeren Act of 1975, P.L. 94-142, children with handicaps are entitled to a free and appropriate public education in conformity with an individualized education program (IEP) which describes the educational and "related services" necessary to meet the child's unique needs. While the State education agencies are financially responsible for educational services, in the case of Medicaid-eligible handicapped child, State Medicaid agencies remain responsible for the "related services" indentified in the child's IEP if they are covered under the State's Medicaid plan, such as speech pathology and audiology, psychological services, physical and occupational therapy, and medical counseling and services for diagnostic and evaluation purposes.

The conference agreement defines an institution for mental diseases (IMD) as a hospital, nursing facility, or other institution of more than 16 beds that is primarily engaged in providing diagnosis, treatment, or care of persons with mental diseases. This would clarify that Federal Medicaid matching funds would be available for services such as personal care and case management that are furnished through or by group homes or other small facilities serving the mentally ill, if those services are covered by the State under its Medicaid plan. The 16-bed limitation parallels current rules under the SSI program.

The conferees wish to clarify the requirements in sections 4201 and 4211 of P.L. 100–203 that nursing facilities with more than 120 beds must have at least one social worker (with at least a bachelor's degree in social work or similar professional qualification) employed full-time to provide or assure the provision of social services. Facilities could meet this requirement by employing either a person with a dregree in social work or with similar professional qualifications, such as a degree in a related field and previous supervised experience in meeting individual psycho-social needs. It is the intent of the conferees that the Secretary ensure that requirements regarding consultation and supervision of social work services be at least as stringent as those in effect prior to enactment of these changes.

The conferees also wish to clarify that it was the intent of sections 4201 and 4211 of P.L. 100–203 that the Secretary ensure that the requirements for dietary services be at least as stringent as those in effect prior to enactment of P.L. 100–203.

36. Technical Amendment Relating to Home and Community-Based Services (Section 19 of Senate amendment)

Present law

Comparable provision included in section 4418(a) of Public Law 100–203.

37. Technical Amendments Relating to New Jersey Respite Care Pilot Project (Section 20 of Senate amendment)

Present law

Comparable provision included in section 4418(o) of Public Law 100–203.

38. Treatment of Garden State Health Plan (Section 25 of Senate amendment)

Present law

Comparable provision included in section 4113 of Public Law 100–203.

39. Technical Amendments Relating to the Omnibus Budget Reconciliation Act of 1987

Conference agreement

PART A AND AMENDMENTS AFFECTING BOTH PARTS A AND B

The conference agreement includes a number of technical and conforming amendments to the Medicare Part A and Parts A and B provisions of OBRA–87. These include:

(1) The prohibition on the issuance by the Secretary of any regulation, instruction, or other policy which is estimated by the Secretary to result in a net reduction in expenditures of more than $50 million is extended to October 15, 1989;

(2) Clarification that the regional floor on hospital payment applies on a census region basis, not a wage area basis;

(3) Clarification that outlying counties of metropolitan areas can only be designated as urban if they meet the commuting rules and all other applicable standards for designation as part of an urban area;

(4) In the case of hospitals with more than 49 beds using swing beds, authorization is provided to continue payment for patients in the hospital receiving skilled mursing care when the hospital reaches its limit for swing bed care;

(5) Clarification that the hospital cost report is to be permanent;

(6) Revisions to the uniform hospital reporting demonstration program to (i) delete date elements on which it is not feasible to collect information at this time; (ii) allow additional time for the collection of data and the preparation of a report; and, (iii) extend the period of time during which funds may be expended for the demonstration;

(7) Amendments to conform anti-fraud and abuse provisions of OBRA '87 to existing statutory provisions;

(8) Extension of the date for submission of a report on hospital quality assurance required by OBRA '86 to January 1, 1990.

(9) Clarification that the rule regarding payment for hospital services by pre-paid plans under section 1876 applies to contracts established under pre-TEFRA demonstration authorities;

(10) Clarification that the hospital payment rule applies only in the case of a pre-paid which does not have a contract with the hospital or the skilled nursing facility seeking payment for its services. Most often, the rule would apply in the case of out-of-plan services or when contract negotiations have not been successful. The hospital or the skilled nursing facility are free to establish any level or type of payment they wish through negotiations pursuant to a contract;

(11) Clarification of the application of the 50/50 rule to H.I.P./Network.

PART B AND PROS

The conference agreement includes a number of technical and conforming amendments to the Medicare Part B and PRO provisions of OBRA–87. These include:

(1) Consolidation of definitions relating to physician payment in new Section 1842(i);

(2) Amendments clarifying that there is only one prevailing charge for payment of physicians' services calculated on the basis of customary charges of participating and non-participating physicians. The differential between participating and non-participating physicians continues without change;

(3) Clarifying that reductions in payment for cataract surgery and requirements relating to the use of an assistant at-surgery for cataract surgery also apply to insertion of an interocular lens subsequent to cataract removal;

(4) Conforming amendments regarding maximum allowable actual charge limits for reductions in payment for concurrent anesthesia services;

(5) Clarifying amendment to the purchase service provision, including an amendment to allow for billing for such services on an unassigned basis;

(6) Amendments clarifying that the scholarship loan default offset provision applies to non-physician defaulters and to physician and non-physician defaulters under the Health Education Assistance Loan program and the Physician Shortage Area Scholarship program;

(7) An amendment clarifying that the 1975 prevailing charge floor continues but is phased-out as it is no longer needed;

(8) Corrections and clarifying amendments to the durable medical equipment fee schedule;

(9) Clarifying penalties for improper billing of interocular lenses included in payment to ASCs;

(10) Consolidating amendments incorporating OBRA-87 policies regarding clinical labs into the Social Security Act and clarifying amendments related to the effective date for the elimination of the 2% differential for hospital laboratories;

(11) Clarifying amendments for new Section 1846;

(12) Clarification of provisions relating to payment of hospital outpatient departments for radiology services;

(13) Clarifying amendments that the standard coinsurance applies to services of nurse midwives and clinical psychologists and conforming amendments applying the same penalties for improper unassigned billings to these services as apply to the services of certified registered nurse anesthetists and physician assistants;

(14) Clarifying amendments to the provision requiring coordination of claims with Medigap insurers and an amendment delaying the effectiveness of this provision for Medigap policies sold in states which did not enact necessary changes prior to July 1, 1988.

NURSING HOME REFORM

The conference agreement includes a number of technical and correcting amendments to the Medicare and Medicaid Nursing Home Reform provisions of OBRA 87. These include amendments revising effective date and other requirements. The effective dates for certain Medicare requirements are changed from the first date noted to the second date noted as follows:

(1) requirement that skilled nursing facilities conduct resident assessments: from October 1, 1990 to January 1, 1991;

(2) required training of nurse aides used by facilities: from October 1, 1989 (or January 1, 1990, in the case of an individual used as a nurse aid before July 1, 1989) to January 1, 1990;

(3) requirement for States to specify approved nurse aide training and competency evaluation programs: from March 1, 1989 to January 1, 1989;

(4) requirement for States to review and reapprove nurse aide training and competency evaluation: from March 1, 1990 to January 1, 1990;

(5) requirement for States to establish nurse aide registries: from March 1, 1989 to January 1, 1989;

(6) requirement for States to provide for an appeals process for transfers: from October 1, 1990 to October 1, 1989;

(7) requirement for States to specify the resident assessment instrument: from July 1, 1989 to July 1, 1990;

(8) requirement for the Secretary to establish guidelines for States appeals process for transfers: from October 1, 1989 to October 1, 1988;

(9) requirement for the Secretary to specify a minimum data set of core elements and common definitions for resident assessments: from July 1, 1989 to January 1, 1989;

(10) requirement for the Secretary to designate one or more resident assessment instruments: from October 1, 1990 to April 1, 1990;

(11) requirement that a facility permit immediate access to any resident by any representative of the Secretary or State, by an ombudsman, or by the resident's individual physician: effective on the date of enactment;

(12) requirement for the Secretary to develop, test, and validate standard and extended survey protocols: from October 1, 1990 to January 1, 1990.

Certain Medicaid effective dates have also been revised:

(1) requirement for States to specify approved nurse aide training and competency evaluation programs: from September 1, 1988 to January 1, 1989;

(2) requirement for States to review and reapprove nurse aide training programs: from September 1, 1990 to January 1, 1990;

(3) agreement between State and Secretary for disposition of residents who require active treatment: from October 1, 1988 to April 1, 1989;

(4) requirement for the Secretary to establish requirements for the approval of nurse aide training and competency evaluation programs: from July 1, 1988 to September 1, 1988;

(5) requirement that a facility permit immediate access to any resident by any representative of the Secretary or State, by an ombudsman, or by the resident's individual physician: effective on the date of enactment.

These amendments also clarify that nursing facilities are required to manage the personal funds of residents if requested to do so by the resident. The amendments also require States to make available to the public information in nurse aide registries.

With regard to requirements for social workers included in the OBRA 87 amendments, the conferees intend that the Secretary ensure that requirements regarding consultation and supervision of social work services be at least as stringent as those in effect prior to enactment of the OBRA changes.

RURAL HEALTH

Clarifies that the set aside for demonstrations applies to both research and demonstrations but only to funds appropriated to and expended by the Health Care Financing Administration. Conforms statutory language to intent of conferees that there be equal ten percent set-asides for rural and for inner city research and demonstrations.

From the Committee on Ways and Means, for consideration of titles I, II, and IV of the House bill, and the entire Senate amendment (except for secs. 14, 14A, 14B, 14C, 19, 20, and 25), and modifications committed to conference:

DAN ROSTENKOWSKI,
PETE STARK,
BRIAN J. DONNELLY,
WILLIS D. GRADISON, Jr.

From the Committee on Energy and Commerce, for consideration of titles II, III, and IV of the House bill, and the Senate amendment (except for secs. 2, 3, 12, and 18(a)) and for sec. 6 of the Senate amendment insofar as consideration of such section entails changes in eligibility requirements to participate in part B of the Medicare program, and modifications committed to conference:

JOHN D. DINGELL,
HENRY A. WAXMAN,
RON WYDEN,
EDWARD R. MADIGAN (except for sec. 204 of the House bill and sec. 7 of the Senate amendment),

For consideration of sec. 204 of the House bill and sec. 7 of the Senate amendment:

MICHAEL BILIRAKIS,

From the Committee on Education and Labor, for consideration of sec. 21 of the Senate amendment, and modifications committed to conference:

GUS HAWKINS,
WILLIAM CLAY,
JAMES JEFFORDS,
Managers on the part of the House.

LLOYD BENTSEN,
MAX BAUCUS,
BILL BRADLEY,
GEORGE MITCHELL,
DAVID PRYOR,
JOHN H. CHAFEE,
JOHN HEINZ,
DAVID DURENBERGER,
Managers on the part of the Senate.

Part III. Administrative, Procedural and Miscellaneous

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Part III. Administrative, Procedural and Miscellaneous

Low-Income Housing Tax Credit—Election of Appropriate Percentage Month; Carryover of Post 1987 Low-Income Housing Credit Dollar Amounts

Notice 89-1

This Notice informs taxpayers of the requirements of two of the amendments to section 42 of the Internal Revenue Code (the Code) made by the Technical and Miscellaneous Revenue Act of 1988 (the 1988 Act) (Pub. L. 100-647). Those amendments relate to (1) an election by a taxpayer to use the appropriate percentage for a month other than the month in which a building is placed in service, and (2) carryover of post-1987 low-income housing credit dollar amounts.

ELECTION OF APPROPRIATE PERCENTAGE MONTH

Section 1002(1)(1)(A) of the 1988 Act amended section 42(b)(2)(A) of the Code to read as follows:

> In the case of any qualified low-income building placed in service by the taxpayer after 1987, the term "applicable percentage" means the appropriate percentage prescribed by the Secretary for the earlier of—
>
> (i) the month in which such building is placed in service, or
>
> (ii) at the election of the taxpayer—
>
> (I) the month in which the taxpayer and the housing credit agency enter into an agreement with respect to such building which is binding on such agency, the taxpayer, and all successors in interest as to the housing credit dollar amount to be allocated to such building, or
>
> (II) in the case of any building to which subsection (h)(4)(B) applies, the month in which the tax-exempt obligations are issued.
>
> A month may be elected under clause (ii) only if the election is made not later than the 5th day after the close of such month. Such an election, once made, shall be irrevocable.

For purposes of the election under section 42(b)(2)(A)(ii)(I) of the Code (as amended) as set forth above, an agreement between a taxpayer and a state housing credit agency is considered binding on the agency, the taxpayer, and all successors in interest if it:

(1) is in writing;

(2) specifies the housing credit dollar amount to be allocated to the building;

(3) specifies the type(s) of building(s) to which the housing credit dollar amount applies (e.g., newly constructed, existing, or substantial rehabilitation under section 42(e));

(4) is a binding contract under state law;

(5) is binding on all successors in interest to the taxpayer; and

(6) is dated and signed by the taxpayer and the agency during the month in which all the requirements of (1) through (5) are met.

A taxpayer may elect under section 42(b)(2)(A)(ii)(I) of the Code to use the appropriate percentage for a month other than the month in which a building is placed in service. If such an election is made, the applicable percentage will be the appropriate percentage for the month in which the binding agreement to allocate a specific housing credit dollar amount is made, assuming that the taxpayer has not previously made the election for a different month. Whether the appropriate percentage is the appropriate percentage for the 70 percent present value credit or the 30 percent present value credit will be determined under section 42(i)(2) when the building is placed in service. The election may be made either as part of the binding agreement to allocate a specific housing credit dollar amount or in a separate document. A proper election under section 42(b)-(2)(A)(ii)(I) must:

(1) be in writing;

(2) reference section 42(b)(2)(A)(ii)(I) of the Code;

(3) if it is in a separate document, reference the binding agreement to allocate the specific housing credit dollar amount that meets the requirements of (1) through (6) above;

(4) be signed by the taxpayer; and

(5) be notarized by the 5th day following the month in which the binding agreement was made. The notarization must be made on the last page of the election statement and may not be made on a separate page.

The original notarized document must be given to the housing credit agency before the close of the 5th calendar day of the month following the month in which the binding agreement was made. The taxpayer must retain a copy of the binding agreement and the election statement and file an additional copy with the taxpayer's Form 8609, Low-Income Housing Credit Allocation Certification, for the first taxable year in which the credit is claimed. The agency must retain a copy of the binding agreement and the election statement and file the original with the agency's Form 8610, Annual Low-Income Housing Credit Agencies Report, for the year the allocation is actually made. If the housing credit dollar amount ultimately allocated on Form 8609 differs from the amount previously agreed to in the binding agreement, an explanation should be furnished.

The housing credit dollar amount ultimately allocated to the building may not be less than the amount specified in the binding agreement, unless at the time the credit is allocated, the product of the building's actual or reasonably expected qualified basis and the appropriate percentage for the month in which the agreement was made is less than the amount specified in the binding agreement. If, at the time of the allocation, the product of the building's actual or reasonably expected qualified basis and the appropriate percentage for the month in which the agreement was made is greater than the housing credit dollar amount specified in the binding agreement, the agency may allocate a greater credit dollar amount if there is any additional housing credit dollar amount available to allocate for the calendar year of the allocation.

Example 1.

In January 1989 the taxpayer and the state housing credit agency enter into an agreement that meets the requirements for an agreement to be binding for purposes of section 42(b)(2)(A)(ii)(I) of the Code. In the agreement, the state housing credit agency agrees to allocate $100,000 of housing credit dollar amount to the low-income housing building being constructed by the taxpayer. This amount will be deducted from the state housing credit ceiling only during the calendar year in which the allocation is actually made. Before February 5, 1989, an election statement that meets the requirements for an election under section 42(b)(2)(A)(ii)(I) is signed by the taxpayer and is notarized so that the applicable percentage for the building will be the appropriate percentage for the month of January 1989. When the building is placed in service in August 1989, the product of the building's qualified basis and the appropriate percentage for the month of January 1989 is $150,000, rather than $100,000. Under the agreement the agency must allocate $100,000 of housing credit dollar amount. However, the agency may also allocate an additional $50,000 of housing credit dollar amount from its state housing credit fund for calendar year 1989 if the agency has credit available to allocate. The appropriate percentage for the month of January 1989 is the appropriate percentage to be used for the building, despite the fact that more housing credit dollar amount is allocated to the building when the building is placed in service than was previously agreed. Because the allocation of the $100,000 of housing credit dollar amount under the agreement and the $50,000 of additional housing credit dollar amount are made during the same calendar year, only one Form 8609 for the total amount allocated to the building must be completed.

The election under section 42(b)(2)(A)(ii)(II) of the Code pertains to buildings that are 70 percent or more financed by tax-exempt bonds subject to the volume cap of section 146. For those buildings, taxpayers may elect to apply the appropriate percentage for the month in which the tax-exempt bonds are issued. A proper election under section 42(b)(2)(A)(ii)(II) must:

(1) be in writing;
(2) reference section 42(b)(2)(A)(ii)(II) of the Code;
(3) specify the percentage of the aggregate basis of the building and the land on which the building is located that is financed by tax-exempt bonds subject to the volume cap of section 146;
(4) state the month in which the tax-exempt bonds are issued;
(5) state that the month in which the tax-exempt bonds are issued is the month elected for the appropriate percentage with respect to the building;
(6) be signed by the taxpayer; and
(7) be notarized by the 5th day following the month in which the bonds are issued. The notarization must be made on the last page of the election statement and may not be made on a separate page.

The taxpayer must provide the original notarized statement to the state housing credit agency before the close of the 5th calendar day of the month following the month in which the bonds are issued. If an agency, other than the state housing credit agency, issues the tax-exempt bonds, the taxpayer must also provide the state housing credit agency with a signed statement from the issuing authority that certifies the material in items (3) and (4). The taxpayer must retain a copy of the election statement and file an additional copy with the taxpayer's Form 8609 for the first taxable year in which the credit is claimed. The agency must retain a copy of the election statement and file the original with the agency's Form 8610 for the year an allocation is made.

Example 2.

A taxpayer plans to rehabilitate a low-income housing building in which 60 percent of the aggregate basis of the building and the land on which such building is located is financed by tax-exempt bonds subject to the volume cap under section 146 of the Code. The building does not meet the requirements of section 42(h)(4)(B) because less than 70 percent of such aggregate basis is financed by tax-exempt bonds subject to the volume cap under section 146. Therefore, the taxpayer may not elect under section 42(b)(2)(A)(ii)(II) to have the appropriate percentage for the month the tax-exempt bonds are issued apply to the low-income housing building. However, the taxpayer may enter into a binding agreement with the state housing credit agency under section 42(b)(2)(A)(ii)(I) as to the housing credit dollar amount to be allocated to the building and may elect to have the appropriate percentage for the month of the agreement apply to the building, assuming that no previous binding agreement exists as to the housing credit dollar amount to be allocated to the building.

If, under state law, a binding agreement for a specific housing credit dollar amount becomes null and void, and the taxpayer enters into another binding agreement for a specific housing credit dollar amount, the taxpayer may elect under section 42(b)(2)(A)(ii)(I) of the Code to apply the appropriate percentage for the month of the new binding agreement, assuming no such election was made with regard to the previous binding agreement.

If a taxpayer and the state housing credit agency entered into a binding agreement (which is still in effect under state law) for a specific housing credit dollar amount during calendar year 1988, the taxpayer may elect the appropriate percentage for the month in which the binding agreement was made by making an election statement in accordance with the requirements of this Notice before January 6, 1989.

If a taxpayer wishes to rely on a binding agreement or an election statement made prior to the date of release of this Notice, the taxpayer may do so if both such agreement and election statement (or solely the election statement in the case of an election made pursuant to section 42(b)(2)(A)(ii)(II) of the Code) are modified to conform to the requirements of this Notice before January 6, 1989. Such modified agreement and election statement shall relate back to the month in which the binding agreement was originally made or the month in which the tax-exempt bonds were issued, as appropriate. With respect to agreements made after December 31, 1988, and tax-exempt bonds issued after such date, the taxpayer has until the close of the 5th day after the month in which the agreement was made or the tax-exempt bonds were issued to elect to apply the appropriate percentage.

CARRYOVER OF POST-1987 LOW-INCOME HOUSING CREDIT DOLLAR AMOUNTS

Sections 1002(1)(14)(A) and 4003 of the 1988 Act amended section 42(h)(1) of the Code dealing with the allocation of housing credit dollar amounts by state housing credit agencies. Section 4003(a) provides an additional exception to the general rule in section 42(h)(1)(B) that allocations by state housing credit agencies must be made not later than the close of the calendar year in which a building is placed in service. The exception, which applies to "qualified buildings" not yet placed in service, is contained in section 42(h)(1)(E) and permits a qualified building to be placed in service in the year in which an allocation is received or in either of the 2 succeeding calendar years.

Section 42(h)(1)(E)(ii) of the Code defines a qualified building for purposes of section 42(h)(1)(E)(i) as any building that is part of a project if the taxpayer's basis in the project (as of the end of the calendar year in which the allocation is made) is more than 10 percent of the taxpayer's reasonably expected basis in the project (as of the end of the second calendar year succeeding the allocation year).

The following rules shall apply for purposes of the 10 percent basis exception in section 42(h)(1)(E) of the Code:

(1) Basis means the adjusted basis of land and depreciable real property, whether or not such amounts are includable in eligible basis; however, an allocation pursuant to section 42(h)(1)(E) of the Code is based upon items includable in eligible basis.

(2) A taxpayer has basis in land and other acquired real property when the benefits and burdens of ownership have been transferred to the taxpayer. In the case of purchased property, this transfer normally occurs at closing. For example, amounts paid to acquire an option to purchase land or a building are not includable in basis because the full benefits and burdens of ownership have not been transferred to the taxpayer; nor have the benefits and burdens of ownership been transferred merely because a nonrefundable downpayment is made.

(3) Whether a taxpayer has basis in construction costs depends upon the method of accounting used by the taxpayer. For example, the cost of construction services is included in the basis of an accrual method taxpayer when the services are performed, and in the basis of a cash method taxpayer when the bill for such services is paid.

(4) With respect to taxpayers who are members of partnerships or other flow-through entities, the accounting method of the flow-through entity shall be applied to determine whether the 10 percent exception applies.

Application of the foregoing rules may result in an answer different from that required by section 42(n) of the Code as it existed prior to the passage of the 1988 Act as interpreted by Notice 88-116. To the extent that the provisions of Notice 88-116 are inconsistent with this notice, Notice 88-116 is superseded.

Generally, an allocation is made when a state housing credit agency issues a Form 8609 to the taxpayer. However, an allocation pursuant to section 42(h)(1)(E) of the Code is an exception to this general rule. When an allocation is made pursuant to section 42(h)(1)(E), a Form 8609 is not issued by the state housing credit agency until the calendar year in which the building is placed in service. State housing credit agencies are responsible for issuing Forms 8609 to taxpayers in the calendar years that buildings are placed in service even if such years are later than the calendar years in which allocations are made pursuant to section 42(h)(1)(E). Thus, even though the state housing credit ceiling is zero for any calendar year after 1989, agencies are required to issue Forms 8609 after that date to taxpayers that received allocations pursuant to section 42(h)(1)(E) and placed buildings in service after December 31, 1989.

An allocation pursuant to section 42(h)(1)(E) of the Code reduces the state housing credit ceiling for the year in which the allocation is made, whether or not a Form 8609 is issued that year.

An allocation pursuant to section 42(h)(1)(E) of the Code is made when an allocation document containing the following information is completed, signed and dated by an authorized official of the housing credit agency:

(1) the address of the building, or if none exists, a specific description of its location;

(2) the name, address, and taxpayer identification number of the building owner receiving the allocation;

(3) the name and address of the housing credit agency;

(4) the taxpayer identification number of the agency;

(5) the date of the allocation;

(6) the housing credit dollar amount allocated to the building;

(7) the taxpayer's total reasonably expected basis in the project;

(8) the taxpayer's basis in the project as of the close of the calendar year in which the allocation is made and the percentage such basis bears to the total reasonably expected basis in the project;

(9) the expected date that the building will be placed in service; and

(10) the Building Identification Number (B.I.N.) to be assigned to the building when the building is placed in service. The B.I.N. should reflect the year the allocation is made, rather than the year the building is placed in service, unless the building is placed in service during the allocation year.

A building receiving an allocation pursuant to section 42(h)(1)(E) of the Code must be placed in service no later than the close of the second calendar year following the calendar year in which the allocation is made. If a building does not receive an allocation pursuant to section 42(h)(1)(E), the building must be placed in service by December 31, 1989, even if all or a portion of the building is financed with tax-exempt debt. Therefore, any building that is to be placed in service after December 31, 1989, must receive an allocation of credit pursuant to section 42(h)(1)(E) before the housing credit agency's authority to allocate credit expires.

When an allocation is made pursuant to section 42(h)(1)(E) of the Code, the taxpayer must retain a copy of the allocation document and file an additional copy with the Form 8609 that is issued to the taxpayer during the calendar year that the building is placed in service. Form 8609 must be filed for the first taxable year in which the credit is claimed. The agency must retain a copy of the allocation document and file the original with the agency's Form 8610, for the year an allocation is made.

If a taxpayer receives an allocation under section 42(h)(1)(E) of the Code and wishes to elect under section 42(b)(2)(A)(ii) to use the appropriate percentage for a month other than the month in which the building is placed in service, the requirements specified above for an effective election under section 42(b)(2)(A)(ii) must also be met.

This document serves as an "administrative pronouncement" as that term is described in section 1.6661-3(b)(2) of the Income Tax Regulations and may be relied upon to the same extent as a revenue ruling or revenue procedure.

Gasohol; Rules Effective January 1, 1989

Notice 89-2

The purpose of this notice is to inform gasohol blenders and sellers of gasoline that the transitional rules for registered gasohol blenders provided in Notice 88-2, 1988-1 C.B. 473, Notice 88-34, 1988-1 C.B. 516, and Notice 88-69, 1988-2 C.B. 369, for 1988 will continue in effect through September 30, 1989. Under the rules provided by Notices 88-2, 88-34 and 88-69 and all the conditions provided therein, the reduced rate of tax under section 4081(c)(1) of the Internal Revenue Code applies to all sales or removals of gasoline to registered gasohol blenders if the gasoline is, or will be, blended with alcohol to produce gasohol.

Registered gasohol blenders are reminded that they must file a Quarterly Federal Excise Tax Return, Form 720, for each of the first three quarters of 1989 (as was required for 1988) and maintain certain records if they purchase gasoline at the reduced rate of tax for blending with alcohol to produce gasohol. The retention of these records is necessary to enable taxpayers to establish that the gasoline purchased at the reduced rate of tax has been blended with alcohol. Registered gasohol blenders are reminded that use of a registration to buy gasoline that is not to be used to blend with alcohol to produce gasohol is a misuse of the registration and may lead to revocation or suspension of the registration.

Section 6104 of the Technical and Miscellaneous Revenue Act of 1988, Pub. L. 100-647 ("1988 Act"), modifies section 4081(c)(1) of the Code effective October 1, 1989. Before that date, the Service will issue rules implementing the changes made by the 1988 Act.

ADMINISTRATIVE PRONOUNCEMENT

This document serves as an "administrative pronouncement" as that term is described in section 1.6661-3(b)(2) of the Income Tax Regulations and may be relied upon to the same extent as a revenue ruling or revenue procedure.

Ordering Rules for the Allocation of Separate Limitation Losses, the Recapture of Overall Foreign Losses, the Recharacterization of Separate Limitation Income, and the Allocation of U.S Source Losses

Notice 89-3

This notice provides guidance relating to the amendments made to section 904(f) of the Internal Revenue Code of 1986 by the Tax Reform Act of 1986, 1986-3 (Vol. 1) C.B. 1 (the Act). Specifically, this notice provides ordering rules for the allocation of separate limitation losses, the recapture of overall foreign losses, the recharacterization of separate limitation losses, and the allocation of U.S source losses to separate limitation income.

The rules in this notice will be incorporated in regulations to be issued under the Act. In addition, those regulations will provide rules concerning the operation of the loss allocation and recapture provisions. This document serves as an "administrative pronouncement" as that term is described in section 1.6661-3(b)(2) of the Income Tax Regulations and may be relied on to the same extent as a revenue ruling or revenue procedure.

LAW

Prior to the Act, if a taxpayer sustained a foreign source loss in a separate limitation income category, the loss reduced the taxpayer's U.S. source income before reducing foreign source income subject to another separate limitation. Section 1203 of the Act amended section 904(f) of the Code by adding paragraph (5), which changed the order in which U.S. and foreign source income are reduced by a foreign source loss. In general, section 904(f)(5) provides that a foreign source loss with respect to any income category (a separate limitation loss) is to be allocated on a proportionate basis among (and operates to reduce) separate limitation income in other income categories for the taxable year before reducing U.S. source income. Section 904(f)(5) also provides that, if a separate limitation loss from an income category ("the loss category") was allocated to separate limitation income in any other category in a taxable year, and there is income in the loss category in a subsequent taxable year, then the income shall be recharacterized as separate limitation income in such other category in an amount equal to the prior reduction. In addition, section 904(f)(5) provides that a U.S. source loss shall be allocated to the separate limitation income of the taxpayer in each income category on a proportionate basis.

The amendments to section 904(f) of the Code made by the Act did not change the prior law requirement under section 904(f)(1) for the recapture of overall foreign losses.

ANALYSIS

Ordering rule for allocation of separate limitation losses, recapture of overall foreign losses, recharacterization of separate limitation income, and allocation of U.S. source losses. For taxable years beginning after December 31, 1986 (post-1986 taxable years), the following ordering rule shall apply for purposes of allocating separate limitation losses, recapturing overall foreign losses, recharacterizing separate limitation income, and allocating U.S. source losses.

(1) Net operating losses from a current taxable year are carried forward or back to a post-1986 taxable year in the following manner. Net operating losses that are carried forward, pursuant to section 172 of the Code, are combined with income or loss in the carryover year in the manner described in this paragraph (1). Net operating losses that are carried back, pursuant to section 172, shall be allocated to income in the earlier year in a manner consistent with the principles of paragraph (1)(b). The income in the carryback year is the foreign source income in each separate limitation category and the U.S. source income after the application of section 904(f) to income and loss in that previous year, including as a result of net operating loss carryforwards or carrybacks from taxable years prior to the current taxable year.

(a) This paragraph (1)(a) applies if the full net operating loss (that remains after carryovers to other taxable years) can be carried forward in its entirety to a particular taxable year. U.S. source losses and foreign source losses in separate limitation categories that are part of a net operating loss from a particular taxable year that is carried forward in its entirety shall be combined with the U.S. income or loss and the foreign source income or loss in the same separate limitation categories in the carryover year; the combined amounts shall then be subject to the ordering rules provided in paragraphs (2) through (5).

(b) This paragraph (1)(b) applies if the full net operating loss (that remains after carryovers to other taxable years) cannot be carried forward in its entirety to a particular taxable year.

(i) First, any U.S. source loss (not to exceed the net operating loss carryover) shall be carried over to the extent of any U.S. source income in the carryover year.

(ii) If the net operating loss carryover exceeds the U.S. source loss carryover determined under paragraph (1)(b)(i), then separate limitation losses that are part of the net operating loss shall be tentatively carried over to the extent of separate limitation income in the same category. If the sum of the separate limitation loss carryovers determined under the preceding sentence exceeds the amount of the net operating loss carryover reduced by any U.S. source loss carried over under paragraph (1)(b)(i), then the separate limitation loss carryovers shall be reduced pro rata so that their sum equals such amount.

(iii) If the net operating loss carryover exceeds the sum of the U.S. and separate limitation loss carryovers determined under paragraph (1)(b)(i) and (ii), then a proportionate part of the remaining loss from each separate limitation category shall be carried over to the extent of such excess. Any separate limitation losses carried over under this paragraph (1)(b)(iii) shall be allocated in accordance with section 904(f)(5).

(iv) If the net operating loss carryover exceeds the sum of all the loss carryovers determined under paragraph (1)(b)(i), (ii), and (iii), then any U.S. source loss not carried over under paragraph (1)(b)(i) shall be carried over to the extent of such excess and allocated in accordance with section 904(f)(5)(D).

(2) The taxpayer shall allocate separate limitation losses sustained during the taxable year (increased, if appropriate, by any net operating loss carryover computed under paragraph (1)), to its separate limitation income in other income categories on a proportionate basis.

(3) The taxpayer's U.S. source income shall be increased or decreased in the following manner:

(a) If the taxpayer's separate limitation losses for the year (including losses carried over under paragraph (1)) exceed the taxpayer's separate limitation income for the year, so that the taxpayer has separate limitation losses remaining after the application of paragraph (2), those losses shall be allocated to the taxpayer's U.S. source income for the taxable year, to the extent thereof. The taxpayer shall increase its overall foreign loss accounts appropriately.

(b) If the taxpayer's foreign source separate limitation income for the year (reduced by any losses carried over under paragraph (1)) exceeds the taxpayer's foreign source separate limitation losses for the year, so that the taxpayer has foreign source separate limitation income remaining after the application of paragraph (2), then the taxpayer shall recapture prior year overall foreign losses, if any. See generally section 1.904(f)-1 through 1.904(f)-6 and section 1.904(f)-13T of the regulations and the Conference Agreement to the Tax Reform Act of 1986 (H.R. Conf. Rep. 99-841, 99th Cong., 2nd Sess. 591 (1986)), which provides that foreign source separate limitation income shall be recaptured as U.S. source income under section 904(f) of the Code only to the extent that an overall foreign loss relates to that income category (that is, to the extent that U.S. source income was reduced by losses in that income category).

(4) The taxpayer shall recharacterize foreign source separate limitation income as income in other separate limitation categories to the extent that income in those other separate limitation categories was reduced by losses in the first category in a previous taxable year.

(5) The taxpayer shall allocate U.S. source losses sustained during the taxable year (increased, if appropriate, by any net operating loss carryover determined under paragraph (1) and decreased, if appropriate, by any recapture of an overall foreign loss determined under paragraph (3)) to foreign source separate limitation income on a proportionate basis.

Estate Tax Marital Deduction—Qualified Terminable Interest Property—Estate of Rose D. Howard

Notice 89-4

The purpose of this notice is to set forth the Internal Revenue Service's position with respect to the application of sections 2044, 2056(b)(7), 2519, and 2523(f)(2) in cases involving facts similar to those at issue in *Estate of Rose D. Howard*, 91 T.C. No. 26 (decided August 23, 1988).

BACKGROUND

In *Estate of Howard*, the United States Tax Court held that a trust does not satisfy the requirements for a qualified terminable interest property ("QTIP") trust under section 2056(b)(7) of the Internal Revenue Code unless the trustee is required by the terms of the trust or state law to pay the income accumulated between the last distribution date and the surviving spouse's death to the surviving spouse's estate or pursuant to the surviving spouse's exercise of a general power of appointment. In so holding, the Court embraced a position that is directly contrary to proposed regulations under section 2056(b)(7).

Section 2056(b)(7) allows an estate tax marital deduction for the value of property passing from a decedent to a trust in which the decedent's spouse has a "qualifying income interest for life" and with respect to which an election is made to treat the trust principal as QTIP. Correlatively, section 2044 provides that property for which a deduction is allowed under section 2056(b)(7) is includible in the spouse's gross estate.

Section 2056(b)(7)(B)(ii)(I) provides that a decedent's spouse has a qualifying income interest for life only if he or she is "entitled to all the income from the property, payable annually or at more frequent intervals. . . ." Proposed regulations under section 2056(b)(7) take the position that the spouse's interest may satisfy that requirement even though income accrued after the last distribution date prior to the spouse's death is payable to the remainder beneficiaries. Prop. Est. Tax Reg. section 20.2056(b)-(7)(c)(1).

The trust before the Court in *Estate of Howard* was funded with property passing from Rose Howard's husband, Volney Howard. The trustee was required to pay all of the income to Rose at quarterly or more frequent intervals and to pay any income undistributed at Rose's death to the remainder beneficiaries.

Consistent with the proposed regulations, Volney's estate elected to treat the trust as a QTIP trust and claimed a marital deduction for the value of the trust property. After Rose's death, Volney's estate filed an amended estate tax return on which it claimed that Rose's interest in the trust was not a "qualifying income interest for life" and therefore did not satisfy the requirements for a QTIP trust imposed by section 2056(b)(7). Consistent with that claim, Rose's estate took the position on its estate tax return that the trust property was not includible in Rose's gross estate under section 2044.

The Service determined that the QTIP election made by Volney's estate was effective and irrevocable and that the trust property was therefore includible in Rose's gross estate under section 2044. Rose's estate petitioned the Court for review of that determination.

In ruling in favor of Rose's estate, the Court rejected the Service's position that the requirements for a qualifying income interest for life are satisfied if the surviving spouse is entitled to all the income payable at the required intervals during his or her life. Instead, the Court found in the statutory language separate requirements: (1) the trustee must be required to distribute the income at annual or more frequent intervals; and (2) the surviving spouse must be entitled to all the income accrued through the date of his or her death. The Court added that the spouse is not "entitled" to the accrued but undistributed income unless that income is payable to his or her estate or pursuant to his or her exercise of a general power of appointment.

SERVICE'S POSITION

The Service continues to believe that the position reflected in the proposed regulations is correct. In response to the Tax Court's decision in *Estate of Howard*, the Service may take one or more of the following steps: (1) recommend appeal, (2) finalize the pertinent provisions of the proposed regulations, and (3) seek clarifying legislation.

The Service understands that because of *Estate of Howard* taxpayers and their representatives are concerned that the Service may abandon the position reflected in the proposed regulations and deny the marital deduction with respect to property passing to a trust that does not meet the requirements articulated by the Tax Court. To allay that concern, the Service has initiated an interim settlement procedure available with respect to any trust that presents the issue addressed in *Estate of Howard*, but otherwise meets the requirements of section 2056(b)(7) or 2523(f)(2). Under the procedure, the Service and the persons having an interest in the trust will formally acknowledge that the marital deduction is allowable for the property passing to the trust and that the spouse's interest in the trust is a "qualifying income interest for life" for purposes of sections 2044 and 2519.

The terms of the settlement will be embodied in a closing agreement under section 7121 signed by the Service's authorized representative and all persons having an interest in the trust. Ordinarily, those required to sign the agreement will include the trustee, the settlor's spouse, and the remainder beneficiaries. However, if it is demonstrated to the Service's satisfaction that under applicable local law the trustee or the settlor's spouse has power to bind the remainder beneficiaries, their signatures will not be required.

The settlement procedure is available with respect to any transfer in trust for which the applicable period of limitations remains open, including a transfer reported on a return that is the subject of a closing letter issued by the District Director. It will remain available with respect to any such transfer until the later of December 31, 1989, or the date that is ninety days after the date the District Director gives the taxpayer written notice of the availability of the procedure.

Ordinarily, the closing agreement will be executed in connection with the examination of the return on which the transfer is reported. In the case of a return that was previously or has not yet been examined, either the Service or the taxpayer may initiate the settlement procedure.

A taxpayer who fails to take advantage of the settlement procedure within the prescribed time period risks the possibility that the Service will change its position retroactively and disallow the marital deduction for the transfer in question. Of course, regardless of whether the Service changes its position or the taxpayer takes advantage of the settlement procedure, the Service will require inclusion in the surviving spouse's transfer tax base under sections 2044 and 2519 of any property for which the marital deduction was actually allowed.

If the Service changes its position with respect to the issue in *Estate of Howard*, it will terminate the settlement procedure only after a period of time sufficient to permit taxpayers to make conforming changes in their wills, revocable trusts, and other dispositive instruments. Moreover, it will continue to make the procedure available to estates of decedents who because of mental disability were unable to amend their dispositive instruments during the extension period.

PROCEDURAL INFORMATION

This notice serves as an "administrative pronouncement" as that term is described in section 1.6661-3 (b)(2) of the regulations and may be relied on to the same extent as a revenue ruling or revenue procedure.

Weighted Average Interest Rate Update

Notice 89-5

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 section 412(c)(7) of the Internal Revenue Code as amended by the Omnibus Budget Reconciliation Act of 1987 (OBRA 1987).

The notice also provides that an announcement will be published monthly to provide the weight average and the permissible range for the plan years beginning each month. The following rates were determined for the plan years beginning in the months shown below.

Month	Year	Weighted Average	Permissible Range
December	1988	8.81	7.93 to 9.69%

Administrative Pronouncement

This document serves as an "administrative pronouncement" as that term is described in section 1.661-3(b)(2) of the Income Tax Regulations and may be relied upon to the same extent as a revenue ruling or revenue procedure.

Low-Income Housing Tax Credit— Utility Allowance Requirements, Determination of General Public Use, and Provision of Services

Notice 89-6

The purpose of this Notice is to inform taxpayers that regulations under section 42 of the Internal Revenue Code of 1986 (the "Code") relating to the Low-Income Housing Tax Credit will provide that—

1. Department of Housing and Urban Development (HUD) regulated buildings shall use HUD utility allowances for purposes of section 42(g)(2) of the Code. Other housing shall use the utility rates or schedules provided for the relevant area by the applicable Public Housing Authority (PHA). Special rules apply to buildings or tenants receiving Farmers Home Administration (FmHA) housing assistance.

2. Residential rental units will be considered to be "for use by the general public" if housing is provided in a manner consistent with federal housing policy governing nondiscrimination as determined under HUD rules and regulations.

3. Any services may be provided to low-income tenants in connection with their occupancy of residential rental units. However, the cost of any services that are required to be paid by a tenant as a condition of occupancy generally must be included in gross rent for purposes of applying the gross rent limitation of section 42(g)(2) of the Code.

UTILITY ALLOWANCES.

In order to qualify as a "rent-restricted unit" within the meaning of section

42(g) of the Code, the gross rent for such unit must not exceed 30 percent of the applicable income limitation. Failure to qualify as a rent restricted unit may result in ineligibility for the section 42 credit, reduction in the amount of the credit, and/or recapture of previously allowed credits. For this purpose, gross rent includes the cost of any utilities, other than telephone. If any utilities are paid directly by the tenant, section 42(g)(2)(B)(ii) requires the inclusion in gross rent of a utility allowance determined by the Secretary, after taking into account the procedures under section 8 of the United States Housing Act of 1937.

Regulations will provide that the owner of a HUD-regulated building—a building whose rents and utility allowances are reviewed by HUD on an annual basis—must use HUD utility allowances. For other buildings occupied by one or more tenants receiving HUD rental assistance payments ("HUD tenant assistance"), an owner must use the applicable Public Housing Authority (PHA) utility allowances established for the Section 8 Existing Housing Program. A building owner must apply FmHA utility allowances to any rent-restricted unit in a building where either the building or any tenant receives FmHA housing assistance. If a building is both HUD-regulated and FmHA assisted, then FmHA utility allowances must be used. Similarly, all low-income tenants receiving HUD rental assistance are subject to FmHA utility allowances where the building or any other tenant in the building receives FmHA assistance. For example, a low-income building receiving assistance under FmHA section 515 shall use Exhibit A-5 of FmHA Instruction 1944-E (or a successor method of determining utility allowances), regardless of whether the building is HUD regulated or any low-income tenant in the building receives HUD rental assistance. These rules will apply only for the purposes of section 42(g), and will not apply to the use of utility allowances by HUD or FmHA for their own internal purposes.

Regulations will also provide that a building owner must use the applicable Public Housing Authority (PHA) utility allowance for a building where there is neither (1) HUD tenant assistance, nor (2) an applicable HUD or FmHA utility allowance. In these cases, any interested party (e.g., a low-income tenant, building owner, or state housing authority) may obtain a letter from a local utility company providing the estimated cost of that utility for each unit of similar size and construction for the geographic area in which the low-income building is located. An interested party may obtain a letter from the local utility company at any time during the building's 15-year compliance period. Costs incurred in this process must be borne by the initiating party. The interested party must furnish a copy of the letter to the owner of the building and should retain the original. If the utility estimates provided by the local utility companies differ from the utility allowances provided by the PHA, the utility company estimates shall be used in calculating the gross rent limitation. If the utility estimates provided by the local utility companies are higher for one or more rent-restricted units, the building owner must adjust the rents of any rent-restricted unit where failure to do so would result in a violation of the gross rent limitation of section 42(g)(2). Finally, if at any time during the building's 15-year compliance period the building or a low-income tenant (1) becomes subject to HUD or FmHA utility allowances, or (2) receives HUD tenant assistance, all rent-restricted units in the building become subject to the appropriate HUD, FmHA, or PHA utility allowance.

A building owner who is required to use either HUD, FmHA, or PHA utility allowances must use such allowances to compute gross rents of rent-restricted units paid more than 90 days after the date of publication of this Notice in the Internal Revenue Bulletin. These allowances shall apply throughout the building's 15-year compliance period and shall be updated at the time rents are revised. A building owner who must apply a new utility allowance during the 15-year compliance period because a building or tenant receives HUD or FmHA assistance, or because local utility company estimates become applicable, must use such new utility allowances to compute gross rents of rent-restricted units paid 90 days after the date of occupancy of the federally-assisted tenant or 90 days from the post date of the last utility company estimate. These utility allowances shall also be updated when rents are revised.

In all cases, rent paid for occupancy after the deadline for applying the correct utility allowance must reflect the correct utility allowance. If application of the correct utility allowance results in a violation of the gross rent limitation of section 42(g)(2) for any low-income tenant, then the building owner must adjust that tenant's rent to claim a credit for the unit occupied by that tenant.

GENERAL PUBLIC USE REQUIREMENT.

The legislative history of section 42 of the Code provides that "Residential rental units must be for use by the general public.... Residential rental units are not for use by the general public, for example, if the units are provided only for members of a social organization or provided by an employer for its employees." H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. II-95 (the "Conf. Rep."), 1986-3 (Vol. 4) C.B. 95. Regulations will provide that the term "for use by the general public" shall be determined in a manner consistent with HUD housing policy governing non-discrimination as evidenced by HUD rules and regulations. See HUD Handbook 4350.3 (or its successor). Accordingly, owners of residential rental units that give preferences to certain classes of tenants (e.g., the homeless, disabled and/or handicapped) will not violate the general public use requirement if such preferences would not violate any HUD policy governing non-discrimination expressed in the HUD handbook. However, if residential rental units are restricted to a class of residents that would violate HUD housing policy (e.g., residential rental units provided solely for members of a social organization or by an employer for its employees) then the building in which these units are located will be ineligible for the credit.

PROVISION OF SERVICES.

Regulations will provide that, solely for purposes of section 42 of the Code, the furnishing to tenants of services other than housing (whether or not such services are significant) will not prevent property from qualifying as residential rental property. Regulations will also provide that, with the exception of certain federally-assisted projects for the elderly and handicapped (see below), any charges for services that are not optional to low-income tenants must be included in gross rent for purposes of section 42(g)(2)(A). A service is optional if payment for the service is not required as a condition of occupancy. Thus, in certain circumstances, a retirement-type facility may qualify under section 42 as residential rental property, notwithstanding that significant services other than housing are furnished to tenants. However, if continual nursing, medical, or psychiatric care is provided, it will be presumed that such services are mandatory. Such is generally the case with hospitals, nursing homes, sanitariums, and lifecare facilities.

For example, assume that meals and other services are provided to low-income tenants in a retirement home. Assume also that the cost of these services, when combined with rent and utility allowances, exceeds the 30 percent gross rent limitation. If any low-income tenants are required to pay for these services as a condition of occupancy, then the units occupied by these tenants are not rent-restricted units and are not included in qualified basis. However, if payment for these services is optional, then these units are rent-restricted units and are includible in qualified basis assuming that the gross rent limitation is otherwise satisfied. Where multiple services are provided, a building owner must decide which services are mandatory and included in the 30 percent gross rent limitation. All other services must be provided on an optional basis.

The cost of services must be included in the 30 percent gross rent limitation even if federal or state law requires that services be offered to tenants by project owners. A limited exception to this rule applies to existing federally-assisted projects for the elderly and handicapped that are authorized by 24 CFR 278 to provide a mandatory meals program. In these projects, mandatory meal charges will not be included in gross rent for purposes of section 42(g)(2)(A) if the provisions of 24 CFR 278 are otherwise complied with.

This document serves as an "administrative pronouncement" as that term is described in section 1.6661-3(b)(2) of the Income Tax Regulations and may be relied upon to the same extent as a revenue ruling or revenue procedure.

Children Liable for Income Tax

Notice 89-7

The Tax Reform Act of 1986 made important changes in the tax law as it applies to a child's income. A child who can be claimed as a dependent on another taxpayer's return may not claim a personal exemption and is entitled to a standard deduction limited to the greater of (i) $500 or (ii) the amount of his or her earned income up to the basic standard deduction. Also, the investment income of a child under age 14 that exceeds $1,000 is taxed to the child at the greater of the child's or parent's tax rate. As a result of these changes, many children had to file returns and pay tax for the first time for the 1987 calendar year.

The following questions and answers provide guidance regarding the tax return and payment requirements applicable to a child's income. They also describe the procedures the Internal Revenue Service will follow in dealing with a child or his or her parent or guardian with respect to the child's tax liability. See Publication 929, Tax Rules for Children and Dependents, for additional general guidance.

Q.1. Under what circumstances is a child required to file an income tax return?

A.1. Generally, a child who can be claimed as a dependent on another taxpayer's return must file an income tax return if (i) all of the child's income is earned income (such as wages) totaling more than the basic standard deduction amount ($2,540 in 1987, $3,000 in 1988) or (ii) the child has any unearned income (such as interest or dividends) and his or her total income (earned and unearned) is more than $500.

Q.2. Who is responsible for filing a child's return?

A.2. A child is responsible for filing his or her own return. If for any reason, such as age, the child is unable to file a return, the child's parent or guardian is responsible for filing the child's return on the child's behalf. The parent or guardian should sign the child's name on the return in the proper place followed by: "By (signature), Parent (or Guardian) for minor child."

Q.3. Who is liable for the tax shown as due on a child's return?

A.3. The child is liable for his or her own tax. The child's parents may also be liable for the child's tax to the extent it is attributable to income for personal services performed by the child.

Q.4. Who is liable for any penalties and interest imposed for failure to file a return or pay the tax with respect to a child's income?

A.4. The child is responsible for the payment of any penalties and interest imposed for failure to file a return or pay the tax with respect to his or her income. The child's parent is not responsible for the payment of penalties and interest merely because he or she is responsible for filing the return on the child's behalf.

Q.5. May a parent report a child's income on the parent's return and thereby relieve the child of the need to file a separate return?

A.5. For tax years beginning after 1988, a parent may elect under limited circumstances to report a child's gross income on the parent's return. If the parent makes the election, the child is not required to file a return.

The election is available only if (i) the child's income is comprised entirely of interest and dividends, (ii) the child's income is more than $500 and less than $5,000, and (iii) no tax payments have been made in the child's name and Social Security number. The Service intends to issue specific guidance on how to make this election.

Q.6. What should a child or the parent or guardian of a child do upon receipt of a notice from the Internal Revenue Service concerning the child's return or tax liability?

A.6. The recipient should immediately inform the Service that the notice concerns a child. The Service will then make a special effort to resolve questions or problems that may arise in connection with the child's return or tax liability. The name, address, and telephone number of the person to contact appear on the notice.

Q.7. What procedures will the Internal Revenue Service follow with respect to a child who fails to file a return or pay a tax liability?

A.7. The Service recognizes the special communication problems presented when dealing with a child concerning his or her tax liability. If the Service is informed that the taxpayer to whom a notice has been sent is a child (see A.6.), it will make every effort to resolve the matter with the parent or guardian of the child, consistent with A.8. Pending the outcome of that effort, the Service will suspend its usual collection procedures. Publication 586A, The Collection Process, provides more information concerning the collection of income tax accounts.

Q.8. Under what circumstance may the parent or guardian of a child deal with the Internal Revenue Service concerning a notice, examination, or collection matter pertaining to the child's return?

A.8. A parent or guardian who signs a return on a child's behalf may deal with the Service concerning all matters arising in connection with the return. A parent or guardian who does not sign the child's return may provide the Service with information concerning the return and pay the child's tax, but is not entitled to receive information from or otherwise deal with the Service unless designated as the child's representative by the child or the person signing the return on the child's behalf. Such a designation is made on Form 2848-D, Tax Information Authorization and Declaration of Representative.

While entitled to receive notices and information concerning the child's return, a parent or guardian named in Form 2848-D may not legally bind the child with respect to a tax liability unless authorized to do so by the law of the state in which the child resides.

PROCEDURAL INFORMATION

This notice serves as an "administrative pronouncement" as that term is described in section 1.6661-3(b)(2) of the regulations and may be relied on to the same extent as a revenue ruling or a revenue procedure.

Application of Section 401(b) to Certain Amendments

Notice 89-8

PURPOSE

The purpose of this notice is to: (1) set forth the circumstances under which the Service will presume any applicable extension of time to file an employer's tax return for purposes of determining the end of the remedial amendment period under section 401(b) of the Internal Revenue Code for plan amendments resulting from certain changes in the law affecting qualified plan requirements; (2) set forth guidance for determining the end of the remedial amendment period in the case of organizations not required to file an employer's tax return; and (3) clarify certain other rules.

BACKGROUND

Amendments to the regulations under section 401(b) of the Code published in the Federal Register on August 8, 1988 (53 Fed. Reg. 29658, 29662) extended the deadline by which an employer maintaining a qualified plan must amend such plan to comply with the Tax Reform Act of 1986 (TRA '86) and the Omnibus Budget Reconciliation Acts of 1986 and 1987 (OBRA '86 and OBRA '87, respectively). In general, in the case of a plan maintained by one employer, amendments will not be required until the later of the due date (including extensions) for filing the employer's income tax return (or partnership return of income) for the taxable year in which the 1989 plan year begins, or the last day of the 1989 plan year. In the case of a plan maintained by more than one employer, amendments generally will not be required until the last day of the tenth month following the end of the first plan year beginning in 1989.

TAX RETURN FILING EXTENSIONS

Solely for purposes of section 401(b) of the Code, an individual, corporate, or partnership employer, other than an employer that is a tax-exempt organization, will be treated as having obtained an automatic extension of time for filing its tax return. The automatic extension periods for such employers are: (1) four months for individuals, (2) six months for corporations, and (3) three months for partnerships. No written application for an extension to file the employer's tax return is required to obtain this extended date. For all other purposes, including obtaining an additional extension of time to file beyond the automatic extension in the case of an individual or partnership employer, an employer must file a timely written application. Thus, the 401(b) period will not be extended to reflect an additional extension of time to file, unless the partnership or individual employer actually applies for and receives an automatic extension and an additional extension of time to file the tax return.

In addition, for purposes of section 401(b), the due date for filing the employer's tax return in the case of a tax-exempt organization that files an annual information return under section 6033 of the Code (generally Form 990) is deemed to be the due date for filing the annual information return. Employers for whom the section 401(b) remedial amendment period is determined by reference to the due date of the annual information return under section 6033 will not be treated as having obtained an extension of time for filing the annual information return unless such extension is actually applied for and granted. If an extension of time to file an annual information return under section 6033 is actually applied for and granted, the section 401(b) period will correspondingly be extended.

Rev. Rul. 79-227, 1979-2 C.B. 185, provides that in the case of a tax-exempt organization that is not required to file an annual information return but is required to file an annual return/report under section 6058 (generally Form 5500), the due date for filing the employer's tax return shall be deemed to be the due date for filing the return/report. Notwithstanding these rules, if a tax-exempt trust forming part of a single employer qualified plan under section 401(a) is also an employer maintaining a separate employee plan for its own employees which is intended to qualify under section 401(a), the relevant date for determining the end of the section 401(b) period shall be determined by reference to the due date of the annual return/report required to be filed for the employer-trust pursuant to section 6058, not the return/report filed by the employer-trust for its own plan. Solely for section 401(b) purposes, employers for whom the section 401(b) remedial amendment period is determined by reference to the due date of their return/report under section 6058 will be treated as having obtained any applicable automatic extension of time to file those returns. If an extension of time to file a return/report under section 6058 is actually applied for and granted, the section 401(b) period will correspondingly be extended.

In the case of any other employer that is not required to file either an employer's tax return, an annual information return under section 6033 of the Code or an annual return/report under section 6058, the due date for filing the employer's tax return for section 401(b) purposes is deemed to be the last day of the seventh month following the end of the plan year.

Section 7503 of the Code provides that when the last day for performing any act prescribed under the authority of the internal revenue laws falls on a Saturday, Sunday or legal holiday, such act shall be considered timely if performed on the next succeeding day that is not a Saturday, Sunday or legal holiday. Rev. Rul. 83-116, 1983-2 C.B. 264, provides that section 7503 applies only to acts required to be performed in connection with the determination, collection or refund of taxes. Therefore, if the deadline for making plan amendments described in this notice is determined by reference to the filing of any return, then, under the rules of section 7503 and Rev. Rul. 83-116, if such deadline falls on a Saturday, Sunday or legal holiday, the amendments will be considered as timely made if made on or before the next succeeding day that is not a Saturday, Sunday or legal holiday. However, if the deadline for making plan amendments is determined by reference to the end of the plan year, then plan amendments must be made by that deadline regardless of whether it falls on a Saturday, Sunday or legal holiday.

SECTION 401(b) RELIEF

Section 1140 of TRA '86, in general, gives employers until the last day of their 1989 plan year to amend their plans. Amendments required by OBRA '86 and OBRA '87 are provided the same delayed date. In addition, the Service, by various notices, has extended the date for making amendments to comply with certain other changes in the law in order to provide a common date for making plan amendments.

The regulations extend this common amendment date until the end of the section 401(b) period. The regulations also make clear that this extension also applies to amendments that are not required, but are integral to a qualification requirement changed by TRA '86, OBRA '86, or OBRA '87, or any requirement which is treated, directly or indirectly, by the Service as if section 1140 applied to it. An example of a provision to which the preceding sentence might apply is a plan amendment permitting contributions to a profit sharing plan whether or not the employer has profits.

In order to qualify for the section 401(b) period, the plan sponsor must satisfy three conditions. First, with respect to requirements effective before 1989, the plan sponsor must have operated the plan in accordance with such requirements from the date the requirement became effective. Second, the plan sponsor must amend the plan retroactively to the date the applicable requirements (including those effective after 1988) become effective. In the case of changed plan provisions that are not required but are integral to a qualification requirement changed by TRA '86, OBRA '86 or OBRA '87, or any requirement which is treated, directly or indirectly, by the Service as if section 1140 applied to it, the plan will be treated as meeting these two conditions if the plan operates in accordance with such changed provisions as of the effective date of such change under the plan. Finally, the section 401(b) extension for making plan amendments applies only to requirements that take effect prior to the first day of the first plan year beginning after December 31, 1989. For example, the deadline is not extended for amending a collectively bargained plan that does not have to meet the TRA '86 requirements until the 1990 or 1991 plan year.

EXAMPLES

The following examples illustrate the extension:

EXAMPLE 1: Corporation X operates on a calendar taxable year and maintains Plan Y on a calendar year basis. Under section 1140 of TRA '86, Corporation X must amend its plan by December 31, 1989 (the last day of the plan year beginning in 1989). The section 401(b) period ends on September 17, 1990 (the due date (including the automatic extension) for filing Corporation X's income tax return for the 1989 taxable year). Thus, Corporation X need not amend Plan Y until September 17, 1990. If, instead Plan Y is maintained by more than one employer, Plan Y need not be amended until October 31, 1990.

EXAMPLE 2: Same facts as example 1 except that the plan year for Plan Y begins on December 1 and ends on November 30. In this example, the last day of the plan year beginning in 1989 ends on November 30, 1990. The due date (including the automatic extension) for filing Corporation X's income tax return for the taxable year ending on December 31, 1989 (the taxable year in which the 1989 plan year begins) is September 17, 1990. Thus, Corporation X need not amend Plan Y until November 30, 1990. If Plan Y is maintained by more than one employer, Plan Y need not be amended until September 30, 1991.

EXAMPLE 3: Same facts as example 1 except that Corporation X operates on a taxable year beginning March 1. Thus, the taxable year in which the 1989 plan year begins is March 1, 1988 to February 28, 1989. In this example, the due date (including the automatic extension) for filing Corporation X's income tax return for the taxable year ending on February 28, 1989 is November 15, 1989. Corporation X, however, does not have to amend Plan Y until December 31, 1989 (the last day of the plan year beginning in 1989). If Plan Y is maintained by more than one employer, Plan Y need not be amended until October 31, 1990.

EXAMPLE 4: Partnership A operates on a calendar taxable year and maintains Plan Y on a calendar year basis. Under section 1140 of TRA '86, Partnership A must amend its plan by December 31, 1989 (the last day of the plan year beginning in 1989). Partnership A has not applied for an automatic extension and an additional extension of time to file its partnership return of income for the taxable year ending on December 31, 1989. The section 401(b) period ends on July 16, 1990 (the due date (including the automatic extension) for filing Partnership A's partnership return of income for the 1989 taxable year). Thus, Partnership A need not amend Plan Y until July 16, 1990. If Partnership A had applied for and received an automatic extension and an additional 3 month extension of time to file its partnership return of income, Partnership A would not need to amend Plan Y until October 15, 1990. If Plan Y is maintained by more than one employer, Plan Y need not be amended until October 31, 1990.

EXAMPLE 5: Same facts as example 4 except that the plan is maintained by Individual B. Under section 1140 of TRA '86, Individual B must amend his plan by December 31, 1989 (the last day of the plan year beginning in 1989). Individual B has not applied for an automatic extension and an additional extension of time to file his income tax return for the taxable year ending on December 31, 1989. The section 401(b) period ends on August 15, 1990 (the due date (including the automatic extension) for filing Individual B's income tax return for the 1989 taxable year). Thus, Individual B need not amend Plan Y until August 15, 1990. If Individual B had applied for and received an automatic extension and an additional 2 month extension of time to file his income tax return, Individual B would not need to amend Plan Y until October 15, 1990. If Plan Y is maintained by more than one employer, Plan Y need not be amended until October 31, 1990.

SCOPE OF NOTICE

The rules in this notice treating employers as having obtained an automatic extension of time to file certain returns and deeming a due date for the employer's income tax return for section 401(b) purposes in the case of an employer not filing such returns are solely for purposes of section 401(b) of the Code and are applicable only to changes in the law discussed in this notice. No inferences should be drawn with respect to any other provision of the Code nor, for section 401(b) purposes, to any other changes in the law.

ADMINISTRATIVE PRONOUNCEMENT

This document serves as an "administrative pronouncement" as that term is described in section 1.6661-3(b)(2) of the Income Tax Regulations and may be relied upon to the same extent as a revenue ruling or a revenue procedure.

Application of Section 141(b)(2) and 141(c) to State and Local Hazardous Waste Remediation Bonds

Notice 89-9

SECTION 1. SCOPE

This notice describes forthcoming regulations concerning the application of the private security or payment test of section 141(b)(2) of the Internal Revenue Code and the private loan financing test of section 141(c) to state and local bonds issued to finance the costs of hazardous waste clean-up activities conducted by state or local governments when some of the clean-up activities occur on privately owned land and reimbursement may be sought from private parties.

SEC. 2. BACKGROUND

.01 Section 6179 of the Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, 102 Stat. 3342, provides that the Secretary of the Treasury or his delegate shall issue guidance concerning the application of the private security or payment test under section 141(b)(2) of the Code to tax-exempt bond financing by state and local governments of hazardous waste clean-up activities conducted by such governments where some of the activities occur on privately owned land.

.02 The specific concern raised by the state or local bonds issued to finance hazardous waste clean-up activities ("hazardous waste remediation bonds") on privately owned land is whether the bonds meet the private security or payment test of section 141(b)(2) of the Code if reimbursement of the costs of the remediation is sought from private parties. *Conference Report to Accompany H.R. 4333*, 2 H.R. Conf. Rep. No. 1104, 100th Cong., 2d Sess. II-204 (1988). The private parties from whom state or local governments may seek or require reimbursements for costs of the remediation may include the owner of the land or persons who are or were responsible for disposing of the hazardous waste. In addition, fees paid by private persons who are engaged in generating or handling hazardous waste, or in refining, producing, or transporting petroleum, may be used, directly or indirectly, to pay for costs of the remediation.

.03 Under section 103 of the Code, interest on a state or local bond generally is not tax-exempt if the bond is a private activity bond.

.04 Section 141(a) of the Code defines the term "private activity bond" as any bond issued as part of an issue which meets either the private business tests of section 141(b) or the private loan financing test of section 141(c). An issue meets the private business tests of section 141(b) only if the issue meets both the private business use test of section 141(b)(1) and the private security or payment test of section 141(b)(2).

.05 An issue meets the private business use test of section 141(b)(1) of the Code if more than 10 percent of the proceeds of such issue is to be used (directly or indirectly) in a trade or business carried on by any person other than a governmental unit.

.06 An issue meets the private security test of section 141(b)(2)(A) of the Code if the payment of the principal of, or the interest on, more than 10 percent of the proceeds of such issue is (under the terms of such issue or any underlying arrangement) directly or indirectly secured by any interest in property used or to be used for a private business use (or by any interest in payments in respect of such property).

.07 An issue meets the private payment test of section 141(b)(2)(B) of the Code if the payment of the principal of, or the interest on, more than 10 percent of the proceeds of such issue is (under the terms of such issue or any underlying arrangement) directly or indirectly to be derived from payments (whether or not to the issuer) in respect of property (or borrowed money) used or to be used for a private business use.

.08 The legislative history of section 141(b)(2) of the Code indicates that payments in respect of property (or borrowed money) financed with the proceeds of an issue need not be pledged as security for, or directly used to pay, debt service on the issue in order to be taken into account under section 141(b)(2). *See* 2 H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. II-688 (1986), 1986-3 C.B. (Vol. 4) 688. Thus, for purposes of section 141(b)(2)(B), the payment of the principal of, or the interest on, the proceeds of an issue generally is considered (under an underlying arrangement) to be derived from such payments.

.09 An issue meets the private loan financing test of section 141(c) of the Code if the amount of the proceeds of the issue which is to be used (directly or indirectly) to make or finance loans (with the exception of certain loans described in the following sentence) to persons other than governmental units exceeds the lesser of five percent of such proceeds or $5,000,000. A loan is described in this sentence if the loan enables the borrower to finance any governmental tax or assessment of general application for a specific essential governmental function or is a nonpurpose investment (within the meaning of section 148(f)(6)(A)).

SEC. 3. GUIDANCE

.01 Under regulations to be promulgated under section 141 of the Code regarding the application of the private security test of section 141(b)(2)(A) of the Code and the private payment test of section 141(b)(2)(B) to hazardous waste remediation bonds:

(1) Payments from private business persons who are not (other than coincidentally) either users of the site being remediated or persons potentially responsible for disposing of hazardous waste on that site which payments secure the payment of principal of, or interest on, the bonds (directly or indirectly), under the terms of the bond issue are not taken into account for purposes of the private security test if such payments are made pursuant to either (a) a generally applicable state or local taxing statute or (b) a state or local statute that regulates or restrains activities on an industry-wide

basis of persons who are engaged in generating or handling hazardous waste, or in refining, producing or transporting petroleum, provided that such payments do not represent, in substance, payment for the use of bond proceeds. For purposes of the preceding sentence, a state or local statute that imposes payments that have substantially the same character as those described in Chapter 38 of the Code are treated as generally applicable taxes.

(2) Payments from private business persons who are either users of the site being remediated or persons potentially responsible for disposing of hazardous waste on that site which payments do not secure the payment of principal of, or interest on, the bonds (directly or indirectly), under the terms of the bond issue are not taken into account in determining whether the private payment test is met if at the time the bonds are issued the payments from the private business persons are not material to the security for the bonds. For purposes of the preceding sentence, there is an irrebuttable presumption that payments are not material to the security for the bonds if (a) the payments from the private business persons are not required for the payment of debt service on the bonds, (b) the amount and timing of the payments are not structured or designed to reflect the payment of debt service on the bonds, (c) the receipt or the amount of the payments is uncertain, and (d)(i) if no judgment has been entered against a private business person by the time the bonds are issued, the payments from such person, when and if received, are used either to redeem bonds of the issuer in an equivalent principal amount or to pay for costs of any hazardous waste remediation project, or (ii) if a judgment (but not a final judgment) has been entered against a private business person by the time the bonds are issued, there are, as of the date of issue of the bonds, costs of hazardous waste remediation other than those financed with bond proceeds which may be financed with the payments and such payments, when and if received, are used either to redeem bonds of the issuer in an equivalent principal amount or to pay for costs of any hazardous waste remediation project.

.02 Under regulations to be promulgated under section 141 of the Code regarding the application of the private loan financing test of section 141(c) to hazardous waste remediation bonds, payments from private persons who are either users of the site being remediated or persons potentially responsible for disposing of hazardous waste on that site which payments do not secure the payment of principal of, or interest on, the bonds (directly or indirectly), under the terms of the bond issue will not cause an issue to meet the private loan financing test of section 141(c) of the Code, where the conditions set forth in section 3.01(2) are satisfied.

RELIANCE

This document serves as an "administrative pronouncement" as that term is described in section 1.6661-3(b)(2) of the Income Tax Regulations and may be relied upon to the same extent as a revenue ruling or revenue procedure.

Foreign Sales Corporation—Independent Prices

Notice 89-10

This Notice provides guidance concerning instances where an independent factory or production price ("IFP") exists under *Example (1)* of section 1.863-3(b)(2) of the Income Tax Regulations. If such a price exists, it must be used to determine the division between domestic and foreign sources of income from sales outside of the United States of inventory produced (in whole or in part) in the United States. *See* Rev. Rul. 88-73, 1988-2 C.B. 173. *See also* H. Rept. No. 426, 99th Cong. 1st Sess. 359 (1985) (income "generally is sourced" on 50/50 basis but IFP must be used if available).

The IFP method is set forth in *Example (1)* of section 1.863-3(b)(2). That example provides as follows:

> Where the manufacturer or producer regularly sells part of his output to wholly independent distributors or other selling concerns in such a way as to establish fairly an independent factory or production price — or shows to the satisfaction of the district director (or, if applicable, the Director of International Operations) that such an independent factory or production price has been otherwise established — unaffected by considerations of tax liability, and the selling or distributing branch or department of the business is located in a different country from that in which the factory is located or the production carried on, the taxable income attributable to sources within the United States shall be computed by an accounting which treats the products as sold by the factory or productive department of the business to the distributing or selling department at the independent factory price so established. In all such cases the basis of the accounting shall be fully explained in a statement attached to the return for the taxable year.

The principles below describe the application of *Example (1)*.

1. *An IFP may be derived only from sales of the manufacturer or producer unless the taxpayer chooses to show that an IFP has been otherwise established.*

Under *Example (1),* certain sales by the manufacturer or producer that establish fairly an IFP must be used to determine the division of income. (For purposes of this Notice, the term "manufacturer or producer" includes manufacturing or producing operations conducted by members of the same affiliated group.) An IFP may be otherwise established only if the manufacturer or producer makes a showing to that effect to the satisfaction of the Internal Revenue Service. Such a showing might be based, for example, on market prices, analysis of economic functions, or transactions of other taxpayers. Such other methods may not be used by the Service to determine the appropriate division of income between domestic and foreign sources under section 863(b) (except to the extent they are used to demonstrate that actual sales of the manufacturer or producer themselves establish an IFP). Thus, for example, sales of taxpayers that are not affiliated with the taxpayer making the sale under consideration may not be used to attempt to establish an IFP unless the taxpayer chooses to use them.

2. *An IFP may be established only on the basis of sales "regularly" made to independent businesses of "part" of the "output" of the manufacturer or producer.*

Under *Example (1),* an IFP may be established only if the manufacturer or producer "regularly sells part of his output" of the relevant product to wholly independent distributors or other selling concerns. An IFP may not be established by sales that are sporadic and occasional, or by sales that represent an insubstantial part of the total output of the relevant product of the manufacturer or producer.

3. *Sales used to establish an IFP must be to "distributors or other selling concerns."*

Under section 1.863-3(b)(2), the purchaser in any sale used to establish an IFP must be a distributor or other selling concern. The use of this language means that such purchaser must be a selling business with respect to the relevant product (or a product into which it is integrated or transformed). If the purchaser of the relevant product customarily retains it for its own use, and does not in turn sell the relevant product or a product into which the relevant product is integrated or transformed, such purchaser is not a distributor or other selling concern within the meaning of *Example (1)*.

4. *Such distributors or other selling concerns must be "wholly independent."*

Sales to distributors or other selling concerns will not be considered in establishing an IFP unless such concerns are wholly independent from the manufacturer or producer. For this purpose, the selling concern will not be treated as wholly independent of the manufacturer or producer if the former controls, or is controlled by, the latter within the meaning of section 482. Such control may be direct or indirect, and may be legally enforceable or control in fact. For this purpose, any sale to a foreign sales corporation (as defined in section 922) controlled by the manufacturer or producer will not be treated as made to a wholly independent selling concern.

5. *An IFP must be "fairly established."*

Example (1) seeks to determine the income attributable to manufacturing or production, and to characterize such income as from sources within the country of manufacture or production. In order for sales to establish an IFP, therefore, they must reasonably reflect the income earned from manufacturing or production. Sales to independent distributors or other selling concerns in certain circumstances, as described below, will not reasonably reflect the income from manufacturing or production.

A. *Significant non-production, income-generating activity.*

Sales will not establish an IFP if income-generating activity of the taxpayer other than manufacturing or production activity with respect to sales of the relevant product is significant in relation to manufacturing or production. For this purpose, if expenses of the manufacturer or producer attributable to non-production, income-generating activity with respect to sales of the relevant product are significant in relation to the gross receipts from such sales, such activity ordinarily will be considered significant. In applying this principle, non-production, income-generating activities shall include marketing and selling activities (at any stage of distribution), and similar activities. Expenses that are not attributable to non-production, income-generating activities shall include transportation, duties, excise taxes, insurance and similar expenses. (Such expenses must, however, be netted from the sales price to determine an IFP.) In addition, if expenses of the manufacturer or producer attributable to non-production, income-generating activity with respect to sales of the relevant product are significant in absolute amount (without regard to their relation to gross receipts), and the manufacturer or producer maintains a trademark with respect to the relevant product that has significant value, such activity ordinarily will be considered significant.

For purposes of determining expenses attributable to sales of the relevant product, the principles of section 1.861-8 shall apply. Such expenses may be allocated directly to sales income from the relevant product or to a class of sales income including sales income from the relevant product under the principles of that section. To the extent such expenses cannot be allocated to sales of the relevant product, such expenses shall be apportioned on the basis of gross receipts from such sales of the relevant product and of other products.

In the case of sales made with a foreign sales corporation acting as commission agent, the commission shall be treated as an expense relating to non-production, income-generating activity.

B. *Different Geographic Markets.*

As noted above, the goal of *Example (1)* is to establish an IFP that reasonably reflects income attributable to manufacturing or production. Sales made to independent distributors or other selling concerns in the country of manufacture or production that meet the other requirements noted above will generally accomplish this result. This will not be the case only if it can be demonstrated that (i) market conditions in the country of manufacture or production permit the taxpayer to earn a substantially higher profit margin from the sale of the relevant product than in the country of the sale to which *Example (1)* is being applied, and (ii) the taxpayer directly engages in substantial activity in connection with such sale in the country of sale that constitutes non-production, income-generating activity.

If a taxpayer produces goods in one country and exports them to two other countries, sales in one destination country will not establish an IFP with respect to sales in the other destination country if the two markets are materially different with respect to sales of the relevant product. Such a difference might arise, for example, because of the taxpayer's policy of selling to unrelated parties at the same level of distribution at a significantly lower price in a particular market to establish or maintain market share. The determination of whether the two markets are materially different shall take into account the prices at which the relevant product is sold in the two markets to unrelated parties at the same level of distribution (whether or not by the manufacturer or producer), after adjustments for transportation, insurance, excise taxes, duties and similar expenses, and after translation into U.S. dollars (if necessary) at the spot rate for the relevant foreign currency in effect as of the date of the relevant sale.

C. *Sales used to establish an IFP must be reasonably contemporaneous with the sales to which Example (1) is being applied.*

Generally, a reasonably contemporaneous sale is one that occurs in the taxable year of the sale to which *Example (1)* applies or in the prior taxable year. However, significant price instability during the period between the time of the sale being used to establish an IFP and the time of the sale to which *Example (1)* is potentially applicable may indicate that the prior sale does not fairly establish an IFP. Such price instability may be shown by reference to sales to independent parties (whether or not made by the manufacturer or producer) at the same level of distribution during the relevant period.

6. *The foregoing rules under Example (1) must be applied with reference to the group of products consisting of substantially similar products.*

An IFP may be established only on the basis of sales of products that are substantially similar in physical characteristics, function, and price of sale to unrelated parties at the same level of distribution. The rules contained in this Notice must, therefore, be applied in relation to sales of such substantially similar products. For example, the principles set forth in paragraph 5.A., above (relating to non-production, income-generating activities), shall be applied by treating all such sales as a statutory grouping under section 1.861-8.

This document is an "administrative pronouncement" as that term is used in section 1.6661-3(b)(2) of the Income Tax Regulations and may be relied on to the same extent as a revenue ruling or revenue procedure.

Definitions and Special Rules Relating to Foreign Sales Corporations

Notice 89-11

For purposes of determining the source of income from export sales of inventory, §1.863-3(b)(2) of the Income Tax Regulations requires the use of an independent factory or production price ("IFP") if available. *See* Rev. Rul. 88-73, 1988-2 C.B. 173. Further guidance concerning the definition of the term independent factory or production price is provided by Notice 89-10, issued simultaneously with this Notice. This Notice provides guidance concerning the application of §1.863- 3(b)(2) in the case of sales to a foreign sales corporation ("FSC") as defined under section 922 of the Internal Revenue Code.

Regulations to be issued under section 927 of the Code will provide that if inventory is sold to a FSC, or with a FSC acting as commission agent, *Example (2)* of §1.863-3(b)(2) will apply for purposes of determining the source of income of the related supplier to the FSC. However, the foreign source income of the related supplier will be subject to the limitation of section 927(e)(1). Thus, such income cannot exceed the amount that would have been earned had the sale been made to or by a domestic international sales corporation under the pricing rules of section 994.

Section 1.863-3(b)(2) permits a taxpayer to "otherwise" establish an IFP if its own non-FSC related sales do not establish such a price. Under the regulations to be issued under section 927, however, use of such an IFP will not be permitted in the case of sales involving a FSC.

This document is an "administrative pronouncement" as that term is used in §1.6661-3(b)(2) of the Regulations and may be relied on to the same extent as a revenue ruling or revenue procedure.

Carryforward Election

Notice 89-12

This notice describes forthcoming regulations regarding the date by which issuers of state and local bonds must file Form 8328, Carryforward Election of Unused Private Activity Bond Volume Cap.

BACKGROUND

Section 146(a) of the Internal Revenue Code provides that the aggregate face amount of private activity bonds issued during a calendar year must not exceed the volume cap of the issuing authority for that calendar year.

Section 146(f)(1) of the Code provides, in general, that if an issuing authority's volume cap for any calendar year exceeds the aggregate amount of tax-exempt private activity bonds it issues during the calendar year, the authority can elect to carry forward the excess amount.

Section 1.103(n)-4T of the Temporary Income Tax Regulations, which was issued under the predecessor of section 146 of the Code, requires the issuer to file the carryforward election with the Internal Revenue Service prior to the end of the calendar year in which the excess amount arises. The instructions to the current (March 1987) version of Form 8328 repeat this requirement that the form be filed by the end of the calendar year.

FORTHCOMING REGULATIONS

Regulations under section 146 of the Code will give the issuer of tax-exempt private activity bonds additional time to file the carryforward election. The regulations will require the issuer to file the carryforward election with the Internal Revenue Service by the earlier of (1) February 15 of the calendar year following the year in which the excess amount arises, or (2) the date of issue of bonds issued pursuant to the carryforward election. Accordingly, issuers may file their 1988 carryforward elections with the Internal Revenue Service on or before February 15, 1989 (or the date of issuance, if earlier), notwithstanding the due date stated in the instructions to Form 8328.

The regulations will also provide that the issuer will be bound by the carryforward amounts stated on the election form and will not be allowed to change those amounts (unless the change is merely to correct a clerical error).

COMMENTS

Comments regarding this notice should be sent to: Internal Revenue Service, Associate Chief Counsel, Attention: CC: FI&P, P.O. Box 7604, Ben Franklin Station, Washington, D.C. 20044.

ADMINISTRATIVE PRONOUNCEMENT

This document serves as an "administrative pronouncement" as that term is described in section 1.6661-3(b)(2) of the regulations and may be relied upon to the same extent as a revenue ruling or revenue procedure.

Dependent Care Assistance

Notice 89-13

This notice provides guidance for reporting on Form W-2, Wage and Tax Statement, the amount of dependent care assistance furnished by an employer to an employee, based on the recent amendment of section 6051(a) of the Internal Revenue Code by section 1011B(c)(2)-(B) of the Technical and Miscellaneous Revenue Act of 1988, Pub. L. 100-647 (Act).

Section 1011B(c)(2)(B) of the Act added a new paragraph (9) to section 6051(a) of the Code to require an employer to show on the written statement to employees required by this Code section the total amount incurred for dependent care assistance with respect to an employee under a dependent care assistance program described in section 129(d) of the Code. Section 1011B(c)-(2)(B) of the Act applies to tax years beginning after December 31, 1987.

For 1988, the dependent care assistance amount should be shown in Box 16 of Form W-2. However, because of the late imposition of this new reporting requirement by Congress, the Internal Revenue Service will consider the reporting requirement to be met for 1988 if the employer maintains adequate records concerning these amounts, and on or before January 31, 1989, a written statement is furnished to each employee showing the amount paid or expenses incurred with respect to 1988, in providing dependent care assistance to such employee as required by section 129(d)(6) of the Code. Information concerning dependent care assistance reporting requirements for subsequent years will be issued at a later date.

This document serves as an "administrative pronouncement" as that term is described in section 1.6661-3(b)(2) of the Income Tax Regulations, and may be relied upon to the same extent as a revenue ruling or revenue procedure.

Extension of Date for Identification of Liabilities That Give Rise to Interest Paid by a U.S. Trade or Business Under Section 884

Notice 89-14

The Internal Revenue Service today announced that the date by which a foreign corporation must specifically identify liabilities that give rise to interest paid by trade or business, as provided under section 1.884-4T(b)(1)(i)(B) of the Temporary Income Tax Regulations, is extended from January 3, 1989, to September 15, 1989. This extension allows taxpayers additional time to identify liabilities in view of the rules announced in Notice 88-133, 1988-2 C.B. 559, relating to the definition of interest paid by a U.S. trade or business. Thus, a foreign corporation may specifically identify liabilities that give rise to interest paid by a U.S. trade or business on or before September 15, 1989, notwithstanding the fact that it did not specifically identify such liabilities on or before January 3, 1989, or identified other liabilities on or before January 3, 1989.

This document serves as an "administrative pronouncement" as that term is described in section 1.6661-3(b)(2) of the regulations and may be relied upon to the same extent as a revenue ruling or revenue procedure.

The temporary regulations under section 884 will be amended to incorporate the rules of this notice, and such amendments will be effective for taxable years beginning after December 31, 1986.

Long-Term Contracts

Notice 89-15

This notice provides guidance with respect to section 460 of the Code, relating to the accounting for long-term contracts.

I. BACKGROUND

Section 804 of the Tax Reform Act of 1986, Pub. L. No. 99-514 (the "1986 Act"), added section 460 to the Internal Revenue Code, effective for contracts entered into after February 28, 1986. Section 10203 of the Revenue Act of 1987, Pub. L. No. 100-203 (the "1987 Act"), amended section 460, effective for contracts entered into after October 13, 1987 (except for certain ship contracts described in section 10203(b)(2) of the 1987 Act). Section 5041 of the Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647 (the "1988 Act") further amended section 460, effective for contracts entered into after June 20, 1988 (except for certain ship contracts, as provided in section 5041(e)-(1)(C) of the 1988 Act). The Questions and Answers in this notice discuss general rules under section 460, changes to section 460 made by the 1988 Act, and transitional rules under the 1988 Act. Previous guidance concerning section 460 was provided in Notice 87-61, 1987-2 C.B. 370, and Notice 88-66, 1988-1 C.B. 552.

Rules for determining whether a contract is a long-term contract within the meaning of section 460 are set forth in Q&A-2 through Q&A-8. The effective date of section 460 is discussed in Q&A-9 through Q&A-13. Rules for determining which of the two long-term contract methods must be used by a taxpayer are set forth in Q&A-14. Rules for applying the percentage of completion-capitalized cost method are set forth in Q&A-15 through Q&A-18. Question 17 addresses the application of the percentage of completion-capitalized cost method by a taxpayer using a LIFO method of valuing inventories. Rules for applying the percentage of completion method are set forth in Q&A-19 through Q&A-36. Q&A-37 and Q&A-38 address the rules that apply to severing and aggregating contracts. Rules for determining which costs are allocable to a long-term contract, and therefore taken into account under section 460, are set forth in Q&A-39 and Q&A-40. The exceptions applicable to certain construction contracts provided by section 460(e) are explained in Q&A-41 through Q&A-46. Rules governing changes in methods of accounting under section 460 are set forth in Q&A-7, Q&A-13, and Q&A-47 through Q&A-49.

The Internal Revenue Service expects to issue separate guidance relating to the look-back method of section 460(b). This notice does not address the look-back method. See Form 8697 and its instructions.

II. PERMISSIBLE METHODS OF ACCOUNTING FOR LONG-TERM CONTRACTS

Q-1: Under section 460 of the Internal Revenue Code, what methods of accounting are to be used for items of income from and costs allocable to long-term contracts?

A-1: With the exception of certain construction contracts (including certain home construction contracts entered into after June 20, 1988) described in section 460(e)(1) (see Q&A-42 through Q&A-44), section 460(a) requires that items of income from and costs allocable to a long-term contract be taken into account under either of two methods of accounting: (1) the percentage of completion method, or (2) the percentage of completion-capitalized cost method. Rules for determining which of these two methods must be used by a taxpayer are set forth in Q&A-14.

III. DEFINITION OF LONG-TERM CONTRACT

Q-2: What is a long-term contract for purposes of section 460?

A-2: In general, under section 460(f), a long-term contract is any contract for the manufacture, building, installation, or construction of property if the contract is not completed within the taxable year in which it is entered into. A contract for the manufacture of property, however, is not treated as a long-term contract unless certain additional conditions set forth in section 460(f)(2) (and explained in Q&A-5) are met. For these purposes, a contract for the production of personal property is generally considered to be a contract for the manufacture of property. In contrast, any contract for the production or installation of real property or any improvements to real property, is considered to be a contract for the building, installation, or construction of property.

In determining whether a contract is completed in the taxable year in which it is entered into, all activities of the taxpayer and any related parties in connection with the manufacture, building, installation, or construction must be taken into account. For additional rules applicable to related parties, see Q&A-8.

Q-3: In determining whether a contract is a long-term contract, is it relevant that the taxpayer reasonably believed at the time that the contract was entered into that it would be completed within the same taxable year?

A-3: No. A contract that satisfies the definition of a long-term contract set forth in Q&A-2 is considered a long-term contract even though the taxpayer expected that it would be completed within the taxable year.

Q-4: Is a contract considered to be for the "manufacture, building, installation, or construction of property," even though the contract provides that the contractor is to retain title to, control over, and risk of loss with respect to the property until it is completed and accepted by the customer, and even though the parties characterize the contract as a contract for the sale of property?

A-4: Such a contract is considered to be for the "manufacture, building, installation, or construction of property," if the manufacture, building, installation, or construction of the subject matter of the contract is necessary in order for the taxpayer's contractual obligations to be fulfilled, and if the manufacture, building, installation or construction has not been completed at the time that the contract is entered into. It is not relevant whether the customer has title to, control over, or risk of loss with respect to the property. Moreover, it is not relevant whether the parties characterize their agreement as a contract for the sale of property.

Example (1). Y notifies X, an aircraft manufacturer, that it wishes to purchase an aircraft of a particular type. At the time X receives the order, X has on hand several partially completed aircraft of this type; however, X does not have any completed aircraft of this type on hand. X and Y agree that Y will purchase one of these aircraft after it has been completed. X retains title to and risk of loss with respect to the aircraft until the sale takes place. The agreement between X and Y is a contract for the manufacture of property within the meaning of section 460(f)(1), even if characterized by the parties as a contract for the sale of property. (See Q&A-5 for additional conditions that must be met in order for a contract for the manufacture of property to be a long-term contract.)

Example (2). A, a calendar year builder with average annual gross receipts of more than $10 million, begins construction of a house in October 1988, on speculation that it will find a buyer. In November 1988, A enters into a contract with B under which B agrees to purchase the house upon completion of construction. The construction of the home is not complete on December 31, 1988. A's contract with B is a contract for the building or construction of property within the meaning of section 460(f)(1), even if characterized by the parties as a contract for the sale of the house, since A must build or construct property to comply with the contract. Assuming, however, that the contract is a "home construction contract" within the meaning of section 460(e)(1)(A) and (e)(6)(A), A is not required to use the percentage of completion method or the percentage of completion-capitalized cost method of accounting for regular tax purposes because A entered into the contract after June 20, 1988. See Q&A-42. A must account for the contract using the rules of section 263A and the regulations thereunder. In addition, because A's average annual gross receipts exceed $10 million, A is required to use the percentage of completion method for purposes of determining A's alternative minimum tax liability. See Q&A-46.

Example (3). The facts are the same as in Example (2) except that A begins construction of the house in October 1987 and enters into a contract with B in November 1987. A is required to use the percentage of completion or percentage of completion-capitalized cost method of accounting for the contract under section 460 as amended by the 1987 Act.

Example (4). The facts are the same as Example (3) except that A completes construction of the house and subsequently enters into a contract with B for the purchase of the house. Because A is not required to build or construct property to complete the contract, the contract is not a long-term contract subject to section 460.

Example (5). C, a calendar year home builder with average annual gross receipts of more than $10 million, enters into a contract with D on July 1, 1988 to build a house for D. D has title to the lot on which the house is built, provides C with all materials, and has title to the house while the house is under construction. The contract is completed in February 1989. The contract is a contract for the construction of property, notwithstanding the fact that C does not have title to the subject matter of the contract. The contract is, therefore, a long-term contract within the meaning of section 460(f). Assume that the contract is a "home construction contract" within the meaning of section 460(e)(1)(A). Because the contract was entered into after June 20, 1988, C is not required to use the percentage of completion method or the percentage of completion-capitalized cost method of accounting. C must account for the contract using the rules of section 263A and the regulations thereunder. Thus, C must capitalize all of its costs incurred in constructing the home, including labor costs, interest, and all indirect costs allocable to the construction activities under section 263A and the regulations thereunder. See section 460(e)(1). In addition, because C's average annual gross receipts exceed $10 million, C is required to use the percentage of completion method for purposes of determining C's alternative minimum tax liability.

Q-5: What additional conditions apply in determining whether a contract for the manufacture of property is a long-term contract within the meaning of section 460(f)?

A-5: Under section 460(f)(2), a contract for the manufacture of property is not treated as a long-term contract unless the contract involves the manufacture of either (A) a unique item of a type that is not normally included in the finished goods inventory of the taxpayer, or (B) an item that normally requires more than 12 calendar months to complete (without regard to the period of the contract).

Since the item must meet only one of these two criteria, a manufacturing contract that is not completed in the taxable year in which it is entered into is a long-term contract within the meaning of section 460(f) if it is for the manufacture of an item that normally requires more than 12 calendar months to complete, even if the item is not unique. In determining the time normally required for the manufacture of an item, all activities of the taxpayer and of any related party relating to the manufacture must be taken into account. See *H.R. Rep. No. 795, 100th Cong., 2d Sess.* 470 (1988). Thus, the time required to manufacture an item is not limited to the time required to assemble the item and includes the time required for activities such as production of components and subassemblies by the taxpayer or by any related party. For purposes of this paragraph, a related party is a person whose relationship to the taxpayer is described in section 707(b) or 267(b), determined without regard to section 267(f)(1)(A) and determined by substituting "80 percent" for "50 percent" with regard to the ownership of the stock of a C corporation in subsections (b)(2), (b)(8), (b)(10)(A) and (b)(12) of section 267.

The rule of this Q&A-5 that the activities of related parties are to be taken into account in determining the normal production period of an item shall, in general, apply only to contracts entered into on or after June 21, 1988. However, this rule shall apply to any contract entered into after February 28, 1986 if (i) the taxpayer has arranged for a party whose relationship with the taxpayer is described in section 267(b) or 707(b) (and regardless of whether the degree of ownership requirements of the applicable section are satisfied) to perform a portion of the activities required to fulfill the contract, and (ii) a principal purpose of that arrangement is to avoid characterization of the contract as a long-term contract.

Example. X, a construction equipment manufacturer that is a calendar year taxpayer, produces a type of crane. X purchases a number of the components of the crane from suppliers that are related parties. The manufacture of these components and their shipment to X normally takes 5 months to complete. Completion of a crane using these components normally requires an additional 8 months from the time X receives them. Therefore, the crane is an item of a type that normally requires more than 12 months to complete. X normally does not produce the cranes under contracts with particular customers, but instead produces the goods for finished goods inventory, and enters into contracts for sale of the cranes after they are completed. X begins work on several cranes on July 1, 1988. Notwithstanding X's normal practice of completing cranes before contracting for their sale, on December 1, 1988, X enters into a contract with buyers for the cranes. On February 1, 1989, X completes the cranes, one month ahead of schedule. The contract is a long-term contract within the meaning of section 460(f), even though the cranes are an item of a type that X normally includes in finished goods inventory, and even though the duration of the contract was only two months, because the crane is an item of a type that normally requires more than 12 calendar months to complete.

Q-6: Do the additional conditions set forth in Q&A-5 apply in determining whether a contract for the building, installation, or construction of property is a long-term contract?

A-6: No. A contract for the building, installation, or construction of property that is not completed in the taxable year in which it is entered into is a long-term contract even if the property is not unique and does not normally require more than 12 months to complete. Thus, for example, a contract to build a house or other building is a long-term contract if it is not completed in the taxable year in which it is entered into, because the requirements applicable to manufacturing (that the property must be unique or that each item normally require more than 12 months to complete) do not apply to building, construction, or installation contracts.

Q-7: For taxpayers that used a long-term contract method for contracts entered into prior to the effective date of section 460, what restrictions apply with respect to the criteria used by the taxpayer for determining whether similar contracts entered into on or after the effective date of section 460 are long-term contracts?

A-7: Any taxpayer that, immediately prior to the effective date of section 460, accounted for contracts based on the position that such contracts were long-term contracts under section 1.451-3(b) of the Income Tax Regulations, is required to account for such contracts (and any successor contracts) under section 460 unless the taxpayer obtains the consent of the Commissioner to change its method of accounting. This is true even if the taxpayer's position under prior law was based on an erroneous application of the definition of "long-term" contract in section 460(f) and this notice. For these purposes, the term "successor contracts" means all contracts which, under the criteria and methods used by the taxpayer prior to the effective date of section 460 in determining whether a contract was a long-term contract under section 1.451-3(b) of the regulations, would be or have been classified by such taxpayer as long-term contracts under section 1.451-3(b), regardless of whether those criteria and methods are correct. Thus, for example, it is anticipated that the criteria and methods used by a taxpayer in determining that items were "unique" prior to February 28, 1986, and thus were produced under long-term contracts, will continue to be used by the taxpayer unless the taxpayer obtains the consent of the Commissioner to change its method of accounting. *See H.R. Rep. No. 495, 100th Cong., 2d Sess.* 923 (1987).

Q-8: How does section 460 apply to activities performed by a taxpayer ("Y") for a related party ("X") that, considered by themselves, would not constitute a long-term contract between X and Y, but that benefit the performance of a long-term contract entered into by X with any customer of X?

A-8: If X has entered into a long-term contract after June 20, 1988, with a customer, and Y, a taxpayer that is related to X, performs any activities for or on behalf of X that benefit or are performed by reason of X's contract, then Y shall account under section 460 for its income and costs attributable to such activities. Such activities include, for example, the production of items, such as components or subassemblies, that are reasonably expected to be used in the production of the subject matter of X's contract. Y is required to account for such activities under section 460 regardless of whether Y's activities, considered by themselves, (i) constitute manufacture, building, construction, or installation of property, (ii) involve the manufacture of items that either are "unique" or require more than 12 months to complete, (iii) span the end of Y's taxable year, or (iv) are performed pursuant to a contract with X. For purposes of this paragraph, a related party is a person whose relationship to the taxpayer is described in section 707(b) or 267(b), determined without regard to section 267(f)(1)(A) and determined by substituting "80 percent" for "50 percent" with regard to the ownership of the stock of a C corporation in subsections (b)(2), (b)(8), (b)(10)(A) and (b)(12) of section 267.

In applying section 460, Y should treat as the total expected contract price the amount to be paid by X, if such amount represents an arm's length charge. If this amount does not represent an arm's length charge, then Y must use an arm's length charge as the total expected contract price. This arm's length charge must reflect both Y's contribution to the long-term contract being performed by X, and the contract price to be received by X. In addition, if Y treats as total expected contract price an arm's length charge that differs from the actual amount that X is obligated to pay, then X must treat that arm's length charge as the cost that X incurs with respect to Y's activities.

For purposes of determining its own percentage of completion, X shall take into account the amount that it accrues as payable to Y (or is treated as accruing as payable to Y under the preceding paragraph) at the time that X accrues such amount, rather than at the time that Y incurs costs to perform activities benefiting X's long-term contract.

The rule of this Q&A-8 requiring that certain activities of related parties such as Y be accounted for under section 460 even though such activities do not, by themselves, constitute a long-term contract shall in general apply only to contracts entered into by X on or after June 21, 1988. However, this rule shall apply to any contract entered into after February 28, 1986, if X has arranged for a party whose relationship with X is described in section 707(b) or 267(b) (and regardless of whether the degree of ownership requirements of the applicable section are satisfied) to perform a portion of the activities required to fulfill the contract, and a principal purpose of that arrangement is to avoid the application of section 460 to the income and expenses attributable to such activities.

Example. On July 1, 1988, X, an accrual method taxpayer, enters into a long-term contract within the meaning of section 460(f) to produce 5 aircraft for C. Y1, an 80-percent-owned subsidiary of X and also an accrual method taxpayer, incurs costs in 1988 and 1989 to perform research, development, engineering and design work necessary to produce the aircraft. Assume that, if X had performed these activities itself, the costs would have been properly allocable to the contract. This work is completed in 1989. Y2, also an 80-percent-owned subsidiary of X, and also an accrual method taxpayer, manufactures engines in 1989 and 1990 for the aircraft. Y2's work is completed in 1990. Assume that X pays Y1 and Y2 amounts that are arm's length charges as determined under the principles of section 482, with such charges reflecting both the contributions of Y1 and Y2 to the contract being performed by X and the price to be received by X.

Both Y1 and Y2 must account for their activities under section 460 regardless of whether (i) Y1's activities considered by themselves would constitute the manufacture of property, (ii) the aircraft engines are "unique" or require more than 12 months to complete, and (iii) Y1 and Y2 have entered into contracts with X. Y1 must include the amount to be payable by X in income in 1988 and 1989, and Y2 must include the amount to be payable by X in 1989 and 1990, under either the percentage of completion or percentage of completion-capitalized cost method, under the rules applicable to long-term contracts entered into on July 1, 1988. Y1 and Y2 must apply the look-back method in 1989 and 1990, respectively. Y1 and Y2 are subject to the cost allocation rules of section 460(b). X is not required to take the costs incurred by Y1 and Y2 into account in determining its own percentage of completion for 1988 through 1990. Instead, X takes into account the amounts that it accrues as payable to Y1 and Y2 in determining its percentage of completion at the time that X incurs such amounts. See Q&A-32 and Q&A-33.

IV. EFFECTIVE DATE OF SECTION 460

Q-9: When is section 460 effective?

A-9: Section 460 (including the interest allocation requirements of section 460(c)(3)) and the rules set forth in this notice are, except as expressly provided to the contrary in this notice, effective for long-term contracts entered into after February 28, 1986, beginning with taxable years ending after February 28, 1986. For rules governing the accounting for costs allocable to contracts entered into after February 28, 1986, but incurred in taxable years ending before March 1, 1986, see Q&A-29 and Q&A-36. No inference is intended concerning the extent to which the rules applicable after the effective date of section 460 would apply to issues arising under the law in effect before the enactment of section 460.

Q-10: Does section 460 apply to a contract that is entered into by the taxpayer before March 1, 1986, but is assigned by the taxpayer on or after that date to another person?

A-10: The assignee must account for such a contract under section 460 unless (i) none of the terms of the contract are changed in connection with the assignment, and (ii) the assignee agrees to perform all of the assignor's remaining obligations under the contract and becomes entitled to all remaining payments under the contract. If the conditions of the previous sentence are met, such a contract is not subject to section 460 even if the assignor does not remain liable to the customer after the assignment and even if the assignee becomes liable to the customer. This rule applies regardless of whether the assignor and assignee are related persons, and regardless of whether the assignment occurs in connection with a taxable sale or a nontaxable transaction. The assignee must account for contract income and costs using its "normal" method of accounting for long-term contracts (as defined in Q&A-18) as of the date of the transfer (which may or may not be the same as the normal method of accounting of the assignor), except as provided in section 381 of the Code, or any other applicable provision of the Code or regulations. If the assignee has not adopted a method of accounting for long-term contracts as of the time of the transfer (as may be the case if, for example, the assignee is a new taxpayer, or has never performed a long-term contract), the assignee generally may use any method of accounting for a long-term contract permitted under section 1.451-3 of the regulations (*e.g.*, the completed contract method or the accrual method). If, however, such an assignee has a relationship to the assignor described in section 267(b) or 707(b) immediately after the assignment, then the assignee must use the assignor's normal method. For this purpose, whether the assignee and assignor have a relationship described in section 267(b) shall be determined without regard to section 267(f)(1)(A) and by substituting "80 percent" for "50 percent" with regard to the ownership of the stock of a C corporation in subsections (b)(2), (b)(8), (b)(10)(A) and (b)(12) of section 267.

Example (1). On February 1. 1986 X Corporation enters into a construction contract with Y. On November 1. 1987, X sells the assets of its division that was performing the contract to Z corporation. As part of the asset sale. Z agrees to perform all of X's obligations under the contract, and X assigns to Z all of its rights under the contract, including the right to all remaining payments under the contract. Y agrees to release X from its obligations under the contract, and Z becomes legally obligated to Y. There is no change in the terms of the contract. Thus, Z does not agree to perform any additional work that X was not obligated to perform, and no adjustment is made in the contract price that Y is obligated to pay. Because X's contract with Y was entered into prior to March 1, 1986, Z is not subject to section 460 in accounting for contract income and costs.

Example (2). The facts are the same as in Example (1), except that the terms of the contract (*e.g.*, the total price to be paid by Y) are changed in connection with the transaction. Z is subject to section 460 in accounting for contract income and costs.

Q-11: Does section 460 apply to revenues and expenses attributable to a change order or other similar agreement entered into by the taxpayer and the customer after February 28, 1986 but relating to a contract entered into on or before that date?

A-11: A change order or other similar agreement entered into by the taxpayer and the customer after February 28, 1986, is subject to section 460 if it is treated as a separate contract under the rules for severing contracts described in Q&A-37 and Q&A-38.

Example. Y enters into a contract on February 1, 1986, with an agency of the Federal Government to build two submarines. On November 1, 1987, the customer and taxpayer agree to a change order providing for a third submarine of the same class to be built by Y. Because the change order is treated as a separate contract under the rules for severing contracts described in Q&A-37, Y must account for costs and income allocable to the third submarine in accordance with section 460.

Q-12: Is a contract considered to have been entered into even if the contract is subject to conditions that have not yet been met?

A-12: Yes. A contract is considered to have been entered into even if it is subject to conditions not within the control of the taxpayer that have not yet been met, so long as the contract is a binding contract under applicable law.

Example. On December 1, 1985, X, a builder, enters into a contract with Y to build a home. Although the contract is contingent on Y's obtaining financing, it is a binding contract under applicable law. Y obtains financing on March 1, 1986. The contract is not subject to section 460, because it was entered into before March 1, 1986, even though it was subject to a condition that was met on or after that date.

Q-13: If a taxpayer has failed to comply with section 460 with respect to one or more contracts entered into after February 28, 1986 for one or more tax years ending after that date, how should the taxpayer correct its method of accounting?

A-13: A taxpayer that has failed to comply with section 460 must change its method of accounting for long-term contracts to conform to section 460 under the following procedures. These procedures are to be used rather than the procedures provided in Rev. Proc. 84-74, 1984-2 C.B. 736. Under this notice, the taxpayer is directed to and is granted consent to conform its method of accounting to a method required under section 460, provided that (1) section 6501 (the applicable statute of limitations) would permit assessment of tax for all years for which the taxpayer has failed to report income and expenses in accordance with section 460, and (2) the taxpayer files amended returns for all such years.

If section 6501 would not permit assessment of tax for all tax years for which the taxpayer has failed to report income and expenses in accordance with section 460, then the taxpayer shall, pursuant to section 446, request the consent of the Commissioner to change its method of accounting for all contracts entered into after February 28, 1986 to a method required by section 460. Such change shall be effective for the earliest tax year for which section 6501 would permit assessment of tax. As a condition of such change, the taxpayer shall file amended returns for the year of change and all subsequent years. Any adjustment required under section 481 as a result of such change shall be taken into account under such terms as may be prescribed by the Commissioner.

V. DETERMINATION OF WHETHER PERCENTAGE OF COMPLETION OR PERCENTAGE OF COMPLETION-CAPITALIZED COST METHOD IS TO BE USED

Q-14: What rules apply in determining whether the percentage of completion method of accounting rather than the percentage of completion-capitalized cost method of accounting is to be used by a taxpayer for a particular long-term contract entered into after February 28, 1986?

A-14: If, immediately prior to the effective date of section 460, the taxpayer used the percentage of completion method of accounting for all long-term contracts within a particular trade or business, then the taxpayer is required to use the percentage of completion method of accounting (as modified by section 460 and explained in Q&A-19 through Q&A-36) for all items of income from and all costs allocable to all long-term contracts within that trade or business entered into after February 28, 1986, unless the taxpayer has obtained the consent of the Commissioner to use a different method of accounting.

If, immediately prior to the effective date of section 460, a taxpayer used a method of accounting other than the percentage of completion method for all long-term contracts within a particular trade or business, then the taxpayer shall use the percentage of completion-capitalized cost method for all long-term contracts within that trade or business (other than contracts exempt under section 460(e)(1)) entered into after February 28, 1986, unless one of the following conditions is met: (1) the taxpayer has changed its method of accounting to the percentage of completion method (*e.g.*, pursuant to Notice 87-61, 1987-2 C.B.

370, or Notice 88-66, 1988-1 C.B. 552, or Q&A-47) for all items under all long-term contracts within that trade or business entered into after February 28, 1986; (2) the taxpayer has changed its method of accounting (*e.g.*, pursuant to Notice 88-66 or Q&A-47) to the percentage of completion method for all items under all long-term contracts within that trade or business entered into after October 13, 1987; or (3) the taxpayer has changed its method of accounting (*e.g.*, pursuant to Q&A-47) to the percentage of completion method for all long-term contracts entered into after June 20, 1988; or (4) the taxpayer has obtained the consent of the Commissioner to use a different method of accounting.

Immediately prior to the effective date of section 460, under section 1.451-3(a)(1) of the regulations, some taxpayers were permitted to use the percentage of completion method for certain long-term contracts within a particular trade or business, but to use another method of accounting for other long-term contracts within that trade or business. For example, the taxpayer might have used the percentage of completion method for long-term contracts of substantial duration and an accrual method for long-term contracts of less than substantial duration. Such a taxpayer must use the percentage of completion method, as modified by section 460, to account for all items under all long-term contracts entered into after February 28, 1986 that are of a duration such that they would have been accounted for under the percentage of completion method, based on the standards applied by the taxpayer, prior to the effective date of section 460. Such a taxpayer must use the percentage of completion-capitalized cost method to account for all items under all long-term contracts entered into after February 28, 1986 that are of a duration such that they would have been accounted for under a method other than the percentage of completion method, based on the standards applied by the taxpayer prior to the effective date of section 460. The requirements of the two preceding sentences shall apply unless the taxpayer has changed to the percentage of completion method pursuant to Notice 87-61, Notice 88-66, or Q&A-47, or has obtained the consent of the Commissioner.

VI. PERCENTAGE OF COMPLETION-CAPITALIZED COST METHOD

Q-15: Under the percentage of completion-capitalized cost method, when are items of revenue from and items of cost allocable to a long-term contract taken into account?

A-15: Under the percentage of completion-capitalized cost method of accounting, a certain percentage of each item of revenue and each item of cost is taken into account at the time that such item would be taken into account using the percentage of completion method for the contract, and the remaining percentage is taken into account at the time that such item would be taken into account using the taxpayer's "normal" method of accounting for the contract. The percentage of each item to be taken into account under each of these two methods of accounting depends on the date that the contract was entered into. For contracts entered into after February 28, 1986, but before October 14, 1987, 40 percent of each item of revenue or cost is taken into account under the percentage of completion method and the remaining 60 percent is taken into account under the taxpayer's normal method of accounting (the "40/60 method"). In general, for contracts entered into after October 13, 1987, but before June 21, 1988, 70 percent of each item of revenue or cost is taken into account under the percentage of completion method and the remaining 30 percent is taken into account under the taxpayer's normal method of accounting (the "70/30 method"). In general, for contracts entered into on or after June 21, 1988, 90 percent of each item of revenue or cost is taken into account under the percentage of completion method and the remaining 10 percent is taken into account under the taxpayer's normal method of accounting (the "90/10 method").

The following exceptions apply to these general rules, however. First, certain ship contracts described in section 10203 of the Revenue Act of 1987 entered into after October 13, 1987, are not required to be accounted for under either the 70/30 method or the 90/10 method. Such ship contracts are required to be accounted for using either the percentage of completion method or the 40/60 method. Second, "residential construction contracts" entered into on or after June 21, 1988, are not required to be accounted for under the 90/10 method. Unless they meet the requirements of section 460(e)(1)(B), such residential construction contracts are required to be accounted for under either the percentage of completion method or the 70/30 method. Third, a contract is not required to be accounted for under the 90/10 method if the contract results from the acceptance of a bid made before June 21, 1988, and the bid could not have been revoked or altered at any time on or after June 21, 1988. Fourth, except for the interest capitalization requirements of section 460(c)(3), section 460 does not apply to any "home construction contract" entered into after June 20, 1988. Unless such a contract meets the requirements of section 460(e)(1)(B), the uniform capitalization rules of section 263A and the regulations thereunder will apply to it. See Q&A-41 through Q&A-44 for definitions and rules relating to "residential" and "home" construction contracts. See Q&A-46 for rules relating to the application of the alternative minimum tax to long-term contracts described in section 460(e).

Q-16: In applying the percentage of completion-capitalized cost method of accounting, is a taxpayer permitted to reduce the amount of contract revenue required to be taken into account in a particular year under the taxpayer's normal method of accounting by the amount of contract revenue taken into account under the percentage of completion method in that year and previous years?

A-16: No. The amount of contract revenue taken into account in a particular year under the taxpayer's normal method of accounting is not affected by the amount of contract revenue required to be taken into account in any year under the percentage of completion method. Similarly the amount of contract revenue taken into account under the percentage of completion method is not affected by the amount of contract revenue taken into account in any year under the taxpayer's normal method.

Example. After October 13, 1987, but before June 21, 1988, X enters into a long-term contract that is accounted for under the percentage of completion-capitalized cost method using the 70/30 method. X's normal method of accounting is an accrual method. Assume that if X were using the percentage of completion method for the contract, X would be required to take into account $500,000 of contract revenue in 1988. Assume that if X were using the accrual method, X would be required to take into account $200,000 of contract revenue in 1988. Under the percentage of completion-capitalized cost method, X is required to take into account the following amounts of contract revenue in 1988: 70 percent of $500,000, or $350,000, plus 30 percent of $200,000, or $60,000, for a total of $410,000.

Q-17: How should a taxpayer that (i) uses the percentage of completion-capitalized cost method of accounting, with an accrual method as its normal method, and (ii) uses the dollar value last-in, first-out (LIFO) method of valuing its inventories apply the LIFO method to value inventories in a pool that includes items being produced under a long-term contract?

A-17: The taxpayer should include in inventory only that percentage of each unit being produced under a long-term contract that is equal to the percentage (60%, 30%, or 10%) of income and costs for such contract that is accounted for under the taxpayer's normal method. To the extent that raw materials included in the pool have been dedicated to a long-term contract, only that portion of such raw materials that is equal to such fraction (*i.e.*, 60%, 30%, or 10%) should be treated as remaining in inventory. Thus, inventory will include fractional units of raw materials, goods in process, and finished goods (as well as whole units if the same pool includes items that are not being produced under a long-term contract).

The following example illustrates the use of the dollar-value LIFO inventory method in conjunction with the percentage of completion-capitalized cost method for long-term contracts:

Example. X is engaged in the manufacture of a single type of metal component for customers in the aerospace industry. The metal component normally takes more than 12 months to manufacture. Since it began business, X sold metal components to customers only from its inventory of finished goods. However, for financial reasons, X modified this practice in 1987 and decided to obtain contracts from a customer in some cases prior to completing the manufacture of a component. X continued to manufacture and sell approximately one-half of its components without first obtaining a contract.

X uses a calendar-year tax year and an overall accrual method to report taxable income. X accounts for the cost of its inventory using the dollar-value LIFO inventory method and the natural business unit pooling method. X uses the double-extension method to compute its LIFO index. X's metal components consist of one type of raw material, and each finished component requires 6 units of raw material and 10 units of labor. X's unit costs are determined on a fully capitalized basis and, therefore, reflect all indirect costs required to be capitalized. Moreover, X does not incur research and experimental expenses and, consequently, its unit costs for items produced under a contract and for items sold from inventory do not differ.

Assume that, since the year X began business, X's ending inventory has always consisted of 20 units of raw material, two half-completed components in work-in-process, and two completed components. Thus, at the beginning of 1987, the LIFO value of X's inventory equals the base-year cost of these items and, accordingly, represents a single LIFO layer accumulated in the base year as shown below in Table 1.

(Note: In the following tables, "M" represents materials, and "L" represents labor.)

TABLE 1

1987 Beginning Inventory:

		Units		Base-year Cost		
	%	M	L	M Value ($5 × Unit)	L Value ($10 × Unit)	Total
Raw Material	100%	20	—	$100 ×	—	$100 ×
Work-in-process:						
Noncontract C	100%	3	5	15 ×	50 ×	65 ×
Noncontract D	100%	3	5	15 ×	50 ×	65 ×
Finished Goods:						
Noncontract A	100%	6	10	30 ×	100 ×	130 ×
Noncontract B	100%	6	10	30 ×	100 ×	130 ×
Total Base-year cost = Total LIFO value						$490 ×

At the end of 1987, X's physical inventory consisted of the same number of components at the same stages of completion. However, the two components carried in ending work-in-process, which were one-half completed (Contract E, entered into in September 1987, and Contract F, entered into in November 1987) were being manufactured under long-term contracts that are subject to section 460.

Because X's components normally require more than 12 months to complete, X's contracts to manufacture the components meet the definition of a long-term contract under section 460(f) of the Code. Assuming that X uses an accrual method as its normal method of accounting for long-term contracts, X must account for the cost of components manufactured under a contract using the percentage of completion-capitalized cost method and, therefore, must apply the dollar-value LIFO inventory method to less than 100 percent (*i.e.*, 60%, 30%, or 10% depending on the date each particular long-term contract is entered into) of the cost of each of these components. Accordingly, assuming again that the volume and mix of raw materials, unfinished components and finished components remains unchanged at the end of 1987, the LIFO value of X's ending inventory will change because X is required by the operation of section 460 to include only a percentage of the cost of components manufactured under a long-term contract in its dollar-value LIFO pool as shown below in Table 2. Note, however, that X does not remove a percentage of the cost of any of the 20 units of raw material from the LIFO pool until those units are dedicated to one of its long-term contracts. See Q&A-35.

TABLE 2

1987 Ending Inventory:

		Units		Base-year Cost		
	%	M	L	M Value ($5 × Unit)	L Value ($10 × Unit)	Total
Raw Material	100%	20	—	$100 ×	—	$100 ×
Work-in-process:						
Contract E-9/87	60%	1.8	3.0	9 ×	30 ×	39 ×
Contract F-11/87	30%	.9	1.5	4.5 ×	15 ×	19.5 ×
Finished Goods:						
Noncontract C	100%	6	10	30 ×	100 ×	130 ×
Noncontract D	100%	6	10	30 ×	100 ×	130 ×
Total Base-year cost						$418.5 ×
Beginning-of-year Base-year cost						490.0 ×
Decrement in LIFO value						(71.5 ×)
Total LIFO value of ending inventory						$418.5 ×

For contracts entered into after the effective date of the 1988 Act (June 20, 1988), X must, for purposes of pricing the items in its dollar-value pool, further reduce the percentage of long-term contract items taken into account to 10 percent. Table 3 reflects the sale of Noncontract items C and D; the inclusion in work in process of the partially completed Contract G, entered into in July 1988, and the partially completed Noncontract item H: and the inclusion in finished goods of Noncontract items I and J, which were started and completed in 1988. Notwithstanding the fractional inclusion of components manufactured under long-term contracts, an increment in X's LIFO pool occurs in 1988 because one fractional component included in 1987 work in process is replaced by a whole component that is being manufactured without a long-term contract.

TABLE 3

1987 Ending Inventory:

	%	Units M	L	Current-year Cost M Value ($20 × Unit)	L Value ($40 × Unit)	Total
Raw Material	100%	20	—	$400 ×	—	$400 ×
Contract G-7/88	10%	.3	.5	6 ×	20 ×	26 ×
Noncontract H	100%	3.0	5.0	60 ×	200 ×	260 ×
Finished Goods:						
Noncontract I	100%	6	10	120 ×	400 ×	520 ×
Noncontract J	100%	6	10	120 ×	400 ×	520 ×
Total Current-year cost						$1726 ×

	%	Units M	L	Base-year Cost M Value ($5 × Unit)	L Value ($10 × Unit)	Total
Raw Material	100%	20	—	$100 ×	—	$100 ×
Work-in-process:						
Contract G-7/88	10%	.3	.5	1.5 ×	5 ×	6.5 ×
Noncontract H	100%	3.0	5.0	15 ×	50 ×	65 ×
Finished Goods:						
Noncontract I	100%	6	10	30 ×	100 ×	130 ×
Noncontract J	100%	6	10	30 ×	100 ×	130 ×
Total Base-year cost						$431.5 ×
Beginning Inventory-Base-year cost						418.5 ×
Increment—Base-year cost						13.0 ×
LIFO Index = $1726 × /$431.5 × × 4						
LIFO value of Increment = 4 × $13.0 =						52.0 ×
Ending Inventory LIFO value						$470.5 ×

As Table 3 demonstrates, the interaction of section 460 and the LIFO inventory method of accounting can cause changes in the value of LIFO layers, even if there is no change in the physical content of raw materials, work in process, and finished goods.

Q-18: What is meant by a taxpayer's "normal" method of accounting?

A-18: In general, a taxpayer's normal method of accounting is the method of accounting that the taxpayer used immediately prior to the effective date of section 460 to account for its long-term contracts within a particular trade or business. This method of accounting might have been, for example, the completed contract method provided by section 1.451-3(d) of the regulations, the cash method, an accrual method such as the accrual shipment, or accrual delivery method.

If, however, the taxpayer has been required by law or has obtained the consent of the Commissioner to change from its normal method to a new method of accounting, then the new method is treated as the taxpayer's normal method of accounting. For example, section 263A may require a change in the taxpayer's normal method of accounting. Similarly, section 448 may require a taxpayer that used the cash method of accounting for long-term contracts immediately prior to the effective date of section 460, to change from the cash method to another method of accounting pursuant to section 448. In this case, that other method of accounting becomes the taxpayer's normal method of accounting for purposes of applying the percentage of completion-capitalized cost method. Although section 448 generally requires that certain taxpayers change from the cash to the accrual method, section 1.448-1T(h)(3) of the regulations may permit a change to the completed contract method in certain cases.

VII. PERCENTAGE OF COMPLETION METHOD

Q-19: Under the percentage of completion method, what portion of the total price under a particular contract is required to be included in gross income in a particular taxable year?

A-19: Under the percentage of completion method, the taxpayer must include in gross income in each taxable year ending after the date that the contract is entered into an amount equal to the excess of (1) the product of (a) the total amount of revenue that the taxpayer estimates it will receive with respect to the contract, multiplied by (b) the cumulative percentage of the contract that has been completed as of the end of the taxable year, over (2) the total cumulative amount of contract revenue required to be included in gross income in all preceding taxable years. This amount may be expressed by the following formula:

$(TCR \times PC) - I$

where

TCR = the total amount of revenue that the taxpayer expects to receive with respect to the contract;

PC = the cumulative percentage of the contract that has been completed as of the end of the taxable year;

I = the total cumulative amount of contract revenue required to be included in gross income in all preceding taxable years.

It should be noted that total estimated contract revenues may be different for the different years of the contract. See Q&A-24.

If the total cumulative amount of contract revenue required to be included in gross income in all preceding taxable years exceeds the product of total expected contract revenues for the taxable year multiplied by the cumulative percentage of the contract completed as of the end of the taxable year, then the taxpayer shall be permitted to deduct the excess as a loss for the taxable year. This may occur, for example, as a result of increases in total estimated contract costs occurring after the end of the tax year in which the contract is entered into.

Q-20: How does a taxpayer determine the percentage of the contract that has been completed as of the end of the taxable year?

A-20: Unless the taxpayer uses the simplified method described in Q&A-22 and Q&A-23, the percentage of the contract considered completed as of the end of the taxable year is equal to the ratio of (a) the total cumulative amount of costs allocable to the contract and incurred in the taxable year and in all preceding taxable years, to (b) the total amount of costs allocable to the contract that the taxpayer expects to incur. The total estimated contract costs may be different for the different years of the contract. See Q&A-24.

Q-21: Should a taxpayer that properly uses the cash method as its over-all method of accounting treat a cost as incurred in the taxable year in which it is paid for purposes of determining the total amount of costs allocable to the contract incurred in a particular taxable year?

A-21: No. Section 460 provides that, in determining percentage of completion, costs are taken into account in the taxable year that they are incurred, regardless of the taxpayer's over-all method of accounting. Similarly, under the percentage of completion method, costs allocable to the contract are deductible in the year incurred, regardless of the taxpayer's overall method of accounting. For this purpose, an item is treated as incurred when it would properly be taken into account under an accrual method of accounting, including the rules of section 461(h). See Q&A-33 through Q&A-35 for further discussion.

Q-22: How is percentage of contract completion determined under the simplified method?

A-22: Under the simplified method, only certain costs are used in determining both (i) costs allocated to the contract and incurred before the close of the taxable year, and (ii) total estimated contract costs. These costs are: (a) direct material costs and direct labor costs, and (b) depreciation, amortization and cost recovery allowances on equipment and facilities (to the extent allowable as deductions under Chapter 1 of the Code) directly used to construct or produce the subject matter of the long-term contract. Direct material costs include the costs of materials such as raw materials, land, equipment and components that become an integral part of the subject matter of a long-term contract and the costs of those materials that are consumed in the ordinary course of building, constructing, installing, or manufacturing the subject matter of a long-term contract.

Q-23: Which taxpayers may use the simplified method?

A-23: The simplified method may be used by taxpayers using the percentage of completion method for all items under all long-term contracts in a particular trade or business. A taxpayer that, pursuant to Q&A-14, uses the percentage of completion method for long-term contracts of substantial duration and the percentage of completion-capitalized cost method for long-term contracts of less than substantial duration, may not use the simplified method for its long-term contracts of substantial duration.

A taxpayer using the percentage of completion-capitalized cost method that properly uses the cash method as its normal method of accounting may also use the simplified method. However, any such taxpayer must automatically change from the simplified method for the first taxable year that the taxpayer is required to change from the cash method under any provision of law, including section 448, unless the taxpayer properly changes its method of accounting to the percentage of completion method for all items under all long-term contracts in its trade or business.

Use of the simplified method is a method of accounting and may not be revoked without the consent of the Commissioner. The Commissioner may, by revenue procedure, or other administrative pronouncement, permit taxpayers to adopt the simplified method without obtaining consent. See, *e.g.*, Notice 87-61.

Q-24: In determining percentage of completion for a particular taxable year, when are total contract costs and total contract revenues to be estimated?

A-24: Total contract revenue and total contract costs are to be estimated based on the facts and reasonable estimates as of the last day of the taxable year. Events that occur after the end of the taxable year that were not reasonably subject to estimate as of the last day of the taxable year are not taken into account.

Example. X, a calendar year taxpayer, enters into a long-term contract on January 1, 1987 Based on the facts as of December 31, 1987, X reasonably estimates that total contract revenue will be $10m and total contract costs will be $5m. X's employees go on strike in February, 1988, causing X to increase its estimate of total contract costs to $6m. After the strike is settled, X receives an order from the customer for additional work under the contract. Assume that this order would not be treated as a separate contract under the rules for severing contracts set forth in Q&A-37. Based on this order, X increases its estimate of total contract costs to $8m, and increases its estimate of total contract revenues to $15m. In applying the percentage of completion method to determine the amount of contract revenue required to be included in gross income in 1987, reasonable estimates of total contract revenue and costs based on the facts as of December 31, 1987, are to be used. Revisions to these estimates based on the strike and the change order occurring in 1988 are not taken into account, even though these revisions were made before X filed its tax return for 1987.

Q-25: Are contingency allowances for extraordinary costs to be included in total estimated contract costs for purposes of computing percentage completion?

A-25: Total estimated contract costs do not include any contingency allowance for costs that, as of the end of the year for which the estimate is made, are unforeseeable or extraordinary and are not reasonably expected to be incurred in the performance of the contract. Thus, for example, total estimated costs do not include costs attributable to abnormal factors not reasonably foreseeable as of the end of the tax year for which the estimate is made, such as prolonged third-party litigation, abnormal weather conditions (considering the season and the job site), prolonged strikes, and prolonged delays in securing required permits and licenses, and other factors that, as of the end of the year for which the estimate is made, could not be reasonably anticipated considering the nature of the contract and prior experience of the taxpayer.

Q-26: Are estimated costs of performing other contracts (such as "follow-on contracts") that the taxpayer expects to enter into with the same customer as a result of having entered into a particular contract included in total estimated contract costs for the initial contract?

A-26: No. The estimated costs of performing such a contract are not included in total estimated contract costs for the initial contract unless the contract would not be treated as a separate contract under the severing and aggregating rules described in Q&A-37.

Q-27: For purposes of applying the percentage of completion method, are "retainages" and "holdbacks" included in total expected contract revenues?

A-27: Yes. All amounts that the taxpayer is or will be entitled to receive from the customer under the contract, or any other rule of law (including, for example, the contract law rule of quantum meruit, or other quasi-contractual remedies) must be included in total expected contract revenues, including amounts, such as retainages, that the customer has contracted to pay only upon satisfactory completion of the contract. (See also section 460(b)(2)(B), which requires that such amounts, including amounts received after contract completion, be included in total contract price for purposes of applying the look-back rule.)

Q-28: For purposes of applying the percentage of completion method, does a taxpayer include in total expected contract revenues award fees and similar incentive payments that the taxpayer is entitled to receive under the contract if certain requirements, in addition to satisfactory completion and acceptance, are met?

A-28: Payments such as award fees, or incentive payments, are to be included in total expected contract revenues at the time and to the extent that the taxpayer can reasonably predict that the corresponding performance objectives will be met.

Q-29: If a taxpayer incurs costs allocable to a contract in a taxable year ending prior to the date that the contract is entered into, does the percentage of completion method require inclusion of any portion of the expected contract revenue in gross income in such prior taxable year?

A-29: No. Under the percentage of completion method the taxpayer is not required to include any amount in gross income in any taxable year ending prior to the date that a contract is entered into, even if costs allocable to the contract are incurred in such a taxable year. With respect to costs incurred in a taxable year prior to the year a contract is entered into, if (i) it is reasonably foreseeable at the time that the costs are incurred that they relate to a long-term contract that will be entered into during a future year, and (ii) the costs are of a nature such that they would otherwise be allocable to the contract under section 460(c), then such costs are to be capitalized in the year in which they are incurred. If, in contrast, it is not reasonably foreseeable at the time that costs are incurred that they relate to a long-term contract that will be entered into during a future year, then such costs are to be accounted for and capitalized under the provisions of section 263A (if such costs are incurred in a taxable year to which section 263A applies). In either case, in the subsequent year in which the contract is entered into, all such costs are to be allocated to the contract and taken into account in determining the completion percentage and, thus, in determining the amount of contract revenue required to be taken into account in the subsequent taxable year in which the contract is entered into. See Q&A-36, which provides for the time for deducting such costs.

Q-30: For the purpose of computing percentage of completion, are nondeductible costs taken into account in determining (i) expected total costs allocable to a contract, or (ii) costs allocable to a contract and incurred through the end of the taxable year?

A-30: No. For these purposes, nondeductible costs are not taken into account, even if otherwise allocable to a contract under section 460(c) and Q&A-39 and Q&A-40. Thus, for example, the following costs would not be taken into account in computing percentage of completion: (i) any payments disallowed under section 162(c); and, (ii) meals and entertainment costs disallowed under section 274.

Q-31: Under the percentage of completion method, what is the treatment of amounts received or to be received by the taxpayer from the customer as reimbursements for costs incurred in performing a long-term contract?

A-31: These reimbursements are included in total contract price in determining the amount included in gross income in the taxable year under the percentage of completion method. Similarly, reimbursed costs allocable to a contract that have been incurred by the taxpayer are treated as contract costs in determining percentage of completion for the taxable year in which such costs are incurred. See Q&A-32 and Q&A-33.

Q-32: How are costs that are allocable to a contract taken into account under the percentage of completion method?

A-32: Under the percentage of completion method, costs that are allocable to a contract are allowable as deductions from gross income in computing taxable income in the year in which they are incurred. The preceding sentence shall not apply if such costs are disallowed permanently under any provision of the Code or regulations, including, for example, section 162(c) or section 274.

Q-33: Under the percentage of completion method, when is a cost that is allocable to a long-term contract treated as incurred, and therefore as deductible and taken into account in computing percentage of completion for the taxable year?

A-33: Regardless of the taxpayer's overall method of accounting, contract costs generally are treated as incurred in the taxable year in which the "all events" test of section 461 and section 1.461-1(a)(2) of the regulations, as modified by section 461(h), is met. Thus, costs that are not treated as incurred as of the end of the taxable year for failure to satisfy the economic performance rules of section 461(h) are not deductible. Similarly, such costs are not treated as contract costs incurred through the end of the taxable year in determining percentage of completion (although those costs are taken into account in determining total expected contract costs). See Q&A-35 for rules relating to the time at which costs of direct materials and supplies are allocable to a contract.

Q-34: When are the costs of materials and supplies deductible under the percentage of completion method?

A-34: These costs are deductible under the percentage of completion method for the first taxable year in which the costs both are allocable to the contract and have been incurred. See Q&A-33 for rules as to when a cost that is allocable to a contract are treated as incurred. See Q&A-35 for rules as to when costs of materials and supplies are allocable to a contract.

Q-35: When are costs of direct materials and supplies treated as allocable to the contract under the percentage of completion method?

A-35: The costs of direct materials and supplies that are purchased specifically for a particular long-term contract are allocable to the contract in the taxable year in which such costs are incurred. The costs of other direct materials and supplies (such as those previously held by the taxpayer) are allocable to the contract in the taxable year in which such materials and supplies are dedicated to the contract. Examples of dedication include the following: (i) delivery of materials to a job site (if only one contract is being performed at that site); (ii) association of materials with a specific contract (for example, by purchase order, entry on books and records, or shipping instructions); and, (iii) if not previously assigned, the physical incorporation of the materials into the subject matter of the contract, or the consumption of the materials in the production of the subject matter of the contract. The cost that is allocated to a contract is to be determined using the taxpayer's method of accounting for such materials or supplies (*e.g.*, specific identification, FIFO, or LIFO) based on the taxable year in which such items are dedicated to the contract.

Q-36: When are costs that are allocable to a long-term contract, but are incurred prior to the date that the contract is entered into, deductible and taken into account for purposes of determining degree of contract completion?

A-36: Such costs are treated as allocated to the contract and are deductible in the taxable year in which the contract is entered into. These costs might include, for example, bidding and proposal costs allocable to the contract, raw land purchased before a construction contract was entered into, and labor costs incurred in anticipation that a contract will be awarded. See Q&A-29 regarding accounting for income attributable to such costs.

Example. In 1988 X Corporation, a calendar year taxpayer using the percentage of completion method, incurs costs to prepare a bid and proposal for a manufacturing contract with an agency of the United States government. In anticipation that the contract will be awarded, X also begins work in 1988 to produce the property that is expected to be the subject matter of the contract, incurring labor, materials, storage costs incurred to store the raw materials, and other costs allocable to this property under section 263A and the regulations thereunder. Then, on February 1, 1989, the contract is awarded and becomes legally binding on both the taxpayer and the agency. None of the bidding and proposal costs are deductible in 1988. Similarly, none of the other costs allocable to the property that is expected to be the subject matter of the contract are deductible in 1988. All of these costs are allocated to the contract on February 1, 1989. Therefore, all of these costs (bidding and proposal costs, as well as labor, materials, storage costs incurred to store the raw materials, and indirect costs allocable under section 263A to the property that is expected to be the subject matter of the contract) are deductible by X in 1989, and are taken into account by X in determining percentage of completion for 1989.

VIII. SEVERING AND AGGREGATION OF CONTRACTS

Q-37: What standards apply in determining whether an agreement should be treated as more than one contract ("severed"), or whether two or more agreements should be treated as a single contract ("aggregated") under section 460(f)(3)?

A-37: Except as provided in Q&A-38, the rules set forth in section 1.451-3(e) of the regulations apply in making this determination.

Q-38: May the taxpayer sever and aggregate contracts, or may such action be taken only by the Commissioner?

A-38: Under section 460(f)(3), a taxpayer is permitted and required to sever and aggregate contracts, notwithstanding the statement to the contrary in section 1.451-3(e)(1)(i)(C) of the regulations, which does not apply to contracts subject to section 460 and this Notice. Forthcoming regulations may require any taxpayer that severs or aggregates contracts under this Q&A-38 to attach a statement to its Federal income tax return for the first year in which it has entered into two or more agreements that are properly treated as a single contract, or a single agreement that is properly treated as more than one contract. If required, such a statement would describe the criteria used by the taxpayer in determining to sever or aggregate the agreements.

IX. ALLOCATION OF COSTS TO CONTRACTS

Q-39: What costs are required to be allocated to a long-term contract?

A-39: All costs (including, where applicable, research and experimental costs and interest costs) that directly benefit or are incurred by reason of the long-term contract activities of the taxpayer must be allocated to those contracts in the same manner that costs are allocated to extended period long-term contracts under section 1.451-3(d) of the regulations. For purposes of section 460(c), costs included in the preceding sentence and thus allocated to long-term contracts include all storage, handling, and processing costs incurred with respect to the long-term contract activities of the taxpayer. (See section 263A and the regulations thereunder for definitions of storage, handling, and processing costs.) Moreover, in the case of a cost-plus long-term contract or a Federal long-term contract, any cost not otherwise allocated to the contract under the general rule of the preceding sentence shall be allocated to the contract if the cost is identified by the taxpayer (or a related person) as being attributable to such contract, pursuant to the contract or any Federal, State, or local law or regulation. If, under a Federal or a cost-plus contract, the costs identified under the contract include a charge for the time value of money, that amount shall be treated as allocable to the contract without regard to whether the property produced is "qualified" property (as defined in Notice 88-99) with respect to which interest is required to be capitalized under section 460(c)(3).

The following costs are not subject to the rules of section 460 and are not allocable to long-term contracts: independent research and development expenses (as defined in section 460(c)(5)); expenses for unsuccessful bids and proposals; and marketing, selling and advertising expenses. Therefore, such costs are not taken into account in determining degree of contract completion under the percentage of completion method, and no portion of such costs is required to be capitalized under the percentage of completion-capitalized cost method by a taxpayer using the completed contract method as its normal method of accounting.

The use, direct or indirect, of the practical capacity concept to account for the costs required to be allocated to long-term contracts is not permitted. The practical capacity concept is defined as any concept, method, procedure, or formula (such as the practical capacity concept described in section 1.471-11(d)(4) of the regulations) whereunder fixed costs are not capitalized or allocated to a contract because of the relationship between the actual production at the taxpayer's production facility and the "practical capacity" of such facility. For this purpose, the practical capacity of a facility shall include either the practical capacity or theoretical capacity of the facility (as defined in section 1.471-11(d)(4) of the regulations), or any other similar determination of productive or operating capacity.

Q-40: What methods are available in accounting for the indirect costs required to be allocated to long-term contracts?

A-40: The indirect costs required to be allocated to a long-term contract must be allocated to particular contracts using either a specific identification (or "tracing") method, the standard cost method, or a method using burden rates (such as ratios based on direct costs, hours, or other items, or similar formulas), so long as the method employed for such allocation reasonably allocates indirect costs among long-term contracts. The method used by the taxpayer to allocate a particular cost must be applied consistently with respect to all long-term contracts of the taxpayer. An allocation method will not be considered to be reasonable if the method does not result in the allocation (and, to the extent applicable, the capitalization) of all costs that directly benefit or are incurred by reason of the performance of the taxpayer's long-term contract activities. The taxpayer shall account for each long-term contract separately and, except as provided, both the direct and indirect costs incurred during the taxable year attributable to long-term contract activities shall be allocated to particular long-term contracts for the taxable year such costs are incurred. See Q&A-35 for special rules relating to when a cost is allocable to a contract.

X. TREATMENT OF CERTAIN CONSTRUCTION CONTRACTS

Q-41: What is a "residential construction contract" for purposes of section 460?

A-41: The term "residential construction contract" means any contract if 80 percent or more of the total estimated contract costs (as of the close of the taxable year in which the contract was entered into) are reasonably expected to be attributable to the building, construction, reconstruction, or rehabilitation of (i) dwelling units, and (ii) improvements to real property directly related to such dwelling units and located on the site of such dwelling units. All costs that are attributable to the building, construction, reconstruction, or rehabilitation under the contract of such dwelling units and improvements and that are allocable to the contract, including costs of materials and raw land, are taken into account towards meeting the 80-percent test. In the case of a contract to construct a mixed-use building (*e.g.*, a building expected to contain both apartments and offices), the portion of costs that is attributable to construction of dwelling units (and improvements directly related to such dwelling units) is equal to the sum of (i) all costs that are attributable solely to the dwelling units (and directly related improvements), and (ii) a pro rata portion of all costs other than costs either solely attributable to the dwelling units (and directly related improvements) or solely attributable to other uses of the building (and directly related improvements). The pro rata apportionment shall be based on the relative amount of space in the building expected to be used for dwelling units. Thus, for example, if 50 percent of the total space in a mixed-use building is expected to be used for apartments, then 50 percent of the cost of land would be considered attributable to dwelling units. However, all of the expected cost of appliances to be installed only in the apartments would be considered attributable to dwelling units, because this cost is attributable solely to dwelling units.

For purposes of this Q&A-41 and for purposes of Q&A-43, the term dwelling unit has the same meaning as in section 167(k)(3)(C). Thus, a dwelling unit is a house or apartment used to provide living accommodations in a building or structure, but does not include a unit in a hotel, motel, inn, or other establishment more than one-half of the units of which are used on a transient basis.

Q-42: Which long-term contracts are exempt under section 460(e) from the requirements of section 460?

A-42: Section 460(e) provides that, except for the interest capitalization requirement of section 460(c)(3), the rules of section 460 do not apply to (1) any home construction contract entered into after June 20, 1988, and (2) any other construction contract entered into by a taxpayer (i) who estimates (at the time such contract is entered into) that such contract will be completed within the 2-year period beginning on the commencement date of such contract, and (ii) whose average annual gross receipts for the 3 taxable years preceding the year in which such contract is entered into do not exceed $10 million.

Thus, except for the interest capitalization requirements of section 460(c)(3), the law in effect before the enactment of section 460 applies to any contract described in clause (2) of the preceding paragraph, regardless of whether the contract involves the construction of a home or of commercial property. In the case of a home construction contract that is not described in clause (2) of the preceding paragraph (*i.e.*, a contract that is not expected to be completed within two years of the commencement date, or a contract entered into by a taxpayer whose average annual gross receipts exceed $10 million), the provisions of section 263A and the regulations thereunder apply, except that the interest capitalization requirements specifically provided in section 460(c)(3) also apply. For purposes of clause (2) of the preceding paragraph, a construction contract is any contract for the building, construction, reconstruction, or rehabilitation of, or the installation of any integral component to, or improvements of, real property. Whether a particular contract is a construction contract under this definition is to be determined by applying the rules set forth in section 1.451-3(b)(3)(ii) of the regulations and Q&A-4.

Q-43: What is a "home construction contract" for purposes of section 460(e)?

A-43: For purposes of section 460(e) the term "home construction contract" means any construction contract if 80 percent or more of the estimated total contract costs (as of the close of the taxable year in which the contract was entered into) are reasonably expected to be attributable to the building, construction, reconstruction, or rehabilitation of (i) dwelling units (within the meaning of section 167(k)) contained in buildings (with each townhouse or rowhouse treated as a separate building) containing four or fewer units, and (ii) improvements to real property directly related to such dwelling units and located at the site of such dwelling units. All costs attributable to the building, construction, reconstruction, or rehabilitation under the contract of such dwelling units and improvements, and allocable to the contract, including costs of materials and land, are taken into account towards meeting the 80-percent test. For the treatment of a mixed-use building, see Q&A 41.

Q-44: For purposes of the 80-percent tests of Q&A-41 and Q&A-43, can costs that a developer expects to incur to construct, build, or install roads, sewers, and other common features not located on the sites of dwelling units ("off-site work") be treated as attributable to dwelling units that the developer is constructing under contract?

A-44: Yes. Assume, for example, that a developer enters into a contract for the construction and sale of a house. The costs of off-site work properly allocable to this contract are treated as attributable to the construction of the house for purposes of the 80-percent test.

Q-45: What rules apply in determining the gross receipts that are to be taken into account in applying section 460(e)-(1)(B)?

A-45: For purposes of applying section 460(e), the taxpayer must take into account the gross receipts of (i) all trades or businesses (regardless of the nature of such trades or businesses) under common control with the taxpayer (within the meaning of section 52(b)), and (ii) all members of any controlled group of corporations of which the taxpayer is a member. For purposes of this determination, the term "controlled group of corporations" has the meaning given to such term by section 1563(a), except that "more than 50 percent" shall be substituted for "at least 80 percent" each place it appears in section 1563(a)(1), and the determination shall be made without regard to paragraphs (a)(4) and (e)(3)(C) of section 1563.

Persons are treated as members of controlled groups within the meaning of section 1563(a), regardless of whether such persons would be treated as "component members" of such group under section 1563(b). (See section 1.52-1(c) of the regulations.) Thus, for example, the gross receipts of a franchised corporation or a foreign corporation that is treated as an excluded member for purposes of section 1563(b) would be included for purposes of the aggregation rules of the gross receipts test under section 460(e) if the corporation and the taxpayer are members of the same controlled group under section 1563(a).

With respect to the group of persons ("members") the gross receipts of which are included in the calculation of the taxpayer's gross receipts for a taxable year, the gross receipts of the taxpayer are determined by aggregating the gross receipts of all members of the group, excluding gross receipts attributable to transactions occurring between such members. Moreover, in determining the gross receipts of any member of the group for a taxable year of less than 12 months, the gross receipts shall be annualized by (i) multiplying the gross receipts for the short period by 12, and (ii) dividing the result by the number of months in the short period.

In addition, in determining the gross receipts of the group for the three taxable years preceding the taxable year in which the contract is entered into, the gross receipts of all persons (or their predecessors) who are members of the group as of the first day of the taxable year in which the contract is entered into are included in such determination, regardless of whether such persons were members of the group for any of the three preceding taxable years. Similarly, the gross receipts of persons that were members of the group for any or all of the three preceding taxable years, but who (including their successors) are not members of the group as of the first day of the taxable year in which the contract is entered into, are not included for purposes of determining the taxpayer's average gross receipts.

Example (1). Assume that a parent corporation (P) has continuously owned 100 percent of the stock of another corporation (S1) since 1983, and that P and S1 are calendar year taxpayers. S1 enters into a long-term contract in March of 1987. In addition, P acquired 100 percent of the stock of another calendar year corporation (S2) as of the beginning of business on January 1, 1987.

In determining whether S1's long-term contract is subject to the provisions of section 460, the gross receipts of P, S1, and S2 for 1984, 1985, and 1986 shall be aggregated, excluding the gross receipts attributable to transactions occurring between the three corporations. The gross receipts of S2 are taken into account because it was a member of the group on January 1, 1987.

Example (2). Assume that a parent corporation (P) has continually owned 100 percent of the stock of two other corporations, (S1) and (S2), since 1983, and that the three corporations are calendar year taxpayers. S1 enters into a long-term contract in April of 1987. On December 31, 1986, P sells all of its stock in S2. In determining whether S1's long-term contract is subject to the provisions of section 460 for the taxable year beginning January 1, 1987, only the gross receipts of P and S1 for 1984, 1985, and 1986 shall be aggregated, excluding the gross receipts attributable to transactions occurring between the two corporations. The gross receipts of S2 are not taken into account because it was not a member of the group on January 1, 1987. Similarly, gross receipts attributable to transactions between S1 and S2 are not excluded.

In addition to the rules set forth above, the rules of section 1.451-3(b)(3)(iii) of the regulations (to the extent not inconsistent with the rules set forth above) relating to the determination, aggregation and attribution of gross receipts apply for purposes of section 460(e).

Q-46: Does the exception provided by section 460(e) apply for purposes of the alternative minimum tax?

A-46: Section 56(a)(3) provides, in general, that the percentage of completion method of accounting (as modified by section 460) shall be used in determining the alternative minimum taxable income ("AMTI") of a taxpayer for all long-term contracts entered into on or after March 1, 1986, for taxable years beginning after December 31, 1986. This general rule does not apply, however, to any home construction contract that both (i) is entered into after June 21, 1988, and (ii) meets the requirements of section 460(e)(1)(B) (*i.e.*, the taxpayer estimates that such contract will be completed within the 2-year period beginning on the contract commencement date, and the taxpayer's average annual gross receipts for the three taxable years preceding the taxable year in which such contract is entered into do not exceed $10 million). Therefore, except for such home construction contracts, the requirement to use the percentage of completion method under section 56(a)(3) applies to all long-term contracts of the taxpayer, even if the contracts are exempted under section 460(e)(1) from the requirement to use the percentage of completion method or percentage of completion-capitalized cost method for regular tax purposes.

Under section 56(a)(3), as amended by section 1007(b)(1) of the 1988 Act, however, the percentage of contract completion for any contract described in section 460(e)(1) shall be determined using the simplified cost-to-cost method. (See Q&A-22 for a discussion of the simplified cost-to-cost method.)

Whether or not a contract is described in section 460(e)(1), a taxpayer may elect, as provided in Notice 87-61, solely for purposes of determining percentage of completion for purposes of the alternative minimum tax, to use either (1) the methods of accounting and costs applied in computing regular tax, or (2) the methods of accounting and costs used in computing alternative minimum taxable income. See Notice 87-61 for procedures for making this election.

XI. CHANGES IN METHODS OF ACCOUNTING

Q-47: If, as a result of the amendment of section 460 by the 1988 Act, a taxpayer wishes to change from the percentage of completion-capitalized cost method to the percentage of completion method, in what circumstances may the taxpayer do so without obtaining the consent of the Commissioner?

A-47: For purposes of section 460 of the Code, any taxpayer using a method of accounting other than the percentage of completion method as its normal method of accounting for long-term contracts (*e.g.*, a taxpayer using the completed contract, cash or an accrual method of accounting) may automatically change its method of accounting to the percentage of completion method (including, if elected, the simplified cost-to-cost method) for—

1) all items under all long-term contracts entered into by the taxpayer after June 20, 1988; or

2) all items under all long-term contracts entered into by the taxpayer after October 13, 1987; or

3) all items under all long-term contracts entered into by the taxpayer after February 28, 1986.

The effect of alternative (2), regarding contracts entered into after October 13, 1987, is to extend the time period set forth in Notice 88-66 within which taxpayers may elect to use the percentage of completion method for all such contracts. The effect of alternative (3), regarding contracts entered into after February 28, 1986, is to extend the period, initially set forth in Notice 87-61, within which taxpayers may elect to use the percentage of completion method for all such contracts. Thus, for example, a taxpayer may use the percentage of completion-capitalized cost method for all contracts entered into after February 28, 1986 and before June 21, 1988, and may, under the terms of this notice, automatically (*i.e.*, without requesting the consent of the Commissioner) change its method of accounting to the percentage of completion method for all long-term contracts entered into after June 20, 1988. Alternatively, a taxpayer may, under the terms of this notice, use the percentage of completion-capitalized cost method for all contracts entered into after February 28, 1986, and before October 14, 1987, and may, under the terms of this notice, automatically change its method of accounting to the percentage of completion method for all items under all contracts entered into after October 13, 1987. In addition, a taxpayer may, under the terms of this notice, use the percentage of completion method for all items under all long-term contracts entered into after February 28, 1986.

This automatic change in method of accounting for long-term contracts is conditioned on the filing of an amended return for any affected tax year for which a Federal income tax return has been filed (subject to the applicable statute of limitations). The period for filing amended returns for taxpayers changing their method of accounting to the percentage of completion method is provided in Q&A-49 of this notice. Any taxpayer changing its method under this Q&A-47 must follow the notification procedures in Q&A-49.

Any automatic change to a method of accounting permitted under this Q&A-47 shall be effectuated by using a "cut-off" method with respect to contracts entered into after February 28, 1986, or October 13, 1987, or June 20, 1988, as the case may be. Thus, there is no change in the accounting method used with respect to any contract entered into before the applicable effective date, and the taxpayer shall not compute a section 481(a) adjustment with respect to its use of the new method of accounting.

Any change in method of accounting to the percentage of completion method other than a change for—

1) all items under all long-term contracts entered into by the taxpayer after February 28, 1986, or

2) all items under all long-term contracts entered into by the taxpayer after October 13, 1987, or

3) all items under all long-term contracts entered into by the taxpayer after June 20, 1988,

will constitute a change in method of accounting that requires the consent of the Commissioner. For example, if a calendar year taxpayer wishes to change from the percentage of completion-capitalized cost method to the percentage of completion method for its taxable year beginning on January 1, 1989, such taxpayer is required to obtain the consent of the Commissioner with respect to such change in method of accounting. Moreover, in such a situation, any change in method of accounting approved by the Commissioner (and any resulting section 481(a) adjustment) shall not consist, in whole or in part, of a change in method of accounting required to initially comply with section 460. Therefore, any resulting adjustment computed pursuant to section 481(a) shall relate only to a change from one proper method under section 460 to another proper method under section 460. See Q&A-13 for rules regarding taxpayers that had not complied with section 460 prior to requesting a change in their method of accounting for long-term contracts.

Q-48: What procedures should taxpayers follow to effectuate (1) the change in the percentage of completion-capitalized cost method of accounting from the 70/30 method to the 90/10 method required by the 1988 Act, and (2) the change in method of accounting for home construction contracts pursuant to the 1988 Act?

A-48: These changes shall be effectuated by using a "cut-off" method with respect to contracts entered into after June 20, 1988, *i.e.*, the taxpayer shall not change its method of accounting for contracts entered into before June 21, 1988, and no adjustment under section 481(a) of the Code shall be computed. Taxpayers making these changes shall follow the notification procedures in Q&A-49 of this notice.

Q-49: What notification and filing procedures should be followed by taxpayers changing methods of accounting under either Q&A-47 or Q&A-48 of this notice?

A-49: Any taxpayer described in Q&A- 47 or Q&A-48 of this notice shall complete and file a statement notifying the Internal Revenue Service of its use of the various methods of accounting (including the simplified cost-to-cost method) permitted under this notice with the taxpayer's Federal income tax return for the first taxable year ending after June 20, 1988, for which the taxpayer is required to account under section 460 for long-term contracts. The taxpayer shall type or legibly print the following language at the top of the statement required to be filed: "NOTIFICATION PROCEDURES UNDER SECTION XI OF NOTICE 89-15." Any amended return filed by a taxpayer for the purpose, in whole or in part, of changing the taxpayer's method of accounting under Q&A-47 must be filed on or before August 14, 1989. The taxpayer shall type or legibly print the following language at the top of each amended return: "NOTIFICATION PROCEDURES UNDER SECTION XI OF NOTICE 89-15."

Notwithstanding the requirements of the preceding paragraph, if a taxpayer has (i) filed a Federal income tax return on which the statement described in the preceding paragraph was required to be included, (ii) failed to file the statement described in the preceding paragraph with such return, and (iii) otherwise properly used the method of accounting as required or allowed under this notice (including Q&A-47 and Q&A-48), the taxpayer may file a statement indicating the use of its method of accounting under the following procedures. This statement must be attached to the taxpayer's first Federal income tax return filed after May 15, 1989, for which the taxpayer is required to account under section 460 for long-term contracts. (A taxpayer, at its option, may attach the statement with any return filed before May 16, 1989.) The taxpayer shall type or legibly print the following language at the top of the statement required to be filed: "NOTIFICATION PROCEDURES UNDER SECTION XI OF NOTICE 89-15."

PROCEDURAL INFORMATION

This notice serves as an "administrative pronouncement" as that term is described in section 1.6661-3(b)(2) of the regulations and may be relied upon to the same extent as a revenue ruling or a revenue procedure. It is expected that provisions of this notice will be included in forthcoming regulations to be issued under section 460. The Commissioner invites comments concerning the issues addressed in this notice, and other issues arising under section 460.

Nuclear Decommissioning Reserve Fund Requirements

Notice 89-16

This notice provides guidance concerning the criteria to be applied in determining whether nuclear decommissioning costs are considered included in the cost of service of a utility company.

On June 27, 1988, the Nuclear Regulatory Commission issued final regulations that set forth certain requirements for the decommissioning of nuclear power plants. 10 C.F.R. section 30.32(f) (53 F.R. 24018, 24044-45). These regulations effectively require a utility company with an ownership interest in a nuclear power plant to establish an external reserve fund to provide for the decommissioning of the power plant. These regulations affect a number of companies that had previously provided for the decommissioning of nuclear power plants through the maintenance of internal reserves.

Section 468A(a) of the Internal Revenue Code allows a deduction for any tax year for payments made by a taxpayer to a qualified nuclear decommissioning reserve fund provided the taxpayer satisfies certain requirements. Section 468A(b) provides that the amount a taxpayer may contribute to the fund shall not exceed the lesser of (1) the amount of nuclear decommissioning costs included in the taxpayer's cost of service for ratemaking purposes, or (2) the ruling amount applicable to such tax year.

Except as provided in certain transitional rules relating to tax years beginning before January 1, 1987, section 1.468A-2(b)(2) of the Income Tax Regulations provides that decommissioning costs shall generally not be considered included in cost of service for ratemaking purposes unless: (A) the order or opinion of the applicable public utility commission identifies the amount of decommissioning costs that is included in cost of service for ratemaking purposes; or (B) the written records of the ratemaking proceeding clearly and unambiguously indicate the amount of decommissioning costs that is included in cost of service for ratemaking purposes. Section 1.468A-8(b)(4)(i) provides that for tax years beginning before January 1, 1987, decommissioning costs shall be considered included in cost of service if such decommissioning costs can be accurately determined from information contained in the regulated books of account or other written records of the taxpayer.

Prior to the issuance of the regulations by the Nuclear Regulatory Commission on June 27, 1988, public utility commissions setting rates for companies that maintained internal reserves generally did not specifically identify in rate orders the amount of decommissioning costs included in cost of service for ratemaking purposes, or otherwise clearly indicate such amount in the written records of ratemaking proceedings. If the general requirements of section 1.468A-2(b)(2) of the regulations are applied to companies maintaining internal reserves for decommissioning their nuclear power plants, these companies will be unable to qualify for a deduction under section 468A of the Code until the effective date of their next rate orders.

The word "generally" in section 1.468A-2(b)(2) of the regulations gives the Internal Revenue Service discretion in the application of the requirements contained in that section. Accordingly, with respect to those companies that, prior to July 1, 1988, maintained an internal reserve to provide for the decommissioning of a nuclear power plant, the Service will, under the circumstances described below, apply the rule contained in section 1.468A-8(b)(4)(i) to determine whether decommissioning costs have been included in cost of service for ratemaking purposes.

With respect to these companies, for any tax year ending on or before December 31, 1993, if no amount of decommissioning costs is identified in an order or opinion of a public utility commission or clearly and unambiguously indicated in the written record of a ratemaking proceeding, then the requirements of section 1.468A-2(b)(2) of the regulations shall not apply unless the rates in effect during all of such tax year are determined in a base rate proceeding initiated on or after July 1, 1988. If the requirements of section 1.468A-2(b)(2) are inapplicable by reason of the preceding sentence then the Service will apply the requirements of section 1.468A-8(b)(4)(i) to determine whether decommissioning costs have been included in cost of service for ratemaking purposes. For tax years beginning after December 31, 1993, or for tax years in which the rates in effect were determined in a base rate proceeding initiated on or after July 1, 1988, the requirements of section 1.468A-2(b)(2) will apply.

This notice does not affect the requirement of section 468A(g) of the Code or section 1.468A-2(c) of the regulations establishing a deemed payment deadline for purposes of section 468A of the Code.

This document serves as an "administrative pronouncement" as that term is described in section 1.6661-3(b)(2) of the Income Tax Regulations and may be relied upon to the same extent as a revenue ruling or revenue procedure.

Definition of Diesel and Aviation Fuel Under Section 4091; Classification of Kerosene

Notice 89-17

The purpose of this notice is to (1) clarify the definitions of diesel and aviation fuel for purposes of the tax imposed by section 4091 of the Internal Revenue Code, and (2) describe special rules applicable to the sale and use of kerosene.

Section 10502 of the Revenue Act of 1987 (P.L. 100-203, 101 Stat. 1330) ("1987 Act") added section 4091 to the Code, which, beginning on April 1, 1988, moved the point of imposition of the tax on diesel and aviation fuel (collectively "taxable fuels") to the sale by the producer from the sale by the retailer. The 1987 Act also added section 4092, which defines the terms "taxable fuel" and "producer," and section 4093, which provides rules concerning exemptions from the tax, including the exemption for taxable fuel destined for use as heating oil. The Technical and Miscellaneous Revenue Act of 1988, P.L. 100-647 ("1988 Act"), provides additional categories of taxpayers who may buy taxable fuel tax free.

Notice 88-30, 1988-1 C.B. 497, as corrected by Announcement 88-64, 1988-16 I.R.B. 35, and modified by Notice 88-55, 1988-1 C.B. 539, and Notice 88-112, 1988-2 C.B. 447, provides interim rules for the administration of the tax on taxable fuels. Notice 88-132, 1988-2 C.B. 552, provides interim rules for the administration of the tax as amended by the 1988 Act. This notice supplements and modifies some of the rules of Notice 88-30.

I. Definition of Diesel Fuel and Aviation Fuel

Section 4092(a)(1) of the Code provides that the term "taxable fuel" means diesel fuel and aviation fuel. Section 4092(a)(2) provides that the term "diesel fuel" means any liquid (other than any product taxable under section 4081 (gasoline)) which is suitable for use as a fuel in a diesel-powered highway vehicle or a diesel-powered train. Section 4092(a)(3) provides that the term "aviation fuel" means any liquid (other than any product taxable under section 4081) which is suitable for use as a fuel in an aircraft.

The regulations will define the term "liquid ... which is suitable for use as a fuel in a diesel-powered highway vehicle or diesel-powered train" as any liquid that is commonly or commercially known or sold as a fuel that is suitable for use in a diesel-powered highway vehicle or diesel-powered train. Similarly, the term "any liquid ... which is suitable for use as a fuel in an aircraft" will be defined as any liquid that is commonly or commercially known or sold as a fuel that is suitable for use in an aircraft.

II. Special Rules Applicable to the Sale and Use of Kerosene

A. Background

Special rules will apply to the sale and use of kerosene. Kerosene is used widely in the aviation industry as a fuel for jet engines and used occasionally as a stand-alone fuel in diesel-powered highway vehicles or diesel-powered trains. Kerosene is used both as an additive to thin diesel fuel in cold weather and as a heating fuel.

B. Classification

As discussed in Section I above, regulations will provide that a taxable fuel will be considered suitable for use in a diesel-powered highway vehicle, a diesel-powered train, or an aircraft if the liquid is commonly or commercially known or sold as a fuel that is suitable for such use. Because kerosene is widely used in the aviation industry as a fuel for jet engines, it will therefore be classified as an aviation fuel. As described below, however, special rules will apply to kerosene sold for use as an additive to diesel fuel. Also, like other taxable fuel, kerosene destined for use as heating oil will be exempt from tax.

C. Tax Consequences of a Producer's Sale of Kerosene

A producer of aviation fuel who is registered with the Service on Form 637A, Registration for Tax-Free Sales and Purchases of Fuel Used in Aircraft Under Chapter 31 of the Internal Revenue Code, will be liable for the tax under section 4091 at the rate of 14.1 cents a gallon on its sale of kerosene unless one of the following requirements is met:

1. The producer's buyer is registered on Form 637 or Form 637A as a producer and the procedures described in section III(B)(1)(c) of Notice 88-30 for tax-free sales between producers are followed.

2. The producer's buyer intends to use the kerosene in an aircraft not in noncommercial aviation. The buyer must evidence such intent by following the registration/certification procedures described in section III(B)(2) of Notice 88-30. (Notice 88-112, however, extended until February 1, 1989, the date by which such buyers must be registered.) The producer is nonetheless liable for tax at the rate of 0.1 cent a gallon on its sale of kerosene to these buyers.

3. The producer's buyer is a heating oil retailer (that is, a person other than a producer or importer who buys taxable fuel for resale as fuel destined for use as heating oil) and the registration/certification procedures described in section III(B)(2) of Notice 88-30 and section II(D) of this notice are followed. (Notice 88-112, however, extended until February 1, 1989, the date by which heating oil retailers must be registered.)

4. The producer's buyer purchases the kerosene for its own use as heating oil.

5. The producer's buyer, when the buyer is not also a producer, certifies to the seller that the kerosene will be used by the buyer as a fuel additive rather than as a stand-alone fuel. Such certification should take the form prescribed for nontaxable uses described in section IV(B) of Notice 88-132. If the producer's buyer purchases the kerosene for resale for use as a fuel additive, tax of 14.1 cents a gallon will be imposed on the producer's sale.

D. Elimination of Registration Requirements for Certain Heating Oil Retailers

In order to reduce the paperwork burden for many small businesses, the regulations will provide, and Notice 88-30 is modified to provide, that heating oil retailers who would be classified as such because they resell kerosene, and not any other taxable fuel destined for use as heating oil, will not be required to register with the Service. These persons may continue to buy kerosene tax free by using the certification procedures of section III(B)(2)(a) of Notice 88-30. However, heating oil retailers who resell not only kerosene, but also other taxable fuel for use as heating oil, will be required to be registered by February 1, 1989, in order to continue to make tax free purchases of taxable fuel other than kerosene on and after that date.

The following examples illustrate the rules of this section II(D).

Example 1. *A*, a convenience store operator, buys kerosene from a producer and resells it to home owners for use in space heaters. *A* does not sell any other type of taxable fuel for use as heating oil. *A* is not registered with the Service on Form 637 or Form 637A, but has given its producer an exemption certificate stating that all of the kerosene will be resold for use as heating oil. *A* may buy the kerosene from the producer tax free and sell the kerosene to the home owners tax free.

Example 2. *B*, a convenience store operator, maintains a diesel fuel pump where diesel fuel is sold at retail to various users including heating oil users. *B* also buys kerosene from a producer and resells it to home owners for use in space heaters. *B* is not registered with the Service on Form 637 or Form 637A, but has given its producer an exemption certificate stating that all of the kerosene will be resold for use as heating oil. *B* may buy the kerosene from the producer tax free and resell the kerosene to the home owners tax free. The fact that *B* sells diesel fuel at retail does not affect this result. After January 31, 1989, *B* may not buy diesel fuel tax free for resale for use as heating oil if *B* has not registered on Form 637 as a heating oil retailer.

E. Tax Consequences of Using Kerosene Mixtures as Fuel

If any person produces a mixture of kerosene on which no tax has been paid and diesel fuel on which no tax has been paid and then uses such mixture as a fuel in a diesel-powered highway vehicle or a diesel-powered train, such person shall be liable for the tax imposed by section 4041 of the Code on the total volume of the blended product. The rate of tax is 15.1 cents a gallon for fuel used in a diesel-powered highway vehicle and 0.1 cent a gallon for fuel used in a diesel-powered train. The tax is reported on Form 720, Quarterly Federal Excise Tax Return. See the form and its instructions for information concerning filing and deposit requirements.

If any person produces a mixture of kerosene on which tax of 14.1 cents a gallon has been paid and diesel fuel on which tax of 15.1 cents a gallon has been paid and then uses such mixture as a fuel in diesel-powered highway vehicle, such person shall be liable for an additional tax of 1 cent a gallon on the total volume of the kerosene so used. The tax is reported on Form 720, Quarterly Federal Excise Tax Return. See the form and its instructions for information concerning filing and deposit requirements.

If any person either—

(a) produces a mixture of kerosene on which no tax has been paid and diesel fuel on which tax of 15.1 cents a gallon has been paid, or

(b) places or has placed kerosene directly into the fuel supply tank of its diesel-powered highway vehicle,

such person shall be liable for tax of 15.1 cents a gallon on the total volume of kerosene so used. The tax is reported on Form 720, Quarterly Federal Excise Tax Return. See the form and its instructions for information concerning filing and deposit requirements.

EFFECT ON OTHER DOCUMENTS

Notice 88-30 is modified.

ADMINISTRATIVE PRONOUNCEMENT

This document serves as an ''administrative pronouncement'' as that term is described in section 1.6661-3(b)(2) of the Income Tax Regulations and may be relied upon to the same extent as a revenue ruling or revenue procedure.

Weighted Average Interest Rate Update

Notice 89-18

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 section 412(c)(7) of the Internal Revenue Code as amended by the Omnibus Budget Reconciliation Act of 1987 (OBRA 1987).

The notice also provides that an announcement will be published monthly to provide the weighted average and the permissible range for the plan years beginning each month. The following rates were determined for the plan years beginning in the months shown below.

Month	Year	Weighted Average	Permissible Range
January	1989	8.80	7.92 to 9.68

Administrative Pronouncement

This document serves as an ''administrative pronouncement'' as that term is described in section 1.6661-3(b)2) of the Income Tax Regulations and may be relied upon to the same extent as a revenue ruling or revenue procedure.

Sections 4986 and 4996; The Definition of "Crude Oil" for Purposes of the Windfall Profit Tax

Notice 89-19

I. BACKGROUND

The Internal Revenue Service has received many inquiries regarding whether certain liquid hydrocarbons, derived from the production of a natural gas well and recovered prior to August 23, 1988, are ''crude oil'' subject to the windfall profit tax (WPT) imposed by section 4986 of the Internal Revenue Code, as in effect prior to its repeal by section 1941 of the Omnibus Trade and Competitiveness Act of 1988. This notice provides guidance to taxpayers concerning the circumstances under which liquid hydrocarbons recovered from a natural gas stream constitute ''taxable crude oil'' for purposes of the WPT.

II. DEFINITION OF ''CRUDE OIL''

In many hydrocarbon producing areas the liquifiable portion of natural gas streams has sufficient value to justify installation of centralized processing facilities. Typically, natural gas rich in heavier hydrocarbons or natural gas commingled with liquid hydrocarbons is transported in a pressurized state via pipeline gathering systems from wells to the central facility where an initial separation of lighter hydrocarbons from heavier hydrocarbons is accomplished by mechanical means. Beyond this point of initial mechanical separation, both streams are usually subjected to additional processing.

In some circumstances, the additional processing of both streams is accomplished by application of various nonmechanical processes including adsorption, stripping, extraneous refrigeration, fractionation, and absorption.

Section 4986 of the Code imposed an excise tax on the windfall profit from ''taxable crude oil'' removed from the premises (or deemed removed) prior to August 23, 1988. Section 4996(b)(1) of the Code provides that the term ''crude oil'' has the meaning given to such term by the June 1979 energy regulations. Section 4996(b)(8)(A) of the Code provides that, in general, the term ''energy regulations'' means regulations prescribed under section 4(a) of the Emergency Petroleum Allocation Act of 1973 (15 U.S.C. 753(a)). Section 4996(b)(8)(C) of the Code, in pertinent part, defines the June 1979 energy regulations as: (i) the terms of the energy regulations as such terms existed on June 1, 1979, and (ii) including final action taken pursuant thereto before June 1, 1979.

In the Technical Corrections Act of 1982 (1982 TCA), Congress modified two provisions of the WPT. One modification clarified that crude oil produced from domestic gas wells was subject to the WPT. The second modification clarified the timing of the imposition of the tax on condensate that is recovered from a natural gas stream after removal of the stream from the well site. In such cases, the 1982 TCA provided that the tax would be imposed when the condensate is recovered from the gas stream rather than when the gas stream is removed from the premises.

In connection with these changes, the legislative history with respect to the 1982 TCA provided that:

> [N]o change is made on the operative definition of crude oil. Thus, condensate recovered from gas production by mechanical separators at any point at or before the inlet side of the gas processing plan[t] and natural gas liquids treated as crude oil under the June 1979 energy regulations remain subject to tax.... Similarly, if a gas stream is introduced directly into a gas processing plant so that no condensate is recovered no tax will be due because there will be no crude oil within the meaning of the June 1979 energy regulations.

S. Rep. No. 592, 97th Cong., 2d Sess. 44-45 (1982). *See also* H.R. Rep. 794, 97th Cong., 2d Sess. 35-36 (1982).

Section 212.31 of the June 1979 energy regulations provides that:

> ''Crude oil'' means a mixture of hydrocarbons that existed in liquid phase in underground reservoirs and remains liquid at atmospheric pressure after passing through surface separating facilities. ''Crude oil'' includes condensate recovered in associated or nonassociated [*i.e.*, gas] production by mechanical separators, whether

located on the lease, at central field facilities, or at the inlet side of a gas processing plant. [10 C.F.R. §212.31 (June 1979).]

The first sentence of the above-quoted definition does not encompass liquids recovered from gas production because such production did not exist in liquid phase in the underground reservoir. Therefore, whether such liquids are within the June 1979 energy regulation definition of "crude oil" turns on the interpretation of the second sentence. The Temporary Emergency Court of Appeals had occasion to interpret this sentence in *UPG, Inc. v. Edwards,* 647 F.2d 147 (TECA 1981). In *UPG,* the court concluded that the employment of a mechanical separator, per se, is not an indispensable element in the definition of condensate. The Court held that pipeline residue (drip condensate) separated by pipeline forces and extraction through drip and ball run tanks was crude oil.

The statutory provisions and legislative history of the WPT make it clear that liquid hydrocarbons separated from a natural gas stream will be taxable under the WPT if, and only if, such liquids are treated as "crude oil" under the June 1979 energy regulations. Treatment of liquids recovered from a natural gas stream by non-mechanical means at or prior to the inlet side of the gas processing plant as "crude oil" is consistent with the 1979 energy regulations.

Therefore, for purposes of the WPT, liquids recovered from natural gas streams are taxable crude oil if, and only if, such liquids are captured, saved, and sold (*i.e.,* "recovered") in liquid form at atmospheric pressure (i) at or before the inlet side of a gas processing plant, or (ii) prior to the application of non-mechanical processes. This notice does not address the definition of the phrase "inlet side of a gas processing plant."

Leaking Underground Storage Tank (LUST) Tax Changes

Notice 89-20

This Notice informs taxpayers of corrections made by the Technical and Miscellaneous Revenue Act of 1988 (Pub. L. 100-647) (1988 Act) to some of the Leaking Underground Storage Tank (LUST) tax provisions and of procedures the Internal Revenue Service will follow in implementing the changes.

Gasoline Floor Stocks Tax

Section 1703(f) of the Tax Reform Act of 1986 (Pub. L. 99-514) (1986 Act) imposed a one-time tax of 9 cents a gallon on gasoline held by dealers on January 1, 1988, on which no tax under section 4081 of the Internal Revenue Code had been paid previously. It is imposed on dealers who are wholesalers, jobbers, distributors, or retailers.

Section 2001(d)(4)(A) of the 1988 Act provides that the LUST Trust Fund financing rate of 0.1 cent a gallon applies to the gasoline held by dealers on January 1, 1988, on which the one-time tax is imposed.

Notice 88-12, 1988-1 C.B. 481, advised taxpayers that the Technical Corrections Bill of 1987 would, if enacted, require payment of the additional 0.1 cent a gallon tax on gasoline or gasohol subject to the floor stocks tax. Any dealer who did not include the LUST tax in determining floor stocks tax liability must file a separate Form 720 for any additional liability. The form should be marked "Amended—1988 Act" at the top; March 31, 1988, should be used for the quarter ending date; the amount of LUST tax owing should be entered at IRS No. 73; and "floor stocks tax, IRS No. 65 & 67" should be written in on that same line. This amended Form 720 must be filed by March 31, 1989.

Tax on Fuel Used on Inland Waterways

Section 521(a)(3) of the Superfund Amendments and Reauthorization Act of 1986 (Pub. L. 99-499) (Superfund Act) amended section 4042 of the Code (relating to fuel used in commercial transportation on inland waterways) to add to the tax already imposed on any liquid used as a fuel in a vessel in commercial waterway transportation a 0.1 cent a gallon tax to be credited to the LUST Trust Fund. Inadvertently, the enactment of section 1404(a) of the Harbor Maintenance Revenue Act of 1986 (Pub. L. 99-662) repealed, before it became effective, the part of section 4042 of the Code that added the LUST tax.

Section 2002(a) of the 1988 Act provides that as of January 1, 1987, the LUST Trust Fund financing rate of 0.1 cent a gallon applies under section 4042 of the Code to fuel used in commercial transportation on inland waterways.

Notice 88-21, 1988-1 C.B. 488, advised taxpayers to pay the additional 0.1 cent a gallon tax on fuel used on inland waterways. Any taxpayer that did not include the LUST tax in determining tax liability under section 4042 for any quarter between January 1, 1987, and December 31, 1988, must file a separate Form 720 for any additional liability. The form should be marked "Amended—1988 Act" at the top; December 31, 1988, should be used as the quarter ending date; and the total amount of tax owing should be entered at IRS No. 76. A schedule must be attached to the amended Form 720 that identifies each past quarter for which the tax is being paid and the amount owing for such quarter. The total amount shown on this schedule is the amount to enter at IRS No. 76. This amended Form 720 must be filed by March 31, 1989.

Tax on Gasoline Used in Noncommercial Aviation

Section 4041(c)(2) of the Code imposes a tax at the retail level on gasoline sold for use or used as a fuel in an aircraft in noncommercial aviation. The tax imposed by section 4041(c) is deposited into the Airport and Airway Trust Fund. This tax is in addition to the tax of 9.1 cents a gallon of gasoline imposed under section 4081 on the refiner or terminal operator. Amendments made by the Superfund Act and the Revenue Act of 1987 (Pub. L. 100-203) to section 4041(c)(3) of the Code did not correctly adjust the amount credited to the Airport and Airway Trust Fund to account for the additional 0.1 cent a gallon LUST tax, thereby reducing the rate of tax to 2.9 cents a gallon from 3 cents a gallon effective as of April 1, 1988.

Section 2001(d)(2) of the 1988 Act provides that the retailer's tax imposed under section 4041(c)(3) of the Code on gasoline sold for use or used as a fuel in an aircraft in noncommercial aviation is 3 cents a gallon rather than 2.9 cents a gallon for sales on or after April 1, 1988. Taxpayers who owe an additional 0.1 cent a gallon tax for any quarter between April 1, 1988, and December 31, 1988, must file a separate Form 720 for such liability. The form should be marked "Amended—1988 Act" at the top; December 31, 1988, should be used as the quarter ending date; and the total additional amount of tax owing should be entered at IRS No. 14. A schedule must be attached to the amended Form 720 that identifies each past quarter for which the tax is being paid and the amount owing for such quarter. The total amount shown on this schedule is the amount to enter at IRS No. 14. The amended Form 720 must be filed by March 31, 1989.

Off-highway Business Use of Special Motor Fuels

Section 521(a)(2) of the Superfund Act amended section 4041 of the Code (relating to special motor fuels) to impose an additional 0.1 cent a gallon LUST tax on such fuels sold for use or used in motor vehicles or motorboats, effective January 1, 1987. Under section 4041(b), as amended by section 521(d)(1) of the Superfund Act, the only off-highway business use of a special motor fuel exempt from the LUST tax is use in a vessel employed in the fisheries or whaling business.

Section 2001(d)(3)(C) of the 1988 Act provides that, effective as of January 1, 1987, all off-highway business uses of special motor fuel exempt from the tax imposed under section 4041 of the Code are also exempt from the LUST tax.

Therefore, any purchaser of tax-paid special motor fuel that used the fuel in an off-highway business use may be eligible under section 6427 of the Code for credit (without interest) for the LUST tax paid on such purchases since January 1, 1987, provided no other claim for credit or refund of such amount has been filed. The claim for credit must be made on Form 4136, *Computation of Credit for Federal Tax on Fuels,* Line 8 and filed with the person's income tax return for the taxable year that includes November 10, 1988 (the date of enactment of the 1988 Act).

Treatment of Diesel Fuel Sold for Use or Used in an Off-highway Business Use Under Section 4041

Section 521(a)(2) of the Superfund Act amended section 4041 of the Code (relating to tax at the retail level on diesel fuel) to impose an additional 0.1 cent a gallon LUST tax on diesel fuel sold for use or used in a dieselpowered highway vehicle, effective January 1, 1987. Under section 4041(b), as amended by section 521(d)(1) of the Superfund Act, diesel fuel sold for use or used in an off-highway business use is exempt from the 15 cents a gallon tax under section 4041(a) of the Code, but only diesel fuel sold for use or used in off-highway business use in a vessel employed in the fisheries or whaling business is exempt from the 0.1 cent a gallon LUST tax imposed under section 4041(d).

Section 2001(d)(3)(C) of the 1988 Act provides that, effective January 1, 1987, diesel fuel used in any off-highway business use other than use in a train that is exempt from the tax imposed under section 4041(a) of the Code is also exempt from the LUST tax. This amendment does not apply to sales by producers of diesel fuel that are taxed under section 4091.

Generally, any person that purchased diesel fuel subject to tax under section 4041 of the Code before April 1, 1988, at a price that included the LUST tax and used the fuel in an off-highway business use other than use in a train may be eligible under section 6427 for a credit (without interest) for the LUST tax on such purchases made since January 1, 1987, provided that no other claim for credit or refund of such amount has been filed. The claim for credit must be made on Form 4136, *Computation of Credit for Federal Tax on Fuels,* Line 8 and filed with the person's income tax return for the taxable year that includes November 10, 1988 (the date of enactment of the 1988 Act).

Gasoline Used in Off-highway Business Uses

Section 521(c)(2) of the Superfund Act amended section 6421 of the Code (relating to credit or refund of tax on gasoline used for certain off-highway business uses) effective January 1, 1987, to provide that the only off-highway business use of gasoline eligible for credit or refund of the LUST tax is use in a vessel employed in the fisheries or in the whaling business.

Section 2001(d)(3)(E) of the 1988 Act provides that, as of January 1, 1987, all off-highway business uses of gasoline, not just use in a vessel employed in the fisheries or the whaling business, may be eligible for credit or refund under section 6421(a) of the Code of the LUST tax. This section also provides that, effective January 1, 1987, there is no credit or refund of the LUST tax imposed on gasoline that is used in a train or in an aircraft.

Therefore, any purchaser of tax-paid gasoline that used the gasoline in an off-highway business use, other than use in a train or an aircraft may be eligible for credit (without interest) for the LUST tax paid on such purchases since January 1, 1987, provided no other claim for credit or refund of such amount has been filed. The claim for credit must be made on Form 4136, *Computation of Credit for Federal Tax on Fuels,* Line 8 and filed with the person's income tax return for the taxable year that includes November 10, 1988 (the date of enactment of the 1988 Act).

See Notice 88-132, 1988-2 C.B. 552, for the rules relating to the exemption from the LUST tax for taxable fuel sold for use as "supplies for vessels and aircraft" as that term is defined under section 4221(d) of the Code.

This document serves as an "administrative pronouncement" as that term is described in section 1.6661-3(b)(2) of the Income Tax Regulations and may be relied upon to the same extent as a revenue ruling or revenue procedure.

Deferred Recognition of Income from Lump-Sum Payments in Connection with Notional Principal Contracts

Notice 89-21

This notice provides guidance with respect to the federal income tax treatment of lump-sum payments received in connection with interest rate and currency swap contracts, interest rate cap contracts, and similar financial products ("notional principal contracts").

Under section 446(b) of the Internal Revenue Code, if a taxpayer's method of accounting does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary, does clearly reflect income. The Commissioner has broad authority to determine whether a method of accounting for a particular item of income or expense clearly reflects income. *See RCA Corporation v. United States,* 664 F.2d 881, 886 (2d Cir. 1981), *cert. denied,* 457 U.S. 1133 (1982).

In the case of a payment received during one taxable year with respect to a notional principal contract where such payment relates to the obligation to make a payment or payments in other taxable years under the contract, a method of accounting that properly recognizes such payment over the life of the contract clearly reflects income. Moreover, including the entire amount of such payment in income when it is received or deferring the entire amount of such payment to the termination of the contract does not clearly reflect income and is an impermissible method of accounting. The method of accounting prescribed in cases such as *Schlude v. Commissioner,* 372 U.S. 128 (1963), and *American Automobile Association v. United States,* 367 U.S. 687, (1961) does not clearly reflect income in the case of notional principal products.

Regulations will be issued under sections 61, 446(b), 451, 461, and 988 providing specific rules regarding the manner in which a taxpayer must amortize or take into account over the life of a notional principal contract payments made or received with respect to the contract. The regulations will provide similar rules governing the treatment of payments made or received in connection with the assignment of the right to receive future payments under a notional principal contract in the absence of a corresponding assumption of the obligations to make payments under the contract. The specific rules for the manner of amortization of payments made or received with respect to various types of notional principal contracts will generally be prospective. A mark-to-market system for dealers in notional principal contracts is also under consideration.

In the case of lump-sum payments made or received with respect to notional principal contracts entered into, or assignments made, prior to the effective date of the regulations (including contracts entered into prior to the publication of this notice), a method of accounting used by a taxpayer is a method that clearly reflects income only if the payments are taken into account over the life of the contract using a reasonable method of amortization. For contracts entered into prior to the effective date of the regulations, the Commissioner will generally treat a method of accounting as clearly reflecting income if it takes such payments into account over the life of the contract under a reasonable amortization method, whether or not the method satisfies the specific rules in the forthcoming regulations.

Taxpayers that have adopted a method of accounting that is inconsistent with the preceding paragraph of this notice must obtain the consent of the Commissioner and change to an acceptable method of accounting. A revenue procedure will be published shortly describing (1) the procedure for obtaining this consent, and (2) the manner in which a changing taxpayer must account for any adjustments under section 481. The revenue procedure will provide that notwithstanding any provision in Rev. Proc. 84-74, 1984-2 C.B. 736, the Service in examining a taxpayer's return may require that a method of accounting consistent with the preceding paragraph of this notice be adopted for the earliest year under examination, regardless of whether it was the taxpayer or the government that raised the issue and regardless of whether the issue was raised in the course of an examination or on a Form 3115 or otherwise.

No inference should be drawn from this notice as to the proper treatment of transactions that are not properly characterized as notional principal contracts, for instance, to the extent that such transactions are in substance properly characterized as loans. In addition, no inference should be drawn from this notice as to the characterization of a contract as an insurance contract or annuity contract or the proper treatment of payments made under insurance or annuity contracts.

This notice serves as an "administrative pronouncement" as that term is described in section 1.6661-3(b)(3) of the Income Tax Regulations and may be relied upon to the same extent as a revenue ruling or revenue procedure.

Four-year Spread of Items From a Common Trust Fund's Short Taxable Year

Notice 89-22

This notice provides guidance for the reporting of items from a common trust fund's short taxable year as a result of the common trust fund being required to adopt a calendar year.

Section 1008(e)(5)(A) of the Technical and Miscellaneous Revenue Act of 1988 (the Act) amended section 584 of the Internal Revenue Code by adding subsection (h). Section 584(h) provides that all common trust funds are required to use the calendar year as their taxable year. This provision is effective for taxable years beginning after December 31, 1987. As a result of this requirement, common trust funds that previously were fiscal year taxpayers had short taxable years in 1988. To prevent the participants in a common trust fund (participants) from including income from two taxable years of the common trust fund in their income for 1988, a spread period of four years is provided for the income from the short year.

Section 1008(e)(5)(B) of the Act provides that for purposes of section 806(e)(2) of the Tax Reform Act of 1986 (TRA) (the four-year spread provisions for partners), a participant in a common trust fund shall be treated in the same manner as a partner, except that a partner's election to include all of the income from the short taxable year in the year of the change is not available to a participant. To the extent that the 1988 Partner's Instructions for Schedule K-1 (Form 1065) provide otherwise, such instructions are superseded by this notice. The four-year spread rules for partners are set forth in section 1.702-3T(b)(1) of the Temporary Income Tax Regulations and provide that, if a partner's share of "income items" exceeds the partner's share of "expense items," the partner's share of each and every income and expense item shall be taken into account ratably (and retain its character) over the partner's first four taxable years with or within which the partnership's year of change ends.

Section 806(e)(2), as applied to common trust funds, provides that a participant must spread income in excess of expenses attributable to the common trust fund's short taxable year ratably over the participant's first four taxable years with or within which the common trust fund's year of change ends. All items, whether ordinary or capital, are subject to the spread provisions if the "income items" exceed the "expense items" that pass to the participant from the common trust fund's short taxable year. The items required to be spread include the participant's proportionate share of any "affected expenses" (within the meaning of section 1.67-2T(i) of the Temporary Income Tax Regulations) from the common trust fund's short taxable year. See section 1.67-2T(d), which provides that each affected investor shall be treated as having paid or incurred an expense described in section 212 in an amount equal to the affected investor's proportionate share of the common trust fund's affected expenses.

Section 1008(e)(10) of the Act amended section 806(e) of the TRA by adding section 806(e)(3). Section 806(e)(3) provides, in general, that if a partner disposes of any interest in the partnership before the four-year spread period has expired, the amounts that would have been included in subsequent taxable years on account of the spread and that are attributable to the interest disposed of shall be included in the partner's gross income for the taxable year in which the disposition occurs.

Similarly, if a participant terminates or withdraws from the common trust fund prior to the expiration of the four-year spread period, the participant must include the amounts that would have been included in subsequent taxable years on account of the spread in the taxable year in which the participant terminates or withdraws from the common trust fund.

Under certain circumstances, the participant is required to accelerate the reporting of all or a portion of the remaining spread amounts if the participant makes a partial withdrawal of its corpus investment in the common trust fund before the last taxable year in the four-year spread period. A fraction is utilized to determine whether an acceleration is required for the taxable year of the withdrawal. The numerator of the fraction is the value of any investments withdrawn during the spread period but on or before the end of such taxable year minus the value of any additional investments contributed during the spread period but on or before the end of such taxable year. The denominator of the fraction is the value of the participant's investment in the common trust fund at the end of the taxable year plus the value of any investments withdrawn during the spread period but on or before the end of such taxable year minus the value of any additional investments contributed during the spread period but on or before the end of such taxable year. Investments withdrawn or contributed during 1988 are used in the fraction only if they occurred during the common trust fund's short taxable year. This fraction indicates the portion of the participant's investment that has been withdrawn for the taxable year of the withdrawal

If the fraction computed above is less than 1/3 (the participant's continuing investment is greater than 2/3 of its investment in the common trust fund), the participant must continue to take the spread items into account ratably over the four-year spread period. If the fraction is equal to or greater than 1/3 but less than 2/3, the participant must, in addition to the ratable amount for the year, take into account 50 percent of the spread items that would otherwise remain unaccounted for at the end of the year. This particular provision will apply only once with respect to a participant's interest in a common trust fund. If the fraction is equal to or greater than 2/3 (the participant's continuing investment is less than 1/3 of its investment in the common trust fund), the participant must take into account the entire balance of the spread items in that year. See examples 4 and 5 below.

The amount to be spread will not be accelerated solely because the income beneficiary of the participant during the short year ceases to be an income beneficiary during the four-year spread period.

If, during any year of the four-year spread period, the participant or the income beneficiary of the participant is a foreign person and if withholding is required under section 1441 or section 1442 of the Code, the tax to be withheld is on the amount of income (including the spread amount) allocable to the nonresident alien. However, if the income from the common trust fund's short taxable year is distributed to a foreign person prior to the time it would be deemed to be earned under the spread rules, the amount to be spread will be accelerated to the extent of the amount distributed. The tax under section 1441 or section 1442, therefore, is required to be withheld on the amount distributed and shall not be refunded to the participant or the income beneficiary of the participant based upon the spread rules. If the tax is withheld on income before it is distributed, then withholding is not required when such income is subsequently distributed.

To ensure that the four-year spread of items from the common trust fund's short taxable year does not create taxable income to a participant that is a simple trust, the mechanics of subchapter J require that there be a deemed increase in trust accounting income during the spread period to accommodate the distributable net income (DNI) limitations in sections 651 and 652 of the Code. Thus, for purposes of sections 651(a) and 652(a), the amount of income required to be distributed currently shall be deemed to be increased, in each of the four years in the spread period, by one-fourth of the amount spread that is includible in DNI.

The provisions set forth above may be illustrated by the following examples. In each example, assume the common trust fund has not paid or incurred, during its short taxable year, any affected expenses and the participant is a trust that: (1) is required to distribute all of its income currently; (2) is not permitted to make charitable contributions; (3) allocates all gains and losses from capital transactions to corpus; and (4) uses the calendar year as its taxable year.

Example (1). The common trust fund makes monthly distributions to a participant of the participant's share of ordinary income less expenses. The common trust fund produces for the participant $12,000 of ordinary taxable income ratably during its fiscal year that ended on April 30, 1988, and $8,000 of ordinary taxable income ratably during the short year from May 1, 1988, to December 31, 1988. On its tax return for 1988, the participant takes into account $12,000 of ordinary taxable income from the common trust fund's fiscal year and, under the Act, $2,000 (1/4 of $8,000) of ordinary taxable income from the common trust fund's short year. The participant's distributable net income (DNI) under section 643(a) of the Code is $14,000. The participant, however, has received only $12,000 of section 643(b) income during its 1988 year. In computing the taxable income of a trust, a deduction is allowed under section 651 for the amount of income required to be distributed currently or DNI, if DNI is less. Without a deemed increase in trust accounting income, the deduction under section 651 would be limited to $12,000 and the participant would have taxable income in 1988 of $2,000 even though the participant is required to distribute all its income currently and would not normally have any taxable income. Accordingly, in each of the four years of the spread period, the trust accounting income will be deemed to be increased by $2,000 (1/4 of $8,000). In 1988, the participant deducts $14,000 under section 651 and the income beneficiary includes in gross income $14,000 of ordinary taxable income under section 652.

Example (2). In its 1988 short year, the common trust fund produces for the participant $10,000 of ordinary taxable income and $12,000 of long-term capital gains. In each of the four years beginning in 1988, the participant takes into account, with respect to the spread items, $2,500 (1/4 of $10,000) of ordinary taxable income and $3,000 (1/4 of $12,000) of long-term capital gains. The participant's accounting income will be deemed to be increased by $2,500 in each year during the spread period. In each year, the participant deducts $2,500 under section 651 of the Code and the income beneficiary includes in gross income $2,500 of ordinary taxable income under section 652.

Example (3). In its 1988 short year, the common trust fund produces for the participant $10,000 of ordinary taxable income and $12,000 of long-term capital losses. Because the income items do not exceed the expense items, the participant is not entitled to spread the recognition of these items. In 1988 the participant takes into account, with respect to items from the common trust fund's short taxable year, $10,000 of ordinary taxable income and $12,000 of long-term capital losses. The participant deducts $10,000 under section 651 of the Code and the income beneficiary includes in gross income $10,000 of ordinary taxable income under section 652.

Example (4). In its 1988 short year, the common trust fund produces for the participant $12,000 of ordinary taxable income so that the participant should take into account $3,000 of ordinary taxable income in 1988, 1989, 1990, and 1991. In 1989, the participant withdraws $110,000 of its investment in the common trust fund. The participant's investment in the common trust fund at the end of the taxable year is valued at $190,000. The participant has made no additional contributions to the common trust fund during the spread period. The numerator of the fraction that indicates the portion of the investment withdrawn is $110,000. The denominator of this fraction is $300,000 ($190,000, the value of the investment at the end of the year, plus $110,000, the amount withdrawn in 1989). The fraction is $110,000/$300,000 (or 11/30). Because the participant withdrew more than 1/3 but less than 2/3 of its investment, the participant must accelerate the reporting of 50 percent of the remaining spread items. Thus, the participant is required to report $6,000 of income in 1989 and $1,500 of income in 1990 and in 1991. The amount reported in 1989 consists of one-fourth of the amount initially spread (1/4 of $12,000) plus 50 percent of the amount that would be includible in subsequent years (1/2 of $6,000).

Example (5). The facts are the same as in example (4) except that in 1990, the participant withdraws $130,000 of its investment in the common trust fund. The participant's investment in the common trust fund at the end of the taxable year is valued at $80,000. The numerator of the fraction is $240,000 ($110,000 withdrawn in 1989 plus $130,000 withdrawn in 1990). The denominator of the fraction is $320,000 ($80,000, the value of the investment at the end of the year, plus $130,000, the amount withdrawn in 1990, plus $110,000, the amount withdrawn in 1989). Because the resulting fraction of $240,000/$320,000 (or ¾) is greater than ⅔, the participant must take into account the remaining spread items of $3,000 in 1990.

This document serves as an "administrative pronouncement" as that term is described in section 1.6661-3(b)(2) of the Income Tax Regulations and may be relied upon to the same extent as a revenue ruling or revenue procedure. Taxpayers may rely upon this notice until regulations are published. The regulations will be effective for taxable years beginning after December 31, 1987.

Section 403(b) Annuities

Notice 89-23

I. BACKGROUND

Section 1120 of the Tax Reform Act of 1986 (TRA '86) amended the rules applicable to annuities qualifying for favorable tax treatment under section 403(b) of the Internal Revenue Code of 1986 to require that such annuities generally must be purchased under a plan that is nondiscriminatory within the meaning of section 403(b)(12) (the Technical and Miscellaneous Revenue Act of 1988 (TAMRA '88) redesignated section 403(b)(10), which was added by TRA '86, as section 403(b)(12)). The term "annuities" refers to annuity contracts, custodial accounts and retirement income accounts purchased under plans eligible for favorable tax treatment under section 403(b) (403(b) annuity plans). Section 403(b)(12) applies to all 403(b) annuity plans other than those contributed to or sponsored by churches or church-controlled organizations described in section 3121(w)(3). Thus, section 403(b)(12) is generally applicable to annuity contracts purchased for employees either by (1) an employer described in section 501(c)(3) that is exempt from tax under section 501(a) and (2) for employees (other than employees of an employer exempt under section 501(a) by reason of being described in section 501(c)(3)) who perform services for an educational organization described in section 170(b)(1)(A)(ii), an employer that is a State, political subdivision of a State, or an agency or instrumentality of any one or more of the foregoing that purchases such contract.

Section 403(b)(12)(ii) sets forth nondiscrimination rules for contributions made to 403(b) annuity plans pursuant to salary reduction agreements. Section 403(b)(12)(i) provides that certain nondiscrimination rules applicable to qualified plans apply to all contributions to 403(b) annuity plans other than those made pursuant to salary reduction agreements. If a 403(b) annuity plan provides for both salary reduction contributions and other contributions, such as matching contributions or employee contributions, the nondiscrimination rules of section 403(b)(12)(ii) apply to the plan with respect to assets attributable to the salary reduction contributions and the nondiscrimination rules of section 403(b)(12)(i) apply to the assets attributable to the other contributions.

This Notice provides that, until further guidance is published, section 403(b)(12) is satisfied if an employer operates its 403(b) annuity plan or plans in accordance with a reasonable, good faith interpretation of such section. Part II of this Notice describes some circumstances in which the Service will and will not consider an employer to be operating a 403(b) annuity plan in accordance with such an interpretation. Part V contains definitions of certain terms the Service will apply in determining whether an employer operates a 403(b) annuity plan in accordance with a reasonable, good faith interpretation of the statute.

The Service has determined that, because of the unique circumstances faced by many employers contributing to or sponsoring 403(b) annuity plans, transitional safe harbors are necessary to facilitate compliance with the nondiscrimination rules of section 403(b)(12). For the first time, an annuity contract purchased for one employee may be required to be considered together with annuity contracts covering other employees. In addition, changes to 403(b) annuity plans sponsored by public educational organizations sometimes require legislative approval and such approval often is delayed in the legislative process.

The safe harbors are set forth in Parts III and IV of this Notice and the definitions of significant terms used in the safe harbors are in Part V. Although section 6052(b) of TAMRA '88 permits an employer to use a statistically valid random sample of employees when applying the nondiscrimination rules of section 403(b)(12), an employer must take into account all of its employees in applying the safe harbors.

The safe harbors are designed to provide reasonable transition rules and are intended to be less restrictive than the permanent rules which will be set forth in regulations or other guidance. Thus, the Service cautions taxpayers not to draw any inferences regarding the provisions of future guidance from the contents of the transitional safe harbors.

II. REASONABLE INTERPRETATION

The Service will deem a 403(b) annuity plan to be in compliance with section 403(b)(12) if the employer operates the plan in accordance with a reasonable, good faith interpretation of section 403(b), as amended by TRA '86 and TAMRA '88, taking into account their legislative histories. This Notice provides certain definitions to aid the employer in interpreting section 403(b).

If contributions to a 403(b) annuity plan may be made pursuant to a salary reduction agreement within the meaning of section 3121(a)(5)(D), the plan meets the nondiscrimination requirements applicable to such contributions only if each participant who elects to make salary reduction contributions may elect to reduce annually his or her salary by more than $200 and the opportunity to make such contributions is available to all employees on a basis that does not discriminate in favor of highly compensated employees.

The Service will not consider it to be a reasonable, good faith interpretation of the statute and its legislative history if the employer treats contributions made pursuant to an employee's one-time, irrevocable election to reduce salary, made at the time of initial eligibility to participate in the plan, as salary reduction contributions subject to the nondiscrimination rules of section 403(b)(12)(ii). Such contributions are considered employer contributions and, thus, are subject to the nondiscrimination rules of section 403(b)(12)(i). If an employee upon initial eligibility to participate in a plan elects to make contributions pursuant to a salary reduction agreement and may subsequently elect to make contributions on an after-tax basis rather than a pre-tax basis or may elect not to participate, then the employee's initial election is not considered to be a one-time, irrevocable election.

In the case of all employer and employee contributions other than salary reduction contributions, a 403(b) annuity plan must satisfy the nondiscrimination requirements of sections 401(a)(4), (5), (17) and (26), 401(m) and 410(b) in the same manner as if the plan were described in section 401(a). The Service will not consider it to be a reasonable, good faith interpretation of the statute and its legislative history unless the employer, whether an organization described in section 501(c)(3) and exempt from federal income tax under section 501(a) or an educational organization described in section 170(b)(1)(A)-(ii), operates the plan in accordance with a reasonable, good faith interpretation of these sections, as amended by TRA '86 and TAMRA '88, taking into account their legislative histories.

III. SECTION 403(b)(12)(ii) SAFE HARBOR

A 403(b) annuity plan is deemed to satisfy the nondiscrimination requirements of section 403(b)(12)(ii) for a plan year only if each employee of the common law employer sponsoring or maintaining the plan is eligible to defer annually more than $200 pursuant to a salary reduction agreement within the meaning of section 3121(a)(5)(D) and the opportunity to make such contributions is available to all employees on the same basis. Contributions made pursuant to an employee's one-time, irrevocable election to reduce salary, made at the time of initial eligibility to participate in the plan, are not treated as deferrals made pursuant to a salary reduction agreement within the meaning of section 3121(a)(5)(D). Individuals, who are excludable employees (see Part V for definition of excludable employees), may be excluded in determining whether a 403(b) annuity plan satisfies this safe harbor. If a common law employer historically has treated its various geographically distinct units as separate for employee benefit purposes, then each unit, rather than the common law employer, may be considered a separate organization for purposes of this safe harbor, so long as the units are, on a day-to-day basis, operated independently. In general, for purposes of this rule, units of the same common law employer are not geographically distinct if such units are located within the same Standard Metropolitan Statistical Area (SMSA).

Examples. 1. The University of State X, a common law employer, has campuses in City A, City B and City C. Each campus is independently responsible for its day-to-day operations and has its own administrative staff. For many years, the University has maintained a separate health plan and a separate 403(b) annuity plan for employees performing services at each of its campuses. Since 1978, the University has contributed to a 403(b) annuity plan for eligible employees at each campus according to their elections made pursuant to salary reduction agreements. Those eligible to participate in the City A campus's 403(b) annuity plan are all of the full-time professors teaching at such campus. All employees at the City B campus are eligible to participate in the City B campus's 403(b) annuity plan. All employees at the City C campus are eligible to participate in the City C campus's 403(b) annuity plan. Each eligible employee has a one-time election to participate in the State X Retirement Plan, which is a profit sharing plan with a cash or deferred arrangement, rather than in the 403(b) annuity plan maintained for employees performing services at the same campus as the electing employee. The employees at each campus are as follows:

	Eligible to participate	Ineligible	Excludable
City A plan	75	200	50*
City B plan	150		2**
City C plan	350		5***

* elected to participate in the State X Retirement Plan.

** under the plan's maximum deferral percentage, such employees would not be able to defer more than $200.

*** student employees described in section 3121(b)(10).

Because the University has historically treated its three campuses which are located in separate, geographically distinct cities as separate for benefit purposes and the campuses are operated independently on a day-to-day basis, each campus may be considered a separate organization and, thus, each campus's 403(b) annuity plan may be tested separately for compliance with the safe harbor. The plan for City C employees satisfies the safe harbor because all employees performing services at the City C campus who are not excludable employees are eligible to participate in the City C plan. The plan for City B employees satisfies the safe harbor because all employees performing services at City B campus who are not excludable employees are eligible to participate in the City B plan. The plan for City A employees does not satisfy the safe harbor because the 200 employees ineligible to participate under the terms of the plan must be included.

2. X, an organization described in section 501(c)(3) and exempt from federal income tax under section 501(a), has two offices, one in City D and another in Suburb E, which is within the SMSA of City D. For eligible employees performing services at each of these offices, X sponsors a health plan and a 403(b) annuity plan. Under the 403(b) annuity plan for employees performing services in City D (403(b) annuity plan D), all of X's employees performing services at the office located in City D are eligible to defer annually 5% of their compensation. Under the 403(b) annuity plan for employees performing services in Suburb E (403(b) annuity plan E), all of X's employees performing services at the office located in City E who are full-time employees are eligible to defer annually 5% of their compensation. There are three part-time employees performing services at the office located in City E who normally work 25 hours per week. Because the offices located in Cities D and E are not geographically distinct from one another, X must test 403(b) annuity plan D and 403(b) annuity plan E on an aggregate basis. The plans fail the 403(b)(12)(ii) safe harbor because three employees performing services at the office located in City E are ineligible to participate.

IV. SECTION 403(b)(12)(i) SAFE HARBORS

A. In general. The Service will deem all of an employer's 403(b) annuity plans included in the employer's aggregated 403(b) annuity program to satisfy section 403(b)(12)(i) only if the aggregated 2 403(b) annuity program satisfies one of the following three safe harbors with respect to all contributions, other than matching contributions and employee contributions within the meaning of section 401(m), that are not made pursuant to a salary reduction agreement within the meaning of section 3121(a)(5)(D). In addition, if a plan or plans included in an aggregated 403(b) annuity program provides for matching contributions or employee contributions, or both, such plan or plans must satisfy section 401(m) and the regulations thereunder. For purposes of applying the regulations under section 401(m), contributions made pursuant to a salary reduction agreement to a 403(b) annuity plan may not be considered. Furthermore, in determining whether an aggregated 403(b) annuity program meets any of the following safe harbors, an employer may not take into account any social security benefits or contributions which may be taken into account under section 401(a)(4) or 401(a)(5) or any permitted disparity under section 401(l).

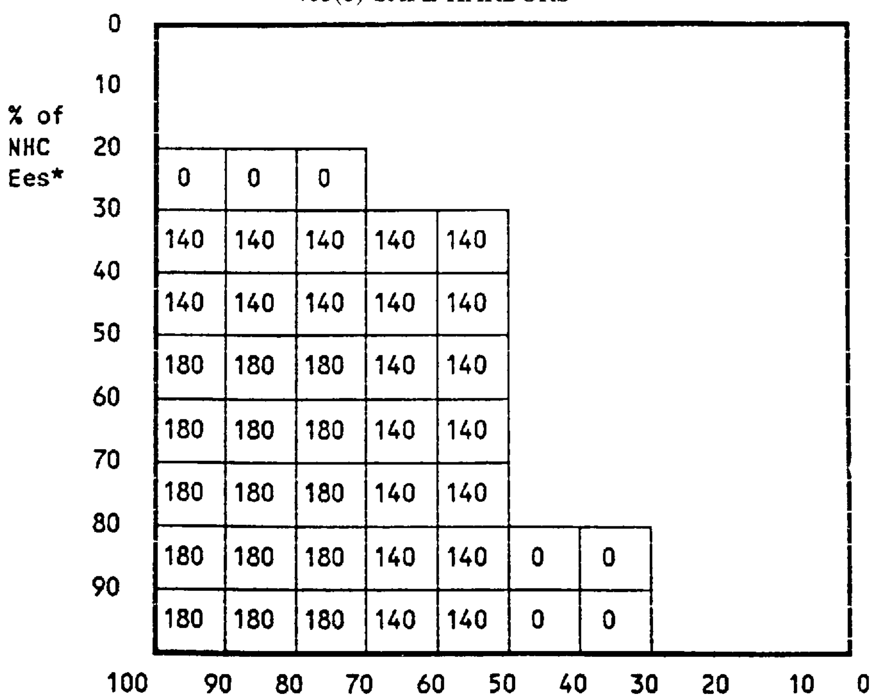
1. Maximum disparity safe harbor. This safe harbor is satisfied only if (i) the highest percentage of compensation for a year contributed on behalf of any highly compensated employee who is currently accruing benefits under a plan or plans included in the program is not more than 180% of the lowest percentage of compensation for a year contributed on behalf of any nonhighly compensated employee who is currently accruing benefits, (ii) at least 50% of the nonhighly compensated employees are currently accruing benefits under the plans included in the program, and (iii) the percentage of employees who are currently accruing benefits under the plans included in the program who are nonhighly compensated employees is at least 70%.

2. Lesser disparity safe harbor. This safe harbor is satisfied only if (i) the highest percentage of compensation for a year contributed on behalf of a highly compensated employee who is currently accruing benefits under the plans included in the program is not more than 140% of the lowest percentage of compensation for a year contributed on behalf of any nonhighly compensated employee who is currently accruing benefits, (ii) at least 30% of the nonhighly compensated employees are currently accruing benefits under the plans included in the program and (ii) the percentage of employees who are currently accruing benefits under a plans included in the program who are nonhighly compensated employees is at least 50%.

3. No disparity safe harbor. This safe harbor is satisfied only if the highest percentage of compensation for a year contributed on behalf of any highly compensated employee who is currently accruing benefits in a plan included in the program is not higher than the lowest percentage of compensation for a year contributed on behalf of any nonhighly compensated employee who is currently accruing benefits, and either one of the following two tests is satisfied. Under the first test, at least 20% of the nonhighly compensated employees must be currently accruing benefits under a plan or plans included in the program and the percentage of participants in the plans included in the program who are nonhighly compensated employees must be at least 70%. Under the second test, at least 80% of the nonhighly compensated employees must be currently accruing benefits under a plan or plans included in the program and the percentage of participants in the plans included in the program who are nonhighly compensated employees must be at least 30%.

4. Example. The employer contribution disparity safe harbors are illustrated in the chart below. The numbers in the blocks represent the benefit disparity (i.e., the ratio of the highest percentage of compensation contributed on behalf of any highly compensated employee who is currently accruing benefits under a plan or plans included in an employer's aggregated 403(b) annuity program to the lowest percentage of compensation contributed on behalf of any nonhighly compensated employee who is currently accruing benefits) permitted under the safe harbors.

403(b) SAFE HARBORS



% of all employees of the employer currently accruing benefits under the program who are nonhighly compensated.

* % of nonhighly compensated employees of the employer currently accruing benefits under the program.

For example, if 55% of an employers nonhighly compensated employees are currently accruing benefits under the program, and 50% of the employees currently accruing benefits under such program are nonhighly compensated employees, the program satisfies the lesser disparity safe harbor in subpart A.2. as long as the highest percentage of compensation for a year contributed on behalf of any highly compensated employee who is currently accruing benefits is not more than 140% of the lowest percentage of compensation for a year contributed on behalf of any nonhighly compensated employee who is currently accruing benefits.

B. Applications. In applying any of the safe harbors, the employer must apply the following principles and interpretations.

1. Testing date. The safe harbors in part IV.A. are to be applied as of the last day of the plan year, taking into account employees who are employed by the employer on such day. However, highly compensated employees of the employer who accrue benefits under the employer's aggregated 403(b) annuity program during the plan year but terminate from employment with the employer during the last quarter of such year must be considered to be currently accruing benefits and included for purposes of determining the highly compensated employee with the highest percentage of contributions in applying the disparity limitation in these safe harbors. Employees who are excludable employees may be excluded, as provided in Part V.B.

2. "Pick-up" contributions. If a government "picks-up' contributions (within the meaning of section 414(h)) to a plan included in an aggregated 403(b) annuity program, such contributions are deemed to be employer contributions.

3. Valuation. a. Vesting schedules. (i). Adjustment. If an employer chooses to include one or more plans described in sections 401(a), 403(a), 414(d) or 414(e) in its aggregated 403(b) annuity program, then, for the purpose of the section 403(b)(12)(i) safe harbors, the value of the benefits under each such plan must be adjusted to take into account the difference between the vesting schedules of such plan and the 403(b) annuity plan or plans. In the case of an included defined benefit plan, this adjustment is made by calculating each participant's benefit by projecting the participant's age and service to the earlier of the participant's attainment of age 65 or the normal retirement age under the plan and multiplying such benefit by the average vested percentage differential. The resultant amount is subtracted from the participant's benefit. In the case of an included defined contribution plan, the adjustment is made by multiplying the percentage of compensation contributed by or on behalf of any highly compensated employee for the plan year by the average vested percentage differential. The resultant amount is subtracted from the amount contributed for the plan year for or on behalf of the participant. This adjustment is based on the principles of Rev. Rul. 74-166, 1974-1 C.B. 97.

(ii). Average vested percentage. The average vested percentage is determined by dividing the sum of the vested percentage at the end of each year of service under the plan by the maximum years of service under the plan. The maximum years of service under the plan are the years of service during the period beginning at the later of age 18 or the earliest entry age under the plan and ending on the later of the normal retirement age under the plan and age 65.

(iii). Average vested percentage differential. The average vested percentage differential is 50% of the difference between the average vested percentage and 100%.

(iv). Vesting valuation example. An employer chooses to include a governmental plan in its aggregated 403(b) annuity program. The governmental plan provides for 0% vesting for the first 9 years of service and 100% vesting for each year thereafter. The earliest entry age under the plan is age 21 and the normal retirement age under the plan is age 65. Assume there are three participants in the governmental plan, participant A with 15 years of service and a projected annual benefit of $50,000, participant B with 2 years of service and a projected annual benefit of $45,000, and participant C with 5 years of service and a projected annual benefit of $30,000. The sum of the vested percentages for each year of service is 3500 [9(0) + 35(100)]. The average vested percentage is 79.55% (3500/44). The average vested percentage differential is 10.23% [(100% − 79.55%)/2]. Participant A's benefit must be adjusted by subtracting $5115 (10.23% times $50,000) from his projected benefit of $50,000. Participant B's benefit must be adjusted by subtracting $4603.50 from her projected benefit of $45,000. Participant C's benefit must be adjusted by subtracting $3069 from his projected benefit of $30,000.

b. Defined benefit plans. If the aggregated 403(b) annuity program includes one or more defined benefit plans, then the value of the contributions to such plan or plans with respect to any employee must be determined on a contribution basis under the rules contained in Treasury Regulation 1.403(b)-1(d)(4). The rules contained in such regulation are to be applied after any adjustment for differences in vesting schedules required by subparagraph a of this paragraph 3.

C. Examples. 1. Employer A, an organization described in section 501(c)(3) and exempt from federal income tax under section 501(a), has a headquarters office in State W and branch offices in States X, Y and Z. A sponsors a separate 403(b) annuity plan, which is a defined contribution plan, for its salaried employees performing services at each of its offices. Under each plan, an employee becomes a participant upon completion of one year of service. A contributes annually 8% of participants' compensation to the 403(b) annuity plan for its employees performing services at the State W office. To each other plan, A contributes annually 5% of participants' compensation. There are no 5% owners. The number of participants in each plan, the significant compensation levels of such participants and the number of nonexcludable employees who are ineligible because they are nonsalaried are set forth below.

	highly compensated employees	nonhighly compensated employees	ineligible, nonexcludable employees*
State W plan	19	45	55
State X plan	2	15	15
State Y plan	3	20	15
State Z plan	3	23	15
	27	103	100

* All of the nonsalaried employees who are ineligible under the plan are nonhighly compensated employees.

Employer A is required to include all of its 403(b) annuity plans in its aggregated 403(b) annuity program for purposes of this safe harbor. The aggregated 403(b) annuity program sponsored by A satisfies the maximum disparity safe harbor because the highest percentage of compensation contributed on behalf of any highly compensated employee is not more than 180% of that contributed on behalf of any nonhighly compensated employee currently accruing benefits (8% / 5% = 160%); at least 50% of the nonhighly compensated employees are currently accruing benefits (103/203 = 50.74%); and the percentage of participants who are nonhighly compensated employees is at least 70% (103/130 = 79.23%).

2. Assume the same facts as in Example 1, and, in addition, that A pays an annual premium for a 403(b) annuity contract for one of its highly compensated employees at the State W office, the Executive Director, who is not eligible to participate in the group annuity plan. The annual premium for the contract is equal to 15% of the Executive Director's annual compensation. Employer A's aggregated 403(b) annuity program must include all of the 403(b) annuity plans for its employees in States W, X, Y and Z and the individual annuity contract purchased for its Executive Director. The aggregated 403(b) annuity program does not satisfy any of the safe harbors because the contribution rate for the Executive Director is 300% of the contribution rate for participants in the 403(b) annuity plans for employees in States X, Y and Z.

3. School District No. 125 operates two schools, located in Boone County in State X, an elementary school for grades kindergarten through six, and a junior high for grades seven and eight. The District has the power to levy tax to provide funds for the elementary and junior high school. The District contributes for its administrative staff and the teachers employed at the schools to the State X Teachers' Retirement Plan, a 403(b) annuity plan which is a defined contribution plan, an amount equal to a percentage of each such employee's annual compensation. The percentage is determined by state statute. The current contribution percentage is 5%. The District contributes to a governmental plan, which is a defined benefit plan, for its janitors and cafeteria personnel in an amount that, after the required adjustments for vesting and plan type (see paragraph B. 3. of this Part IV), is the actuarial equivalent of 3% of each such employee's annual compensation. In addition, the District annually purchases a deferred annuity contract for its superintendent, who also participates in the 403(b) annuity plan. The premium paid each year, and thus the face amount of the annuity, varies from year to year as the school board of District No. 125 may determine. The contribution percentage for the current year is 15%. The District makes contributions either to the 403(b) annuity plan or the governmental plan on behalf of all of its employees. No employee is in both the 403(b) plan and the governmental plan. The number of employees currently accruing benefits under each plan and the number of highly compensated and nonhighly compensated employees in each are set forth below.

	highly compensated employees	nonhighly compensated employees
403(b) annuity plan	18	80
Governmental plan	0	30
Annuity contract	1	0

The aggregated 403(b) annuity program of District No. 125, which includes the 403(b) annuity plan and the annuity contract for the superintendent, does not satisfy any of the safe harbors because the highest percentage of compensation contributed on behalf of any highly compensated employee is more than 180% of the lowest percentage of compensation contributed on behalf of any nonhighly compensated employee currently accruing benefits (20%/5% = 400%).

4. Assume the same facts as in Example 3, except that 40 of the teachers eligible to participate in the 403(b) annuity plan who are not highly compensated employees elect not to participate and the District does not purchase a deferred annuity contract for its superintendent. If the District decides to include the governmental plan in its aggregated 403(b) annuity program, the program satisfies the maximum disparity safe harbor because the highest percentage of compensation contributed on behalf of any highly compensated employee is not more than 180% of the lowest percentage of compensation contributed on behalf of any nonhighly compensated employee (5%/3% = 166.67%); at least 50% of the nonhighly compensated employees are currently accruing benefits (70/110 = 63.64%); and the percentage of participants who are nonhighly compensated employees is at least 70% (70/88 = 79.55%).

5. Employer X maintains a section 403(b) plan. X requires all employees other than Executive Director, A, a highly compensated employee, to make a salary reduction contribution equal to at least 2% of compensation to the plan in order to receive a matching 10% contribution. A 10% employer contribution to A's account is made regardless of whether A makes any salary reduction contribution. There are no other contributions to the plan. All employer contributions, other than those for A, are treated as matching contributions. A is treated as receiving no matching contributions. This plan will satisfy section 401(m) for matching contributions (because only nonhighly compensated employees are eligible for the match); but it will fail the safe harbor for employer contributions because only A has employer contributions.

V. DEFINITIONS

A. In general. The definitions contained in this subpart A of Part V apply for all purposes under this Notice.

1. Highly compensated employees. Generally, the determination of which individuals are highly compensated employees is made under section 414(q) and the regulations thereunder. An employer may elect to include in its class of highly compensated employees only those employees who, during the plan year, are 5% owners of any entity within the same controlled group as the employer or receive compensation in excess of $50,000 (adjusted at the same time and in the same manner as under section 415(d), $54,480 in 1989).

2. Compensation. "Compensation" means compensation as defined in section 414(s) and the regulations thereunder and as limited under section 401(a)(17), ($200,000 for 1989) except that compensation includes only the

amount of compensation received for services performed for an organization described in section 501(c)(3) which is exempt from tax under section 501(a) or for an educational organization described in section 170(b)(1)(A)(ii) of a state, political subdivision of a state, or an agency or instrumentality of a state or political subdivision.

3. Plan year. If a plan document (e.g., an annuity contract) specifies a plan year, the plan year for purposes of this Notice is the plan year specified in the document. If no plan year is specified in the plan document, the plan year is the calendar year unless the employer designates in writing by December 31, 1989, that the plan year is a fiscal year of the employer. If an aggregated 403(b) annuity program has plans with plan years that end on different dates, the calendar year in which the plan years end will be the plan year for all of the plans for purposes of the transitional safe harbors unless the employer designates in writing by December 31, 1989, that the plan year of all of the plans in the program is either (i) the plan year specified in one of the plan documents or (ii) a fiscal year of the employer.

B. Safe harbor definitions. The definitions contained in this subpart B of Part V apply to the safe harbors contained in this Notice, as specified in each definition.

1. Aggregated 403(b) annuity program. For purposes of the section safe harbors set forth in part IV.A., the term 'aggregated 403(b) annuity program'' means all of the annuity contracts described in section 403(b)(1), all of the custodial accounts described in section 403(b)(7), and all of the retirement income accounts described in section 403(b)(9) to which an employer makes contributions. In addition, an employer may decide, in testing its aggregated 403(b) annuity program to include any one or more of the employer's plans described in section 401(a), annuity plans described in 403(a), governmental plans described in section 414(d) and church plans described in section 414(e) to which the employer contributes, to the extent that any such plan covers the employer's employees, so long as each plan that the employer decides to include in the program satisfies sections 410(b) and 401(a)(4). A plan that satisfies sections 410(b) and 401(a)(4) only when considered together with one or more comparable plans may be included in an employer's aggregated 403(b) annuity program only if the employer also includes the comparable plans such plan relied on in satisfying sections 410(b) and 401(a)(4) in the aggregated 403(b) annuity program.

Each non-403(b) plan that an employer decides to include in its aggregated 403(b) annuity program continues to be subject to the nondiscrimination rules applicable to such plans as if they were not included in the aggregated 403(b) annuity program. If an employer makes contributions only to one annuity contract described in section 403(b)(1), one custodial account described in section 403(b)(7), or one retirement income account described in 403(b)(9), then the employer's aggregated 403(b) annuity program is such contract or account and any of the employer's plans described in section 401(a), annuity plans described in 403(a), governmental plans described in section 414(d) and church plans described in section 414(e) that the employer includes in the program pursuant to the first sentence of this definition.

2. Employer. a. In general. For purposes of the section 403(b)(12)(i) safe harbors, the employer as defined in section 414(b), (c), (m) and (o) is deemed to be the entity contributing to or maintaining the 403(b) annuity plan (contributing employer) and each entity in the same controlled group as the contributing employer which, under section 403(b), may contribute to or maintain a 403(b) annuity plan. The controlled group includes each entity of which at least 80% of the directors, trustees or other individual members of the entity's governing body are either representatives of or directly or indirectly control, or are controlled by, the contributing employer. In addition, an entity is included in the same controlled group as the contributing employer if such entity provides directly or indirectly at least 80% of the contributing employer's operating funds and there is a degree of common management or supervision between the entities. A degree of common management or supervision exists if the entity providing the funds has the power to appoint or nominate officers, senior management or members of the board of directors (or other governing board) of the entity receiving the funds. A degree of common management or supervision also exists if the entity providing the funds is involved in the day-to-day operations of the entity.

b. Governmental entities. In addition to the entities described in paragraph a. of this definition, in the case of an educational organization described in section 170(b)(1)(A)(ii) of an employer which is a state, a political subdivision of a state, or an agency or instrumentality of any one or more of such entities (governmental entity), the term ''employer'' includes any other educational organization described in section 170(b)(1)(A)(ii) that has the power to levy tax to provide funds to the contributing employer or to set or review the contributing employer's budget (involvement in the budgetary process must consist of more than mere approval of a previously developed budget), and all other educational organizations described in section 170(b)(1)(A)(ii) that receive tax disbursements pursuant to the same tax levy of an educational organization. If the contributing employer receives a majority of its tax disbursements pursuant to a tax levy of one governmental entity, each other educational organization described in section 170(b)(1)(A)(ii) receiving at least 80% of its tax disbursements pursuant to the same levy is included in the term ''employer'' so long as its budget is set or reviewed by the same educational organization that sets or reviews the contributing employer's budget. Thus, for example, if a two-year college and a university each receive 80% or more of their tax disbursements pursuant to a tax or taxes levied by a state and each of their budgets is reviewed by an educational organization, then both educational organizations are one employer for purposes of the safe harbors provided in part IV.A.. For the purposes of this definition, an entity that is organized under a state statute and qualifies for an exemption under section 501(c)(3) is treated as described in section 170(b)(1)(A)(ii).

3. Excludable employees. a. In general. For purposes of applying any of the safe harbors contained in this Notice to a 403(b) annuity plan, the following individuals and employees of an employer are excludable employees: (i) employees who are nonresident aliens described in section 410(b)(3)(C); (ii) employees who are students performing services described in section 3121(b)(10); (iii) employees who normally work less than 20 hours per week; (iv) employees who make a one-time election to participate in a governmental plan described in 414(d) instead of a 403(b) annuity plan; (v) professors employed by an educational organization described in section 170(b)(1)-(A)(ii) (original employer) who are providing services on a temporary basis

to another educational organization described in section 170(b)(1)(A)(ii) and for whom a contribution to a 403(b) annuity plan or other tax-favored plan is being made at a rate no greater than the rate such professors would receive under the aggregated 403(b) annuity program of the original employer, provided that such professors are not excluded for this reason for more than one year; and (vi) employees who are affiliated with a religious order who have taken a vow of poverty and the religious order provides for such employees in their retirement. If an individual is eligible to participate in a 403(b) annuity plan even though the individual is included in a class of employees specified in the previous sentence, then the other individuals in such class may not be excluded for purposes of applying the safe harbors contained in this Notice.

b. Employees covered by collective bargaining agreements. For purposes of applying any of the safe harbors contained in this Notice to a 403(b) annuity plan, an employer may exclude employees whose retirement benefits were the subject of good faith bargaining between a representative of such employees and the employer (collectively bargained employees) in determining whether the safe harbor is satisfied with respect to employees whose retirement benefits were not the subject of such bargaining. Moreover, in determining whether any of the safe harbors is satisfied with respect to collectively bargained employees, an employer may exclude employees who are not collectively bargained employees and collectively bargained employees covered under an agreement that does not provide for benefits under the plan being tested.

c. Governmental employees. For purposes of applying any of the safe harbors contained in this Notice to a 403(b) annuity plan, an employer who is a state or a political subdivision, agency or instrumentality thereof may exclude the following individuals in addition to the excludable employees set forth in paragraphs a and b of this definition: (i) those individuals who were initially employed for the principal purpose of relieving unemployment and who have not become a part of the employer's regular workforce; (ii) inmates and patients of prisons, hospitals, homes and other institutions who perform services therein; and (iii) those individuals performing services on a temporary basis in case of fire, storm, snow, earthquake, flood or similar emergency.

d. Section 403(b)(12)(ii) safe harbor. In addition to those who are excludable employees under paragraphs a, b and c of this definition of excludable employees, the following employees of an employer are excludable employees for purposes of applying the 403(b)(12)(ii) safe harbor to a 403(b) annuity plan: (i) employees who are participants in an eligible deferred compensation plan within the meaning of section 457; (ii) employees who are eligible to participate in a qualified cash or deferred arrangement within the meaning of section 401(k)(2) or another 403(b) annuity plan sponsored or maintained by the employer which provides for contributions pursuant to a salary reduction agreement; and (iii) each employee whose contribution to the plan under its maximum deferral percentage would be $200 or less. If an employee is eligible to participate in a 403(b) annuity plan even though the employee is included in one of the classes of employees specified in the previous sentence, then all employees within that same class must be eligible to participate in the plan.

e. Section 403(b)(12)(i) safe harbors. (i) General age and service exclusion rule. In addition to those who are excludable employees under paragraphs a, b and c of this definition of excludable employees, for purposes of applying the 403(b)(12)(i) safe harbor to a 403(b) annuity plan, employees who have not satisfied the minimum age and service requirements set forth in the plan are excludable employees, so long as such requirements are permissible under section 410(a)(1) (assume plans not subject to section 410(a)(1) are subject to such section in determining those who are excludable employees) and all employees not meeting such requirements are excluded from participating in the plan.

(ii) Separate testing alternative to age and service exclusion rule. Employees who would be excludable under subparagraph (i) of this paragraph (e), but for the fact that they (or other employees with the same or lower age and service) are not excluded from coverage under the plan (otherwise excludable employees), may nevertheless be treated as an excludable employee if the employer provided benefits provided under such plan would satisfy the section 403(b)(12)(i) safe harbor by reference only to such employees and the benefits provided to such employees (expressed as percentages of compensation) are not greater than the benefits provided to the employees who are not otherwise excludable under the plan.

VI. EFFECTIVE DATE

Except as provided in the following sentence, section 403(b)(12) is effective for plan years beginning after December 31, 1988. In the case of a 403(b) annuity plan maintained pursuant to one or more collective bargaining agreements between employee representatives and one or more employers (a collectively bargained 403(b) annuity plan) that is ratified before March 1, 1986, section 403(b)(12) does not apply to plan years beginning before the earlier of (i) January 1, 1991, or (ii) the later of January 1, 1989, or the date on which the last of such collective bargaining agreements terminates (determined without regard to any extension thereof after February 28, 1986). Of course, if a collectively bargained 403(b) annuity plan is aggregated with other plans in an aggregated 403(b) annuity program, the delayed effective date applies only with respect to the collectively bargained 403(b) annuity plan.

The safe harbors set forth in this Notice apply for plan years commencing in the 1989 or 1990 calendar year.

VII. RELIANCE

Until additional guidance is published, this Notice may be relied upon by taxpayers to design and administer section 403(b) annuity plans and to determine the tax treatment of contributions. If such guidance is more restrictive than this Notice, then such guidance will be applied without retroactive effect.

This document serves as an ''administrative pronouncement'' as that term is described in Treasury Regulation 1.6661-3(b)(2) and may be relied upon to the same extent as a revenue ruling or revenue procedure.

Valuation Tables

Notice 89-24

The purpose of this notice is to provide guidance to taxpayers in determining the present value of an annuity, an interest for life or for a term of years, or a remainder or reversionary interest under section 7520 of the Internal Revenue Code. The methods established under section 7520 and this notice apply for valuation purposes under several Code provisions that include sections 170, 642, 664, 2031, 2055, 2512, 2522, and 2624.

BACKGROUND

In general, actuarial factors used in determining the present value of an annuity, an interest for life, or a remainder or reversionary interest are, for federal estate, gift, and certain income tax purposes, based on two components: the life expectancy of a designated individual or individuals (the "mortality component") and the assumed rate of return (the "interest rate component"). Valuation factors for determining the present value of interests measured by a term certain are based on two components: a term of years component and an interest rate component. For gifts made before May 1, 1989, and for estates of decedents dying before that date, the mortality component is computed on the basis of Table 1 of United States Life Tables: 1969-71 and the interest rate component is assumed to be 10 percent per annum. Actuarial factors used in the valuation of interests that are measured by one life can be found in sections 1.642(c)-6(d)-(3) and 1.664-4(b)(5) of the Income Tax Regulations, section 20.2031-7(f) of the Estate Tax Regulations, and section 25.2512-5(f) of the Gift Tax Regulations. Actuarial factors used in the valuation of interests that are measured by two lives are contained in Internal Revenue Service (Service) Publication 723E (12-83), *Actuarial Values II: Factors at 10 Percent Involving One and Two Lives.* In addition, actuarial factors used in the valuation of charitable remainder unitrust interests and pooled income fund interests that are measured by two lives are contained in I.R.S. Publication 723C (9-84), *Actuarial Values I: Valuation of Last Survivor Charitable Remainders, Part C,* and I.R.S. Publication 723D (9-84), *Actuarial Values I: Valuation of Last Survivor Charitable Remainders, Part D,* respectively. The current method for determining actuarial factors, as described in this paragraph, is applicable to gifts made before May 1, 1989, and estates of decedents dying before May 1, 1989.

Section 5031 of the Technical and Miscellaneous Revenue Act of 1988 ((P.L. 100-647) 102 Stat. 3342) amended the Internal Revenue Code by adding section 7520. Generally, under section 7520, the value of an annuity, interest for life or for a term of years, or remainder or reversionary interest is determined under new tables that are to be prescribed by the Secretary. Section 7520 is applicable to gifts made after April 30, 1989, and to estates of decedents dying after that date.

INTEREST RATES AND SOURCE OF TABLES FOR TRANSFERS AFTER APRIL 30, 1989

With respect to the interest rate component, the new valuation tables under section 7520 of the Code are to be based, in part, on the interest rate that the Service announces monthly in a news release and publishes in a revenue ruling in the Internal Revenue Bulletin. This rate is 120 percent of the applicable federal midterm rate compounded annually (rounded to the nearest two-tenths of one percent) in effect under section 1274(d)(1) of the Code for the month in which the valuation date falls. For example, the applicable federal midterm interest rate for February 1989, as set forth in Rev. Rul. 89-15, page 00, this Bulletin, is 9.42 percent; 120 percent of this amount is 11.36 percent. Thus, if section 7520 were effective as of February 1, 1989 (instead of May 1, 1989), then the rate for February under section 7520 would be determined by rounding the rate of 11.36 to 11.4 percent.

With respect to the mortality component, the new valuation tables will be based on the most recent mortality experience available. The Service will publish these tables in publications that may be purchased from the Superintendent of Documents, United States Government Printing Office, Washington, D.C. 20404.

CHARITABLE CONTRIBUTIONS MADE AFTER APRIL 30, 1989

Section 7520(a) of the Code provides in part that, if an income, estate, or gift tax charitable contribution is allowed for any part of the property transferred, the taxpayer may use the federal midterm rate for the month of the transfer or for either of the 2 months preceding the month in which the valuation date falls. In the case of transfers of more than one interest in the same property, each interest must be valued on a basis consistent with the valuation of all other such interests. For example, if a taxpayer transfers property to a charitable remainder trust in October 1989, the taxpayer may use an interest rate based upon the federal midterm rate for August, September, or October 1989; however, the taxpayer must use the same rate for both the noncharitable lead interest and the charitable remainder interest. For charitable contributions made in May or June 1989, if the taxpayer elects to use the federal midterm rate for the preceding 2 months, which may include March and April, the valuation factors for March or April that involve the lives of one or more individuals will be computed on the basis of Table 1 of United States Life Tables: 1969-71 and interest at 120 percent of the applicable federal midterm rate for March or April. Thus, the March and April actuarial factors (in the case of contributions made in May or June) will not be based on the new mortality component.

Charitable contribution transfers and other transfers of partial interests in property actually made in March or April 1989 will continue to be valued with actuarial factors based solely on Table 1 of United States Life Tables: 1969-71 and an assumed interest rate of 10 percent per annum.

In the case of gifts made after April 30, 1989, and estates of decedents dying after that date, if no charitable deduction is allowable for any portion of the property transferred, then all interests therein must be valued on the basis of 120 percent of the applicable federal midterm rate for the month in which the transfer is made.

INITIAL GUIDANCE ON NEW VALUATION FACTORS

(a) *Valuation of Interests Measured by a Term Certain After April 30, 1989*

Although the Service publications setting forth the new tables of valuation factors are not yet available, many of these factors may be determined by taxpayers prior to issuance of the publications. Taxpayers who expect to make transfers after April 30, 1989, of partial interests in property measured by a term of years may find applicable term certain factors in commercially available financial publications that contain present value tables computed to six significant figures. Taxpayers may also compute the term certain valuation factors for valuing a remainder interest, an income interest, or an annuity interest. These computations are illustrated by the following examples:

Example 1: Computation of a Remainder Interest. Assume that a donor makes a gift of an interest in a trust for an 8-year term certain after April 30, 1989, and needs to value the remainder interest. Assume also that 120 percent of the applicable federal midterm rate for the month is 10.8 percent. The applicable factor for valuing a remainder interest based on a term of years may be determined by use of the following mathematical formula:

$$\text{Remainder Factor 1} = \frac{1}{(1 + i)^t}$$

where i equals 120 percent of the applicable federal midterm interest rate under section 7520 and the exponential power t equals the number of years in the term.

Based upon interest at 10.8 percent per annum, the present worth of \$1.00 due at the end of 8 years is \$0.440232.

Example 2: Computation of an Income Interest. Assume the same facts as in Example 1, except that the donor needs to value the income interest. The valuation factor for a term certain income interest may be computed by using this formula:

Income Factor = \$1.000000 − Remainder Factor

Thus, if 120 percent of the applicable federal midterm rate for the month is 10.8 percent and the remainder factor as computed in Example 1, above, is .440232, the income factor for an income interest in a trust for a term of 8 years is 1.000000 minus .440232, which equals .559768.

Example 3: Computation of an Annuity Interest. Assume that a donor makes a gift of an annuity interest for an 8-year term certain after April 30, 1989. Assume also that 120 percent of the applicable federal midterm rate for the month is 10.8 percent. The valuation factor for a term certain annuity interest may be computed by using this formula:

$$\text{Annuity Factor} = \frac{\text{Income Factor}}{i}$$

where i equals the applicable interest rate under section 7520.

Thus, if 120 percent of the applicable federal midterm rate for the month is 10.8 percent and the income factor, as computed in Example 2 above, is .559768, the valuation factor for an annuity interest for a term of 8 years is .559768 divided by 10.8 percent, which equals 5.1830.

Example 3 may be used to compute term certain valuation factors for charitable remainder annuity interests.

(b) *Valuation of Interests Measured by One or More Lives in the Case of Charitable Contributions Made in May and June 1989*

In valuing a charitable remainder interest in a transfer that is made to a pooled income fund after April 30, 1989, the federal midterm rate is disregarded. Instead, such interests are valued on the basis of the applicable yearly rate of return of the pooled income fund at the time of the transfer and the applicable mortality table. Taxpayers who plan to make charitable contributions to pooled income funds in May or June 1989 and who wish to rely on the actuarial factors that are applicable for the preceding 2 months, which may include March and April can, in the case of remainder interests that are measured by a single life, obtain the applicable factors from Table G of section 1.642(c)-6(d)(3) of the regulations. Thus, in the case of contributions in May or June, taxpayers are permitted to elect to use actuarial factors for the 2 months preceding the contribution, notwithstanding the fact that the federal midterm rate is disregarded in valuing pooled income funds.

Example 4: Computation of a Remainder Interest Transferred to a Pooled Income Fund. Assume that in May 1989 a donor, aged 45, transfers property to a pooled income fund, retaining the income interest for life. Assume also, that at the time of the transfer, the highest yearly rate of return of the fund for its three preceding taxable years is 10.2 percent and 120 percent of the applicable federal midterm rate for one of the 2 months before May is 11.4 percent. The donor elects to value the transfer based on the prior mortality experience contained in Table G. The applicable yearly rate of return for the fund is used when valuing a remainder interest transferred to a pooled income fund. The applicable valuation factor is .11121 that is found in Table G under the column for 10.2 percent yearly rate of return. The value of the transferred interest multiplied by this factor represents the present worth of the remainder interest in property transferred by a donor, aged 45, to a pooled income fund having a yearly rate of return of 10.2 percent.

The valuation factors for valuing transfers to pooled income funds based on two lives are found in Table G(2) of Service Publication 723D (9-84), cited above.

Taxpayers who make qualifying charitable contributions in May or June 1989 of certain partial interests in property (other than contributions to charitable remainder unitrusts and pooled income funds) that are measured by a single life, and who wish to elect under section 7520(a), can obtain the applicable factors for March and April for valuing many such interests from Table G, cited above.

Example 5: Computation of a Qualifying Remainder Interest in a Farm. Assume that a donor, aged 40, makes a gift to a charity of a remainder interest in farmland in May 1989. Assume, for purposes of illustration, that 120 percent of the applicable federal midterm rate for one of the 2 months before May, which the donor elects to use, is 11.4 percent. The applicable remainder interest actuarial factor, which may be found in Table G in the column listing factors for the yearly rate of return of 11.4 percent, is .06828. This is the present worth of \$1.00 due at the death of a person aged 40 based on an interest rate of 11.4 percent.

Taxpayers who plan to make contributions of certain partial interests in property to charity after April 30, 1989, and who wish to value remainder interests that are measured by two lives may obtain the applicable factors for the months of March and April 1989 from Table G(2), cited above.

ADMINISTRATIVE PRONOUNCEMENT

This document serves as an "administrative pronouncement" as that term is described in section 1.6661-3(b)(2) of the regulations and may be relied upon to the same extent as a revenue ruling or revenue procedure.

Miscellaneous Taxability Issues

Notice 89-25

Introduction

This Notice provides further guidance, in the form of questions and answers, to certain provisions of the Tax Reform Act of 1986 (TRA '86) generally affecting the taxation of distributions from qualified employee plans, section 403(b) annuity contracts, and individual retirement arrangements (IRAs). Guidance has previously been issued in Notice 87-13, 1987-1 C.B. 432, and Notice 87-16, 1987-1 C.B. 446. This Notice is intended to clarify certain provisions of those Notices, and to provide guidance on other issues affecting employee plans, changes in plan valuation date, distributions to federal employees, and distributions of certain annuity contracts.

Until further guidance is published, the guidance provided by these questions and answers may be relied upon by taxpayers to design and administer plans and to determine the tax treatment of plan contributions and distributions. The Service will apply these questions and answers in issuing rulings and in examining returns with respect to taxpayers and plans. If future guidance is more restrictive than that provided in this Notice, such guidance will be applied without retroactive effect. No inference should be drawn, however, regarding issues not addressed in this Notice which may be suggested by a particular question and answer or as to why certain questions, and not others, are included.

Questions and Answers

Q-1: How does section 72(e)(8) of the Internal Revenue Code, which was added by TRA '86, affect the tax treatment of a distribution of employer securities having net unrealized appreciation?

A-1: Distributions from qualified plans are generally taxed according to the rules of section 72 (relating to annuities). However, section 402(a)(1) provides a specific rule that net unrealized appreciation (NUA) in employer securities attributable to employee contributions shall be excluded from the distributee's gross income. Section 402(e)(4)(J) also provides for the exclusion from gross income of all NUA in employer securities included as part of a lump sum distribution (determined without regard to section 402(e)(4)(H)).

Section 402(j) of the Code provides that the determination of NUA in employer securities shall be made without regard to any transaction in which the plan trustee exchanges the plan's securities for other such securities or disposes of employer securities and uses the proceeds of such disposition to acquire securities of the employer corporation within 90 days (or such longer period as the Secretary may prescribe). This change does not apply to any employee to whom a distribution of money was made after the disposition of securities and before the acquisition of other employer securities.

Section 402(e)(4)(J) of the Code as amended by TRA '86 also provides that a taxpayer may elect not to exclude NUA in employer securities distributed as part of a lump sum distribution (determined without regard to whether the employee has been a participant in the plan for five or more years). Such an election is to be made by attaching a signed statement to that effect to the income tax return (or amended return) filed for the year in which the distribution was received and by including the NUA as part of the distribution on the Form 4972, or, if no Form 4972 is filed, on line 16 of Form 1040.

The portion of NUA attributable to employee contributions is determined according to section 1.402(a)-1(b) of the Income Tax Regulations and the provisions of the plan document. Under these rules the employee contributions used to purchase the security shall be the amount of the employee contributions properly allocable to the employer security. Employee contributions are treated as properly allocable to employer securities that have been specifically earmarked as purchased with employee contributions. If employer securities cannot be so identified, a ratable allocation may be used. See section 1.402(a)-1(b)(3) of the regulations. Except as provided above, TRA '86 did not change the rules for allocating employee contributions to employer securities, or for excluding NUA received in a lump sum distribution pursuant to section 402(e)(4)(J).

NUA attributable to employee contributions in a distribution that is not a lump sum distribution is excludable from the distributee's gross income. The remainder of the distribution is taxed according to the rules of section 72. Prior to TRA '86, the remainder of a distribution received before the annuity starting date was excluded from gross income until the distributee's investment in the contract had been recovered. TRA '86 amended section 72 by adding section 72(e)(8), which provides for a pro-rata recovery of the employee's investment in the contract according to a ratio, the numerator of which is the employee's investment in the contract, and the denominator of which is the employee's account balance. Since NUA attributable to employee contributions is excluded under the rules of section 402(a)(1), the pro-rata rule of section 72(e)(8) is applied by reducing the employee's account balance by all NUA attributable to employee contributions, whether or not all of such securities are distributed. Notice 87-13, Q&A-11, is hereby modified to the extent that it states that the account balance is only reduced by the NUA portion of the distribution.

Example 1

Employee A has been a participant in Employer X's qualified profit-sharing plan since January 1, 1987. A contributes $6,000 to the plan over a five year period. All such contributions are invested in X securities, and the fair market value of these securities appreciates to $10,000. On January 1, 1992, A elects a distribution of X securities equal to one-half of his employee account balance, which has a value of $5,000. $2,000 of the distribution constitutes NUA, which is excluded from A's gross income. The remaining portion of the distribution ($3,000) is taxed according to the fraction determined under section 72(e)(8) after reducing the denominator of the fraction by the $4,000 NUA allocable to the account as follows:

$$\frac{\$6{,}000 \text{ employee contributions}}{(\$10{,}000 \text{ account balance} - \$4{,}000 \text{ NUA})} \times \$3{,}000 = \$3{,}000 \text{ recovery of basis}$$

Thus, A has no amount includible in gross income and has a basis in the securities distributed of $3,000.

On January 1, 1993, A receives an X securities distribution of his remaining account balance with a value of $5,000. $2,000 of the distribution constitutes NUA which is excluded from income. The remaining portion of the distribution ($3,000) is treated as a recovery of basis as follows.

$$\frac{\$3{,}000 \text{ employee contributions}}{(\$5{,}000 \text{ account balance} - \$2{,}000 \text{ NUA})} \times \$3{,}000 = \$3{,}000 \text{ recovery of basis}$$

Thus, A has no amount included in gross income as A has a basis in the securities of $3,000.

Example 2

Employee B has contributed $10,000 to his employer's qualified defined contribution plan since 1987. One-half of the employee's contributions is invested in a mutual fund and the other one-half is invested in employer securities. The mutual fund and the securities have a value of $10,000 each. Thus, B's basis in the plan, the NUA in employer securities, and the total value of B's account balance is as follows:

	Basis	*NUA*	*Value*
Employer Securities:	$5,000	$5,000	$10,000
Mutual Fund:	$5,000		$10,000
Total:	$10,000	$5,000	$20,000

The tax result of the following distributions under section 72(e)(8) is described below for each taxable year.

Year 1: The plan distributes employer securities which have a value of $3,000. $1,500 of the distribution constitutes NUA which is excludable from B's gross income. The amount of the distribution that is treated as a recovery of basis is determined as follows:

$$\frac{\$10{,}000 \text{ employee contributions}}{(\$20{,}000 \text{ account balance} - \$5{,}000 \text{ NUA})} \times \$1{,}500 = \$1{,}000 \text{ recovery of basis}$$

Thus, $1,000 is excluded from gross income as a recovery of basis, and $500 is included in income. After the distribution, the employer's account stands as follows:

	Basis	NUA	Value
Beginning Balance:	$10,000	$5,000	$20,000
Distribution:	($ 1,000)	($1,500)	($ 3,000)
Ending Balance:	$ 9,000	$3,500	$17,000

Year 2: The plan distributes mutual fund shares with a value of $3,000. The amount of the distribution that is treated as a recovery of basis is determined as follows:

$$\frac{\$9{,}000 \text{ employee contributions} \times \$3{,}000}{\$17{,}000 \text{ account balance} - \$\ 3{,}500 \text{ NUA})} \times \$2{,}000 \text{ recovery of basis}$$

Thus, $2,000 is excluded from gross income as a recovery of basis, and $1,000 is included in gross income. After the distribution, the employee's account stands as follows:

	Basis	NUA	Value
Beginning Balance:	$9,000	$3,500	$17,000
Distribution:	($2,000)	(0)	($ 3,000)
Ending Balance:	$7,000	$3,500	$14,000

Year 3: The plan distributes employer securities which have a value of $4,000. $2,000 of the distribution constitutes NUA which is excludable from B's gross income. The amount of the distribution that is treated as a recovery of basis is determined as follows:

$$\frac{\$7{,}000 \text{ employee contributions} \times \$2{,}000}{(\$14{,}000 \text{ account balance} - \$\ 3{,}500 \text{ NUA})} = \$1{,}333 \text{ recovery of basis}$$

Thus, $1,333 is excluded from gross income as a recovery of basis, and $667 is included in gross income. After the distribution, B's account stands as follows:

	Basis	NUA	Value
Beginning Balance:	$7,000	$3,500	$14,000
Distribution:	($1,333)	($2,000)	($ 4,000)
Ending Balance:	$5,667	$1,500	$10,000

Year 4: The plan distributes the remaining account balance consisting of $7,000 cash and $3,000 employer securities. $1,500 of the distribution constitutes NUA which is excludable from B's gross income. The amount of the distribution that is treated as a recovery of basis is determined as follows:

$$\frac{\$5{,}667 \text{ employee contributions} \times \$8{,}500}{(\$10{,}000 \text{ account balance} - \$\ 1{,}500 \text{ NUA})} = \$5{,}667 \text{ recovery of basis}$$

Thus, $5,667 would be excluded from gross income as a recovery of basis, and $2,833 would be included in gross income.

Q-2: What is the effective date of section 72(t) for section 403(b) annuity contracts?

A-2: In general, section 1123(e) of TRA '86 provides that the early distribution tax under section 72(t) will apply, with certain exceptions, to distributions under section 403(b) annuity contracts received in the taxable year of the individual taxpayer beginning after December 31, 1986. Section 72(t) applies to all distributions from plans described in section 4974(c) (as amended by TRA '86), which includes section 403(b) annuities. See also Q&A-22 of Notice 87-13.

Q-3: What withholding rules apply to qualified plan distributions to nonspouse alternate payees?

A-3: Section 3405 of the Code provides that federal income tax must be withheld from all designated distributions unless the individual elects not to have withholding apply. In general, a designated distribution is any payment or distribution from or under an employee deferred compensation plan but does not include the portion of a distribution which it is reasonable to believe is not includible in gross income.

Section 402(a)(9) of the Code provides that, for purposes of section 402(a)(1) and 72, any alternate payee who is the spouse or former spouse of the participant shall be treated as the distributee of any distribution or payment made to the alternate payee under a qualified domestic relations order as defined in section 414(p). The withholding rules therefore are applied as if the spouse or former spouse were the employee. However, there is no similar provision for distributions to nonspouse alternate payees. Therefore, distributions to a nonspouse alternate payee during the lifetime of the participant are not includible in such payee's gross income, but instead are included in the gross income of the plan participant. Consequently, amounts shall be withheld from the distribution as if the plan participant were the payee, unless the plan participant elects not to have the withholding rules apply.

Q-4: May a distribution to a nonspouse alternate payee be rolled over by the nonspouse alternate payee?

A-4: No. Section 402(a)(5) of the Code generally provides rollover treatment only if the distribution is paid to an employee and the employee transfers any portion of the property received to an eligible retirement plan; this rollover treatment applies only to the taxable portion of the distribution. However, a special rollover rule is provided under section 402(a)(6)(F). Under that special rollover rule, if the balance to the credit of the recipient by reason of a qualified domestic relations order (within the meaning of section 414(p)) is paid to the recipient within one taxable year, any portion of the distribution may be transferred to an individual retirement account or annuity in a qualifying rollover distribution. This treatment is available, however, only for a distribution that would otherwise be includible in the gross income of the recipient. Because the distribution to a nonspouse alternate payee is includible in the gross income of the participant under section 402(a)(9), no part of such a distribution may be rolled over by the nonspouse alternate payee. However, the participant may roll over such amounts by making a contribution to an eligible retirement plan if the requirements of section 402(a)(5) are otherwise satisfied.

Q-5: If an employee who has been cashed-out of a plan described in section 72(e)(8)(D) of the Code subsequently buys back into the plan, will the grandfathered investment in the contract be restored?

A-5: Section 72(e)(8)(D), as added by TRA '86, provides a special grandfather rule for pre-annuity starting date distributions from plans that on May 5, 1986, permitted withdrawal of any employee contributions before separation from service. Under this grandfather provision, the pro-rata rule of section 72(e)(8) will apply only to the extent that the amount of the nonannuity distribution is greater than the remaining amount of the participant's total investment in the trust or contract on December 31, 1986 (See Q&A-13 of Notice 87-13). Therefore, if an employee has been cashed-out of such a plan before January 1, 1987, a buyback after December 31, 1986, will not restore the grandfathered investment. In addition, a cash-out of a participant's interest after December 31, 1986, that reduced the participant's December 31, 1986, investment causes a permanent reduction in such grandfathered investment that may not be restored by a later buy-back.

Q-6: If an employee receives a distribution of a portion of the balance to the employee's credit after age 59½, is a subsequent distribution to the employee of the remainder of the balance to the credit in a later taxable year a lump sum distribution within the meaning of section 402(e)(4)(A)?

A-6: A lump sum distribution under section 402(e)(4)(A) is a distribution within a single taxable year of the entire balance to the credit of an employee which is paid to the recipient (a) on account of the employee's death, (b) after the employee attains age 59 ½, (c) on account of the employee's separation from service (in the case of an individual who is an employee without regard to section 401(c)(1)), or (d) after the employee has become disabled (in the case of an employee within the meaning of section 401(c)). The employee's balance to the credit is determined as of the first distribution received after such an event. Additional amounts that are credited to the employee after the date the balance is determined may be treated, but are not required to be treated, as part of the balance to the credit. For example, if in 1989 employee A receives $100,000 which represents A's entire balance as of January 1, 1989, A will be treated as having received the entire balance to his credit even though an additional $5,000 is allocated to A's account on December 31, 1989, on account of A's service in 1989.

Q-7: What is the tax treatment of distributions from an IRA containing nondeductible contributions when the participant's basis in the IRA exceeds the value of the IRA?

A-7: For purposes of determining the taxation of IRA distributions, all IRAs maintained for an individual must be aggregated and treated as one IRA. If the IRA owner has made nondeductible IRA contributions, a portion of a distribution from any IRA of such individual must be excluded from income as a return of nondeductible contributions according to a ratio, the numerator of which is the individual's total nondeductible contributions to all IRAs maintained for the individual, and the denominator of which is the total IRA account balance for all such IRAs. If the aggregate account balance of all IRAs is less than the aggregate nondeductible contributions to all IRAs, distributions are treated as consisting entirely of nondeductible contributions. A loss may be recognized if all IRA accounts have been distributed and the amounts distributed are less than the individual's unrecovered basis. Notice 87-16, D-5, is hereby clarified.

Q-8: How does the early distribution tax under section 72(t) of the Code apply to individuals who retire from the United States Government before age 55 and elect to receive the "lump sum credit" and alternative annuity pursuant to section 204 of the Federal Employees' Retirement System Act of 1986?

A-8: A federal retiree may elect to receive, in lieu of the normal monthly annuity retirement benefit, a "lump sum credit" (an amount generally equal to the retiree's after-tax contributions) and an actuarially reduced annuity. If a federal employee retires prior to the year in which he or she attains age 55, and elects to receive the lump sum credit, the 10-percent additional early distribution tax under section 72(t) will apply to the portion of the lump sum credit that is included in the retiree's gross income. However, this tax will not apply if the federal employee retires during or after the year in which he or she attains age 55. Furthermore, the additional tax will not apply to annuity payments paid after retirement, even if the federal employee retires prior to age 55 and receives his or her lump sum credit.

Q-9: May a federal employee who transfers from the Civil Service Retirement System to the Federal Employees' Retirement System roll over the taxable portion of a refund of employee contributions?

A-9: No. The taxable portion of a distribution may be rolled over into an eligible retirement plan only if the amount of the distribution is at least 50 percent of the employee's balance to the credit, and the distribution is made on account of the employee's death, separation from service, or disability. Since the distribution to federal employees who transfer to the Federal Employees' Retirement System will be less than 50 percent of the employee's balance to the credit, and is not made on account of any of the events described above, rollover treatment is not available.

Q-10: What amount is included in a plan participant's gross income when the participant receives a distribution from a qualified plan that includes a policy issued by an insurance company with a value substantially higher than the cash surrender value stated in the policy?

A-10: Subject to certain exceptions not here applicable, section 402(a) of the Code provides that the amount actually distributed by a qualified employees' trust shall be taxable to a plan participant in the year in which so distributed under section 72 (relating to annuities). Section 1.402(a)-1(a)(1)(iii) of the regulations provides that the amount includible in a plan participant's gross income by reason of the distribution of property by the plan shall be the fair market value of such property. Life insurance contracts constitute property within the meaning of this section. Section 1.402(a)-1(a)(2) of the regulations provides that a distributee must include in gross income the cash value of any retirement income, endowment, or other life insurance contract at the time of the distribution. Section 1.72-16(c)(2)(ii) of the regulations indicates that the reserve accumulation in a life insurance contract constitutes the source of and approximates the amount of such cash value.

Individuals who receive an insurance policy as a distribution from a qualified plan use the stated cash surrender value of the policy as its fair market value for purposes of determining the amount includible in their gross income under section 402(a) of the Code. However, this practice is not appropriate where the total policy reserves, including life insurance reserves (if any) computed under section 807(d), together with any reserves for advance premiums, dividend accumulations, etc., represent a much more accurate approximation of the fair market value of the policy than does the policy's stated cash surrender value. These circumstances are illustrated by the following example.

A is a participant in a qualified noncontributory defined benefit plan. On January 1, 1986, $400,000 of plan assets were used to purchase an insurance policy. The policy was distributed to A on January 1, 1988, two years after the date of purchase.

The policy provides a stated cash surrender value for each of the first five policy years, as set forth in the table below. The total end of year reserves held by the insurance company for the policy also are set forth in the table. These reserves may include life insurance reserves and any reserves for advance premiums, dividend accumulations, etc. Life insurance reserves, if any, are calculated using the rules in section 807(d) of the Code, which provides rules for determining the amount of those reserves for purposes of calculating the tax liability of the insurance company issuing the policy.

Year	Surrender Value	Reserves
1	$106,000	$406,949
2	$112,360	$426,596
3	$119,102	$447,052
4	$126,248	$468,178
5	$489,908	$489,908

As the total reserves for the policy at the end of year two, $426,597, substantially exceed the policy's cash surrender value, $112,360, the reserves represent a much more accurate approximation of the fair market value of the policy when distributed than does the policy's cash surrender value. Accordingly, the amount includible in A's gross income by reason of the distribution of the policy at the end of year two is an amount equal to the $426,597 reserve, not the $112,360 stated cash surrender value at that date.

In the case of a distribution in excess of A's accrued benefit, as defined in section 1.411(a)-7(a)(1) of the regulations, resulting from valuing the policy at $112,360 rather than $426,547, the distribution would not be treated as a distribution to A from a qualified plan and, depending upon the facts and circumstances of the case, could be treated as a reversion to the employer. Of course, depending on the facts and circumstances, such distributions could disqualify the plan because they raise a number of qualification issues under, for example, section 415 of the Code, limitations on benefits and contributions, section 401(a) requirements that benefits be definitely determinable, and section 401(a)(4), discrimination in contributions and benefits, particularly if A was a member of the group of employees in whose favor discrimination is prohibited and other employees were not provided with similar distributions.

Q-11: Does the 10-percent tax under section 72(t) apply to amounts that are included in a plan participant's gross income pursuant to section 72(m)(3)?

A-11: No. Section 72(m)(3) provides generally that employer contributions and trust income that are treated under regulations as having been applied to the purchase of life insurance protection for a plan participant must be included in the participant's gross income. However, such an amount is not treated as a distribution for purposes of section 72(t).

Q-12: In the case of an IRA or individual account plan, what constitutes a series of substantially equal periodic payments for purposes of section 72(t)(2)(A)(iv)?

A-12: Section 72(t)(1) imposes an additional tax of 10 percent on the portion of early distributions from qualified retirement plans (including IRAs) includible in gross income. However, section 72(t)(2)(A)(iv) provides that this tax shall not apply to distributions which are part of a series of substantially equal periodic payments (not less frequently than annually) made for the life (or life expectancy) of the employee or the joint lives (or joint life expectancies) of the employee and beneficiary. Section 72(t)(4) provides that, if the series of periodic payments is subsequently modified within five years of the date of the first payment, or, if later, age 59 ½, the exception to the 10 percent tax under section 72(t)(2)(A)(iv) does not apply, and the taxpayer's tax for the year of modification shall be increased by an amount, determined under regulations, which (but for the 72(t)(2)(A)(iv) exception) would have been imposed, plus interest.

Payments will be considered to be substantially equal periodic payments within the meaning of section 72(t)(2)(A)(iv) if they are made according to one of the methods set forth below.

Payments shall be treated as satisfying section 72(t)(2)(A)(iv) if the annual payment is determined using a method that would be acceptable for purposes of calculating the minimum distribution required under section 401(a)(9). For this purpose, the payment may be determined based on the life expectancy of the employee or the joint life and last survivor expectancy of the employee and beneficiary.

Payments will also be treated as substantially equal periodic payments within the meaning of section 72(t)(2)(A)(iv) if the amount to be distributed annually is determined by amortizing the taxpayer's account balance over a number of years equal to the life expectancy of the account owner or the joint life and last survivor expectancy of the account owner and beneficiary (with life expectancies determined in accordance with proposed section 1.401(a)(9)-1 of the regulations) at an interest rate that does not exceed a reasonable interest rate on the date payments commence. For example, a 50 year old individual with a life expectancy of 33.1, having an account balance of $100,000, and assuming an interest rate of 8 percent, could satisfy section 72(t)(2)(A)(iv) by distributing $8,679 annually, derived by amortizing $100,000 over 33.1 years at 8 percent interest.

Finally, payments will be treated as substantially equal periodic payments if the amount to be distributed annually is determined by dividing the taxpayer's account balance by an annuity factor (the present value of an annuity of $1 per year beginning at the taxpayer's age attained in the first distribution year and continuing for the life of the taxpayer) with such annuity factor derived using a reasonable mortality table and using an interest rate that does not exceed a reasonable interest rate on the date payments commence. If substantially equal monthly payments are being determined, the taxpayer's account balance would be divided by an annuity factor equal to the present value of an annuity of $1 per month beginning at the taxpayer's age attained in the first distribution year and continuing for the life of the taxpayer. For example, if the annuity factor for a $1 per year annuity for an individual who is 50 years old is 11.109 (assuming an interest rate of 8 percent and using the UP-1984 Mortality Table), an individual with a $100,000 account balance would receive an annual distribution of $9,002 ($100,000/11.109 = $9,002).

Q-13: Will the Service grant automatic approval of a change in valuation date for certain plans maintained by partnerships, S corporations, and personal service corporations (hereinafter referred to a "employers") that change their taxable year pursuant to section 806 of TRA '86?

A-13: Yes, provided certain requirements are met. A change in valuation date is a change in funding method requiring approval by the Internal Revenue Service. If a change in plan year is made in order for the plan year to continue to coincide with the employer's new taxable year, the plan's valuation date may be changed, without requesting prior approval from the Service, provided the requirements set forth below are satisfied.

1. The employer's taxable year and the plan year must coincide both before and after the change in taxable year.
2. The plan's valuation date is either the first day of the plan year or the last day of the plan year, both before and after any change in plan year. For example, if the valuation date was the first day of the plan year before any change in plan year, the plan must continue to use the first day of of the plan year, including the first day of the short plan year, as the valuation date after the change in plan year.
3. The employer's taxable year was changed to comply with section 706 of the Code, as amended by section 806 of TRA '86.
4. The principles regarding the creation and maintenance of amortization bases stated in section 4 of Rev. Proc. 85-29, 1985-1 C.B. 581, must be followed.
5. There must be attached to the Schedule B for the plan year of change a statement signed by the plan administrator (within the

meaning of section 414(g) of the Code) or an authorized representative of the plan sponsor stating that the plan administrator or plan sponsor agrees to the change in funding method.

A change in valuation date made pursuant to the requirements described above constitutes a change in funding method in determining whether Rev. Proc. 85-29 may be used in future plan years. If the change is made as part of an overall process to conform the plan year to a new calendar taxable year adopted by the employer pursuant to section 806 of TRA '86, the change in valuation date will be timely if all the requirements for change in valuation date specified in Rev. Proc. 85-29 are satisfied by the later of the time for filing the employer's tax return for the year ended December 31, 1987, or [sixty days after the date of publication of this Notice in the Internal Revenue Bulletin] and all the requirements under Rev. Proc. 87-27, 1987-1 C.B. 769, for automatic approval of a change in plan year are satisfied by August 26, 1988 (*See* Announcement 88-97, 1988-26 I.R.B. 47).

Reliance

This document serves as an "administrative pronouncement" as that term is described in section 1.6661-3(b)(2) of the regulations and may be relied upon to the same extent as a revenue ruling or revenue procedure.

Cost-of-Living-Adjustments—Defined Benefit Pension Plans

Notice 89-26[1]

The cost-of-living adjustments applicable to dollar limitations on benefits under qualified defined benefit pension plans and to other provisions affecting such plans are set forth.

Section 415 of the Internal Revenue Code provides for dollar limitations on benefits and contributions under these plans. It also requires that the Commissioner annually adjust these limits for cost-of-living increases. Effective Jan. 1, 1989, the maximum limitation for the annual benefit under section 415(b)(1)(A) for defined benefit plans is increased from $94,023 to $98,064.

The limitation for defined contribution plans under section 415(c)(1)(A) remains at $30,000 for 1989 since the law provides that it shall not be changed until the section 415(b)(1)(A) limit for benefits exceeds $120,000.

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 section 415(b)(1)(A) is adjusted. These dollar amounts and the adjusted amounts are as follows:

The special limitation for qualified police or firefighters under section 415(b)(2)(G) is increased from $52,235 to $54,480.

The limitation on the exclusion for effective deferrals under section 402(g)(1) is increased from $7,313 to $7,627.

The dollar amounts under section 409(o)(1)(C)(ii) for lengthening the distribution period of that section for tax credit employee stock ownership plans are increased from $104,470 to $108,960 and from $522,350 to $544,800.

The threshold amount under section 4980A(c)(1) regarding excess distributions is increased from $117,529 to $122,580.

The limitations used in the definition of highly compensated employee under section 414(q) of $75,000 and $50,000 are respectively increased to $81,720 and $54,480.

Because the $200,000 annual compensation limit under section 401(a)(17) and 404(1) of the Code is first effective for this year, such amounts will not be increased until 1990.

The compensation amount under section 408(k)(2)(C) regarding simplified employee pension plans (SEPs) is increased from $313 to $327. However, the compensation amount under section 408(k)(3)(C) is reduced, in accordance with the Technical and Miscellaneous Revenue Act of 1988, from $208,940 to $200,000.

Administrators of 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.

[1]Based on News Release IR-89-10, dated January 26, 1989.

Weighted Average Interest Rate Update

Notice 89-27

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 section 412(c)(7) of the Internal Revenue Code as amended by the Omnibus Budget Reconciliation Act of 1987 (OBRA 1987).

The notice also provides that an announcement will be published monthly to provide the weighted average and the permissible range for the plan years beginning each month. The following rates were determined for the plan years beginning in the months shown below.

Month	Year	Weighted Average	Permissible Range
February	1989	8.79	7.91 to 9.66

Administrative Pronouncement

This document serves as an "administrative pronouncement" as that term is described in section 1.6661-3(b)(2) of the Income Tax Regulations and may be relied upon to the same extent as a revenue ruling or revenue procedure.

Election of Special Treatment for Certain Losses on Deposits in an Insolvent or Bankrupt Financial Institution

Notice 89-28

As a result of recently enacted tax legislation, certain taxpayers may be eligible to elect ordinary loss treatment for reasonably estimated losses on deposits in a qualified insolvent or bankrupt financial institution, the deposits in which are not federally insured. The election is limited to qualified individuals and is effective for taxable years beginning after December 31, 1981, thus providing retroactive relief for certain taxpayers. This notice provides guidance to affected taxpayers, including substantive rules relating to both this ordinary loss election and a related casualty loss election, and procedural rules for electing the special loss treatment.

I. Background

Section 165(l) of the Internal Revenue Code was amended by section 1009(d) of the Technical and Miscellaneous Revenue Act of 1988 ("TAMRA"), Pub. L. No. 100-647, 102 Stat. 3342, to provide, in new section 165(l)(5), an election to treat reasonably estimated losses incurred on deposits in insolvent or bankrupt financial institutions (the deposits in which are not federally insured), as ordinary losses.

An election under section 165(l)(5) of the Code is in lieu of any election under section 165(l)(1). Section 165(l)(1) was added to the Code by section 905(a) of the Tax Reform Act of 1986 ("1986 Act"), Pub. L. No. 99-514, 100 Stat. 2746, to provide an election to treat reasonably estimated losses on deposits in insolvent or bankrupt financial institutions as casualty losses.

Prior to the 1986 Act, individual taxpayers who incurred losses on deposits in a financial institution were generally limited to treatment of the loss as a bad debt under section 166 of the Code in the taxable year in which the loss was sustained. In general, such a loss would be sustained in the year in which the actual amount of nonrecovery could be determined (the "final determination year"). Unless the loss arose in connection with the taxpayer's trade or business, it was generally considered a short-term capital loss. Thus, the 1986 Act, as amended by TAMRA, provides special relief both in terms of timing and character of the loss claimed.

The alternative elections provided in sections 165(l)(1) and 165(l)(5) of the Code apply to amounts that are "reasonably estimated" and therefore apply to taxable years prior to the final determination year. However, the failure of a taxpayer to claim a loss under section 165(l) in the year in which the loss can first be reasonably estimated will not preclude the taxpayer from claiming such loss in a later taxable year that is prior to the final determination year.

II. Eligibility

Before making an election to claim a loss under section 165(l) of the Code (either as a casualty loss or an ordinary loss), a taxpayer must confirm that: (1) the taxpayer is a qualified individual, as defined in section 165(l)(2); and (2) the amount at stake is a deposit (within the meaning of section 165(l)(4)) in a qualified financial institution (as defined in section 165(l)(3)). In addition, a taxpayer who wishes to make the ordinary loss election provided in section 165(l)(5) must determine that no part of the taxpayer's deposits in the financial institution is federally insured. Generally, this requirement will be met only in cases where none of the deposits in the financial institution are federally insured.

In general, a "qualified individual" is an individual who is not: (1) a 1% or more owner of the financial institution; (2) an officer of the financial institution; or (3) a person who is related, within the meaning of section 165(l)(2)(C) or (D), to any such owner or officer.

The term "deposit" means any deposit, withdrawable account, or repurchasable share. The term "qualified financial institution' includes any commercial bank, thrift institution, insured credit union, or similar financial institution chartered and supervised under federal or state law.

III. Determination of amount, character and timing of loss

In the event of insolvency or bankruptcy of a qualified financial institution, a qualified individual must determine the amount of the reasonably estimated loss on deposits in such financial institution. The character of the loss will depend on whether the taxpayer makes an election under section 165(l) of the Code. If an election is made under section 165(l), the reasonably estimated loss is deductible (after all applicable limitations) as an itemized deduction.

An election under section 165(l) of the Code is made for the taxable year in which the amount of the loss can be reasonably estimated. The amount of the loss is determined by the difference between a taxpayer's basis in the deposit and the amount that is reasonably estimated to be recovered. A reasonable estimate might be based, for example, on the percentage of total deposits likely to be recovered by the depositors according to a determination made by the regulatory authority or trustee having responsibility over the institution. If the estimated loss is less than the amount ultimately determined, a taxpayer may claim the difference in the final determination year under section 166.

IV. Retroactivity and consent to revoke previous casualty loss election

Taxpayers should note that, as a result of TAMRA, the casualty loss election provided in section 165(l)(1) is available for taxable years beginning after December 31, 1981. The ordinary loss election provided in section 165(l)(5) is also available for taxable years beginning after December 31, 1981.

Section 1009(d)(4) of TAMRA provides that, notwithstanding a bar on refunds for an earlier taxable year by any other provision of law, a taxpayer may, nevertheless, make an election under either section 165(l)(1) or (5) on or before November 9, 1989.

The Internal Revenue Service is aware that certain taxpayers previously elected to treat estimated losses as casualty losses under section 165(l)(1) of the Code. Under section 165(l)(6), a taxpayer may only revoke an election under section 165(l) with the consent of the Secretary. Based on the broad relief provided through the changes in the law resulting from section 1009(d) of TAMRA, the Secretary has concluded that otherwise eligible taxpayers should be allowed to claim ordinary loss treatment, notwithstanding a previously made casualty loss election. Accordingly, the Secretary hereby consents to a revocation of an election under section 165(l)(1) by a taxpayer provided the taxpayer elects under section 165(l)(5) by November 9, 1989, to treat the reasonably estimated loss as an ordinary loss. For all other cases, in which a taxpayer desires to revoke an election under section 165(l), the taxpayer must request, in writing, the consent of the Secretary setting forth the pertinent facts surrounding the election and the reasons for requesting a revocation.

V. Limitations on amount of loss

There are several limitations that apply to elections under section 165(l) of the Code for reasonably estimated losses with respect to deposits in an insolvent or bankrupt institution.

First, a taxpayer may make only one election with respect to all reasonably estimated losses on deposits in a qualified financial institution for any particular taxable year. Thus, a taxpayer who makes an ordinary loss election under section 165(l)(5) of the Code may not make a casualty loss election under section 165(l)(1) with respect to losses on deposits in the same financial institution. Likewise, a taxpayer who makes a casualty loss election with respect to losses on deposits in a financial institution may not also make an ordinary loss election with respect to losses on deposits in the same financial institution. Any election under section 165(l) precludes the taxpayer from claiming the same loss as a bad debt under section 166.

Second, the ordinary loss treatment allowed under section 165(l)(5) of the Code is limited to $20,000 ($10,000 in the case of a separate return by a married individual) in aggregate losses on deposits in any one financial institution. For this purpose, a taxpayer must aggregate losses with respect to all types of deposits (e.g., separate demand and savings accounts, shares, and certificates) in the same institution for any taxable year in which an election is made under section 165(l)(5). Furthermore, the applicable dollar limit must be reduced by the amount of any insurance proceeds that can reasonably be expected to be received under any state law.

VI. Effect of election on final determination year.

A taxpayer who makes an election under either section 165(l)(1) or (5) of the Code for a taxable year must reduce the taxpayer's basis in the deposits to the extent that a loss is claimed. Thus, any additional loss with respect to the final determination year must be determined by reference to a reduced basis in the deposits.

If a taxpayer claims a loss pursuant to an election under either section 165(l)(1) or (5) of the Code that exceeds the actual loss sustained, the taxpayer will be required to include in income (in the final determination year) the excess loss claimed.

VII. Time and manner of election

Section 5h.5 of the temporary Income Tax Regulations, relating to the time and manner of making certain elections under the 1986 Act, contains rules relating to the casualty loss election(§5h.5(f), 1987-1 C.B. 362). This notice provides superseding procedural rules, as follows in this section VII, for any election made under section 165(l) of the Code. Thus, a taxpayer making an election under section 165(l) makes the election under the procedural rules contained in this notice in lieu of the rules contained in §5h.5(f). In addition, these new time and manner rules for section 165(l) (as well as rules regarding the revocation of an election under section 165(l)) will be included in forthcoming regulations relating to elections under TAMRA.

In general, an election pursuant to section 165(l) of the Code is made by claiming the loss (casualty or ordinary) on the income tax return for the taxable year in which a reasonable estimate of such loss can be made.

In the case of an income tax return for a taxable year with respect to which: (1) no election under section 165(l) of the Code was made; and (2) the period prescribed for filing a claim for refund or credit has not yet expired, the qualified individual may file an amended return (Form 1040X) by the end of the period for filing such claim for the year of loss to claim the loss for that taxable year.

In the case of an income tax return previously filed, with respect to which the claim for refund or credit is barred by another provision of law, the affected taxpayer may, nevertheless, file an amended return (Form 1040X) on or before November 9, 1989, to make the election.

The election should include any information requested in applicable forms and instructions (e.g., Form 4684, Casualties and Thefts). If the pertinent form and its instructions contain no guidance on this election for a particular situation (e.g., certain refund cases), the taxpayer should, on an appropriate line or space: (1) clearly indicate the name of the financial institution; (2) include the following language: "Insolvent Financial Institution Election;" and (3) include the calculation of the reasonably estimated loss claimed.

VIII. Examples of limitations on amounts claimed as a loss

To illustrate the limitations under section 165(l) of the Code, assume individual *A* had $10,000 and individual *B* had $100,000 in aggregate deposits on account in bank *X*, the deposits in which are not federally insured. Assume further that in 1983 the bank became insolvent and the trustee estimated that depositors will eventually recover 65% of the basis in their deposits, although the final determination of that amount has not yet occurred. Finally, assume that *A* filed a claim for refund under section 165(l)(1) during 1987 with respect to 1983, claiming a $3,500 (35 %) casualty loss (before any limitation under section 165(h) and assuming no previous casualty loss claim), and that *B* (who is single) has not filed any claim for refund of any loss.

Under the facts presented, *A* may revoke the prior election under section 165(l)(1) of the Code as provided in section IV of this notice. *A* may elect ordinary loss treatment with respect to the $3,500 for 1983 by filing a properly completed Form 1040X in accordance with section VII of this notice by November 9, 1989. If *A* makes an election under section 165(l), *A* must also reduce the basis in the deposits by $3,500. If the actual loss that is ultimately determined exceeds the estimated loss, then *A* may claim the excess amount as a bad debt under section 166.

B, based on the facts presented, may make an election under section 165(l)(5) of the Code to treat $20,000 of the estimated $35,000 loss (35%) as an ordinary loss incurred in 1983. If *B* so elects, the basis of the deposits is reduced by $20,000. By making an election under section 165(l)(5), B is precluded from claiming a casualty loss under section 165(l)(1) with respect to any losses on deposits in the same institution. Therefore, B may not claim a casualty loss for the remaining $15,000. If the loss actually sustained exceeds $20,000, in the final determination year *B* may claim such excess loss under section 166.

In the alternative, *B* may make an election under section 165
(l)(1) by November 9, 1989, to treat the entire estimated loss of $35,000 as a casualty loss incurred in 1983, subject to the generally applicable limitations of section 165(h).

IX. Administrative pronouncement

This document serves as an "administrative pronouncement" as that term is described in section 1.6661-3(b)(2) of the Income Tax Regulations and may be relied upon to the same extent as a revenue ruling or revenue procedure.

Gasoline Wholesalers; Credit or Refund under Section 6416

Notice 89-29

This Notice informs taxpayers of an amendment made by section 6102 of the Technical and Miscellaneous Revenue Act of 1988 (Pub. L. 100-647) ("1988 Act") to the gasoline excise tax credit and refund provision under section 6416 of the Internal Revenue Code, and sets forth the procedures the Internal Revenue Service will adopt in regulations implementing this section of the 1988 Act. These procedures will be effective as of October 1, 1988. Section 6102 of the 1988 Act provides that, if certain conditions are met, a gasoline wholesale distributor will be treated as the person who paid the gasoline excise tax for purposes of claiming a credit or refund under section 6416 of the Code.

Section 6416(b)(2) of the Code provides that the person that paid gasoline excise tax to the government under section 4081 may receive a credit or refund of the amount of such tax if the gasoline is, by any person, exported, used or sold for use as supplies for vessels or aircraft, sold to a state or local government for its exclusive use, sold to a nonprofit educational organization for its exclusive use, or used or sold for use in the production of special fuels, ("exempt purposes").

Section 48.6416(a)-3(b) of the Manufacturers and Retailers Excise Tax Regulations conditions this credit or refund upon a showing that the person that paid the tax (1) has not included the tax in the price of the gasoline with respect to which it was imposed and has not collected the amount of the tax from a person that purchased such gasoline; or (2) has repaid or agreed to repay the amount of the tax to the ultimate vendor of the gasoline; or (3) has obtained the written consent of such ultimate vendor to the allowance of the credit or refund. Section 48.6416(b)(2)-3 sets forth the supporting evidence required for obtaining such credit or refund.

Effective for sales of gasoline on or after October 1, 1988, section 6102 of the 1988 Act added section 6416(a)(4) to the Code. Section 6416(a)(4) provides that a wholesale distributor who purchases gasoline tax paid and sells the gasoline directly to its ultimate purchaser is treated as the person (and the only person) who paid the gasoline tax to the government.

Under section 6416(a)(4)(B) of the Code, the term "wholesale distributor" includes any person who sells gasoline to producers, retailers, or to users who purchase in bulk quantities and deliver into bulk storage tanks. For this purpose, the term "producer" includes a refiner, compounder, blender, or wholesale distributor of gasoline, or a dealer selling gasoline exclusively to producers of gasoline. The term "wholesale distributor" does not include any person that is an importer, refiner, compounder, or blender of gasoline, or is a dealer selling gasoline exclusively to producers.

Therefore, if a wholesale distributor (1) purchases gasoline at a price that includes the tax, (2) sells such gasoline after September 30, 1988, directly to the ultimate purchaser for an exempt purpose (with an exporter treated as the ultimate purchaser in the case of exported gasoline), and (3) meets the other requirements of section 6416 of the Code and this Notice, then the wholesale distributor is treated as the person who paid the tax to the government and is the only person eligible to claim a credit or refund under section 6416. In such a case the person that actually paid the tax on the gasoline is not eligible to claim the credit or refund. However, if the tax is not included in the price of the gasoline purchased by the wholesale distributor, or the gasoline is not sold directly to the ultimate purchaser by the wholesale distributor, then only the person who actually paid the tax to the government may file a claim under section 6416.

Regulations will provide that, for purposes of section 6416(a)(4) of the Code, a sale charged on an oil company credit card issued to an exempt person is not considered a direct sale by the wholesale distributor to the ultimate purchaser (assuming that the wholesale distributor receives a reimbursement from the oil company with respect to such sale that is based on a price that includes the tax). Thus, the person who actually paid the tax is treated as the taxpayer eligible to claim a credit or refund for such sale.

Regulations will provide that, in order to qualify as a wholesale distributor for purposes of eligibility to claim a credit or refund under section 6416 of the Code, a person must (1) hold itself out to the public as being engaged in the trade or business of selling gasoline to producers of gasoline (including wholesale distributors), to retailers, or to users of gasoline who purchase in bulk quantities and accept delivery into bulk storage tanks; and (2) actually make more than casual sales of gasoline to the producers, retailers, or users described in (1). For purposes of determining whether a person meets this definition of wholesale distributor, a bulk storage tank is any tank that is not the fuel supply tank of an aircraft, train, vehicle, or vessel. Delivery into a bulk storage tank may be made by means of a "cardlock system" at an unattended location.

In order for the wholesale distributor to obtain a credit or refund under section 6416 of the Code for gasoline sold to an ultimate purchaser after September 30, 1988, the wholesale distributor must (1) submit a statement that it sold the gasoline at a price that did not include the tax, and did not otherwise collect the amount of the tax from a purchaser, and (2) obtain a certificate of ultimate purchaser as described in section 48.6416(b)(2)-3(b) of the Regulations. However, any wholesale distributor that provides a Statement of Ultimate Vendor, or transmits a certificate of ultimate purchaser, as described in section 48.6416(b)(2)-3(b), to its vendor, if such Statement or certificate is executed on or before March 31, 1989, for any sale of gasoline to which this amendment applies, is not treated as the taxpayer for such sale. If the wholesale distributor provides a Statement of Ultimate Vendor, or transmits a certificate of ultimate purchaser, to its vendor, then the person that actually paid the tax on gasoline for sales covered by such Statement or certificate is the person eligible to claim the credit or refund of such tax. Any wholesale distributor that is eligible to claim a credit or refund under section 6416 of the Code may not provide a Statement of Ultimate Vendor, or transmit a certificate of ultimate purchaser, to its vendor if such Statement or certificate is executed on or after April 1, 1989.

A claim for credit, up to the amount of the wholesale distributor's excise tax liability for the quarter (including, for example, liability for tax on sales of diesel fuel), is made on Form 720 ("*Quarterly Federal Excise Tax Return*"), Line 2. A claim for refund is made on Form 843 ("*Claim*"). Each claim for refund of gasoline excise tax imposed on any gasoline sold for an exempt purpose generally must be filed within three years of the date the excise tax return was filed by the person that actually paid the tax. A claim for credit or refund must be accompanied by the required supporting documents described in section 48.6416(b)(2)-3(a) of the Regulations and must include a statement that sets forth the basis for the claimant's eligibility to claim a credit or refund under section 6416 of the Code as a gasoline wholesale distributor.

A claim for credit or refund under section 6416 of the Code by the person that paid (or that is treated under this Notice as having paid) the tax to the government is an alternative to a claim for credit or refund under section 6421 by the ultimate purchaser. For any particular transaction, a claim may be filed under only one of these two sections. As provided in Notice 88-13, 1988-1 C.B. 481, the regulations under section 6416 as they relate to the gasoline excise tax will be amended to provide that the person that paid (or that is treated under this Notice as having paid) the tax to the government may not claim a credit or refund unless it has received from the ultimate purchaser a certification that the ultimate purchaser has not and will not claim a credit or refund under section 6421.

This document serves as an "administrative pronouncement" as that term is described in section 1.6661-3(b)(2) of the Income Tax Regulations and may be relied upon to the same extent as a revenue ruling or revenue procedure.

Amendments to Temporary Income Tax Regulations Under Section 367(b) of the Code

Notice 89-30

Concurrently with this Notice, section 7367(b)-9 of the temporary Income Tax Regulations is being amended to provide that a foreign corporation will not succeed to the earnings and profits or deficit in earnings and profits of another foreign corporation except to the extent provided in section 381(a) of the Internal Revenue Code of 1986 and the regulations under that section if the stock of the first corporation is received in an exchange subject to section 7.367(b)-9 of the temporary regulations, and a U.S shareholder described in section 7.367(b)-7 (b) or section 367(b)-8(c)(1) owns (applying the attribution rules of section 958 of the Code) more than 50 percent of either the total voting power or the total value of the stock of both the corporation whose stock is received in the exchange and the corporation whose stock is exchanged. The amendment is effective on or after the date it is filed with the Federal Register.

Since under the above amendment to the temporary regulations, the foreign corporation whose stock is received in the exchange will only succeed to the earnings and profits or deficit in earnings and profits of the acquired corporation and of lower-tier subsidiaries of the acquired corporation as provided in section 381(a) of the Code and the regulations thereunder, post exchange distributions of earnings and profits and sales of stock may in some circumstances result in double counting of section 1248 earnings. Regulations which will finalize the temporary regulations under section 367(b) will be issued to prevent this double counting of earnings and profits. The regulations with regard to this issue, when finalized, will be retroactive to the effective date of the above amendment.

ADMINISTRATIVE PRONOUNCEMENT

This document serves as an ''administrative pronouncement'' as that term is described in section 1.6661-3(b)(2) of the Income Tax Regulations and may be relied upon to the same extent as a revenue ruling or revenue procedure.

Interest Rate for Pension Plan Funding

Notice 89-31

This notice provides guidance as to the reasonable interest rate within the permissible range that is to be used for purposes of determining the current liability component of the full funding limitation for plan years commencing after December 31, 1987, and prior to January 1, 1989.

Background

Section 412(c)(7) of the Internal Revenue Code, as amended by section 9301 of the Omnibus Budget Reconciliation Act of 1987 (OBRA 87) provides that the full funding limitation of a pension plan for a plan year is the excess (if any) of (i) the lesser of (I) 150 percent of current liability, or (II) the accrued liability (including normal cost) under the plan (determined under the entry age normal funding method if such accrued liability cannot be directly calculated under the funding method used for the plan) over (ii) the lesser of (I) the fair market value of the plan's assets, or (II) the value of such assets determined under paragraph (2) of section 412(c).

Section 404(a)(1)(A) of the Code provides that the amount deductible with respect to a defined benefit pension plan may not exceed the full funding limitation of section 412 of the Code. Therefore, the changes made by section 9301 of OBRA 87, limit the maximum deductible amount with respect to plan years beginning after December 31, 1987, to the amount needed, if any, to increase the plan's assets to the lesser of 150 percent of current liability or the accrued liability under the plan.

Section 412(b)(5) of the Code, as amended by section 9307 of OBRA 87, provides that in determining current liability the interest rate to be used shall be within the permissible range which is not more than 10 percent above and not more than 10 percent below the weighted average of the 30-year Treasury securities and shall be consistent with the assumptions which reflect the purchase rates which would be used by insurance companies to satisfy the liabilities under the plan.

Notice 88-73, 1988-2 C.B. 383, sets forth the methodology used to determine the permissible range. Also, Notice 88-73 provided the permissible range for plan years commencing in January and February 1988. Subsequent notices have provided the permissible range for plan years commencing during subsequent months of 1988. These notices did not provide guidance as to what rate within the permissible range is to be used to in determining the current liability of any plan.

Interest Rate

For plan years commencing after December 31, 1987, and prior to January 1, 1989, the interest rate within the permissible range that is to be used to determine current liability must be any interest rate that (1) is not less than the greater of (a) the interest rate that is 90 percent of the weighted average of 30-year Treasury securities (i.e. the lower end of the permissible range) and (b) 8 percent, and (2) is not greater than 110 percent of the weighted average of 30-year Treasury securities (i.e. the upper end of the permissible range). The interest rates specified in the previous sentence are deemed to be consistent with the assumptions which reflect the purchase rates which would be used by insurance companies to satisfy the liabilities under a plan upon plan termination for the plan years commencing prior to January 1, 1989. No interest rate other than those specified in this notice may be used to compute current liability.

Examples

Example 1 The plan year of defined benefit plan *A* is the calendar year. For the 1988 calendar year, the permissible range is 8.25 percent to 10.09 percent. Accordingly, under this notice, the interest rate used to determine current liability must be any interest rate from 8.25 percent to 10.09 percent. No interest rate less than 8.25 percent (e.g. 8.00 percent or 8.24 percent) may be used and no interest rate greater than 10.09 percent (e.g. 10.10 percent or 10.25 percent) may be used.

Example 2 - The plan year of defined benefit plan *B* begins on October 1 of one calendar year and ends on September 30 of the following calendar year. For the plan year beginning October 1, 1988, the permissible range is 7.97 percent to 9.75 percent. Accordingly, under this notice, the interest rate used to determine current liability must be an interest rate from 8.00 percent to 9.75 percent. No interest rate less than 8.00 percent (e.g. 7.99 percent) may be used and no interest rate greater than 9.75 percent (e.g. 9.76 percent) may be used.

Administrative Pronouncement

This document serves as an ''administrative pronouncement'' as that term is described in section 1.6661-3(b)(2) of the regulations and may be relied upon to the same extent as a revenue ruling or revenue procedure.

Employee Plans—Corrective Distributions

Notice 89-32

PURPOSE AND SCOPE

This Notice describes the reporting requirements of the Internal Revenue Code of 1986 (''Code'') for corrective distributions of excess deferrals under section 402(g), excess contributions under section 401(k), and excess aggregate contributions under 401(m). It applies to qualified plans described in section 401(a), section 401(k) cash or deferred arrangements, annuity plans described in section 403(a), section 403(b) salary reduction agreements, and salary reduction simplified employee pensions described in section 408(k)(6).

Notice 87-77, 1987-2 C.B. 385, and Notice 88-33, 1988-1 C..B. 513, summarize the reporting requirements for 1988 corrective distributions of excess amounts includible in gross income in 1987. Generally, those excess amounts, adjusted for any gains and losses (''income'') allocable to those amounts, are reported on Form W-2P (or, in rare circumstances, Form 1099-R) for 1988, the year in which the distribution was made. However, the 1988 Form W-2P (or Form 1099-R) should contain the distribution code ''P'' to indicate that the amounts (and income) are includible in gross income in the prior year, 1987.

The Technical and Miscellaneous Revenue Act of 1988, P.L. 100-647 (TAMRA), retroactively amended sections 402(g)(2) and 4979(f)(2) of the Code, which prescribe when excess deferrals, excess contributions and excess aggregate contributions (and the income allocable to such amounts) are includible in gross income. This Notice describes the effects of the TAMRA amendments on the corrective distribution reporting procedures of Notices 87-77 and 88-33.

TAMRA AMENDMENTS

Section 1011(c)(1)(B) of TAMRA retroactively amends section 402(g)(2)(C)(ii) of the Code, which governs the tax treatment of income allocable to excess deferrals. Effective for taxable years after 1986, the income allocable to a corrective distribution of an excess deferral shall be treated as earned and received in the year of distribution, rather than in the year of deferral. The principal amount of the excess deferral is still includible in gross income in the year of deferral. The transition rules applicable to this provision are described below in "EXCESS DEFERRALS."

Section 1011(1)(11) of TAMRA retroactively amends section 4979(f)(2) of the Code, by adding new subparagraph (B) for de minimis distributions of excess contributions and excess aggregate contributions, effective for plan years after 1986. Under this rule, certain corrective distributions of de minimis amounts (less than $100) of excess contributions and excess aggregate contributions (but not excess deferrals) are includible in gross income in the year distributed rather than in the year deferred. The conditions under which this de minimis rule applies are described below in "EXCESS CONTRIBUTIONS AND EXCESS AGGREGATE CONTRIBUTIONS."

REPORTING REQUIREMENTS

For corrective distributions in 1989 (and subsequent years until further guidance is issued), the reporting requirements in Notices 87-77 and 88-33 continue to apply, except as specifically modified by this Notice. Recipients of corrective distributions who may choose any alternative tax treatment permitted in this Notice may do so regardless of the treatment chosen by the plan administrator or payor for reporting purposes.

EXCESS DEFERRALS

Before TAMRA, both an excess deferral and any income allocable to the excess deferral were includible in gross income in the year of deferral, if they were distributed in a corrective distribution. After TAMRA, the income allocable to the excess deferral is includible in gross income in the year of the corrective distribution. TAMRA did not change the tax treatment of the principal amount of the excess deferral, which remains includible in gross income in the year of deferral.

In reliance on Notices 87-77 and 88-33, many plan administrators, payors, and recipients reported the income allocable to excess deferrals for 1987 (distributed timely in 1988) as income for 1987. Furthermore, many plan administrators and payors have applied the principles of those Notices to excess deferrals for 1988, notifying the recipient that the income on the excess deferrals (distributed timely in 1989) is includible in gross income for 1988. In such a case, the Service will consider the plan administrator or payor to have satisfied the reporting requirements of Notice 87-77 and Notice 88-33, provided that the excess deferral is distributed timely on or before April 17, 1989. Moreover, the income on such an excess deferral may be reported by the recipient, at his or her option, as income for either the year of distribution (TAMRA rule) or the year of deferral (pre-TAMRA rule), even if the plan administrator or payor has reported it as income for a different year.

For excess deferrals distributed after April 17, 1989, the pre-TAMRA rule may not be used. Thus, income on an excess deferral distributed in a corrective distribution after April 17, 1989, should be included in gross income only in the year of distribution.

Corrective Distributions of Excess Deferrals

If a corrective distribution of excess deferrals and income is made timely in the year after the year of the deferral, and the TAMRA rule is used to treat the income on the excess deferral as income for the year of distribution, two separate Forms W-2P must be filed for the year of distribution. The portion of the distribution representing the excess deferral (unadjusted for income) is reported in both the gross distribution box and the taxable amount box on one Form W-2P, and the appropriate distribution code (code "P" for the taxable year before the distribution year) is specified in the code box. The portion of the distribution representing the income on the excess deferral is reported in both the gross distribution box and the taxable amount box on a second Form W-2P, and a current year distribution code (code "8") is specified in the code box. If income on the excess deferral is negative (due to net losses), the reporting procedures described below under "*Loss on Excess Deferral*" should be followed.

If the corrective distribution is made in the same taxable year as the excess deferral, or if the pre-TAMRA rule is used to treat the income on an excess deferral for 1987 or 1988 as income for the year of deferral, only one Form W-2P (or, if applicable, Form 1099-R) must be filed as provided in Notice 87-77. The excess deferral (adjusted for income on the excess deferral) must be reported in both the gross distribution box and the taxable amount box on the Form W-2P (or Form 1099-R) for the year of the distribution and the appropriate distribution code must be specified.

Loss on Excess Deferral

If income allocable to an excess deferral is negative (as a result of allocation of losses to the excess deferral), Notice 88-33 permits the loss to be reported as a bracketed amount on the Other Income line, Form 1040. The full amount of the excess deferral (without reduction for the loss) is reported on Line 7, Wages, Salaries, Tips, Etc., of the Form 1040.

Prior to TAMRA, both amounts were reported on the Form 1040 for the year in which the elective deferral was made. After TAMRA, the income (whether positive or negative) allocable to the excess deferral is reportable in gross income for the year in which the corrective distribution is made. However, for corrective distributions of excess deferrals on or before April 17, 1989, recipients may report the loss on the Other Income line, Form 1040, either for the year of the deferral or for the year of the distribution.

For corrective distributions of excess deferrals after April 17, 1989, the recipient may not report the loss on the Form 1040 for the year of the deferral, unless the corrective distribution occurs in the same year. Thus, if the corrective distribution of an excess deferral is made in the year after the year of deferral, and a net loss has been allocated to the excess deferral, the loss is reported on the Other Income line, Form 1040, for the year in which the corrective distribution occurs, though the excess deferral (unadjusted for the loss) is reported on Line 7, Form 1040, for the year of the deferral. Since the corrective distribution amount cannot exceed the excess deferral adjusted for the loss, filers of Form W-2P should report the corrective distribution amount in both the gross distribution box and taxable amount box on Form W-2P for the year of the distribution, and the distribution code for the year in which the excess deferral is included in gross income should be specified. Filers of Form W-2P should provide the participant with a separate statement that an excess deferral, unadjusted for loss, is reportable on Line 7, Form 1040, for the year of deferral, and that the loss may be reported as a bracketed amount on the Other Income line, Form 1040, for the appropriate year (either the deferral year or the distribution year for corrective distributions on or before April 17, 1989; only the distribution year for corrective distributions after April 17, 1989).

Reporting Total Elective Deferrals on Form W-2

Instructions for Box 16 of the 1988 Form W-2, Wage and Tax Statement, require the filer to include in Box 16 the amount of elective deferrals made by an employee during 1988. This amount should be the total elective deferrals (including excess deferrals unadjusted for income) of the employee under the plan for the year. No portion of the elective deferrals (whether or not excess deferrals were made) should be reported as wages in Box 10 of Form W-2.

For example, Employee Smith receives an annual salary of $50,000. For 1988, he makes elective deferrals to a 401(k) plan totalling $8,313, reducing his salary to $41,687. His excess deferral to the plan for 1988 is $1,000 ($8,313 minus $7,313, the 1988 dollar limit). Mr. Smith's 1988 Form W-2 should reflect $41,687 in wages in Box 10, and $8,313 in elective deferrals in Box 16. Though the $41,687 wage amount, the $1,000 excess deferral, and any income on the excess deferral (to the extent includible in income in 1988) must be combined and reported as wages on Line 7 of Mr. Smith's 1988 Form 1040, Individual Income Tax Return, such amounts should not be combined in Box 10 of his 1988 Form W-2.

EXCESS CONTRIBUTIONS AND EXCESS AGGREGATE CONTRIBUTIONS

Before TAMRA, excess contributions and excess aggregate contributions (and allocable income) distributed within 2½ months after the close of the plan year were includible in the gross income of the employee in the earliest taxable year for which the employee could have received those contributions in cash. Under the TAMRA de minimis rule, if the principal amount of excess contributions and excess aggregate contributions under a plan for a plan year total less than $100, and are distributed to a recipient in a corrective distribution within 2½- months after the close of the plan year, the excess amounts (adjusted for any income on those amounts) are includible in gross income for the recipient's taxable year in which the corrective distribution is made.

This de minimis rule is retroactively effective for plan years after 1986. However, many plan administrators, payors, and recipients have relied on Notices 87-77 and 88-33 to treat deminimis amounts of excess contributions and excess aggregate contributions (adjusted for income) for 1987 or 1988 as includible in gross income for the year of the elective contribution, instead of the year of the corrective distribution. In such a case, the Service will consider the plan administrator or payor to have satisfied the reporting requirements of Notice 87-77 and 88-33, provided that the corrective de minimis distribution of excess contributions and excess aggregate contributions is made within 2½ months after the close of the plan year, but not later than April 17, 1989. Moreover, in such a case, the recipient may report the corrective de minimis distribution in gross income for either the year of distribution (TAMRA rule) or the year for which the contribution is made (pre-TAMRA rule), even if the plan administrator or payor has reported it as income for a different year.

If the pre-TAMRA rule is used, the procedures specified in Notice 87-77 for excess contributions and excess aggregate contributions should be followed even for amounts under $100. If the TAMRA rule is used, the de minimis total of excess contributions and excess aggregate contributions (adjusted for income) should be reported in the gross distribution box and the taxable amount box on Form W-2P for the year of the distribution, and the current year distribution code should be specified.

The pre-TAMRA rules may not be used for excess contributions and excess aggregate contributions distributed after April 17, 1989. Thus, a corrective de minimis distribution made after April 17, 1989, but within 2½ months after the close of the plan year must be included in gross income in the distribution year.

CORRECTIVE DISTRIBUTIONS IN SECOND YEAR AFTER ELECTION

For plan years commencing after October 15 and before January 1, a corrective distribution might be made timely in the second calendar year following the year in which it is includible in gross income. For example, a corrective distribution on February 15, 1989, from a plan with a plan year commencing December 1, 1987, is generally includible in the recipient's gross income in calendar year 1987. This distribution is reportable on the 1989 Form W-2P; new distribution code "D" for 1989 indicates that the amounts are includible in gross income for 1987.

RECHARACTERIZED EXCESS CONTRIBUTIONS

To the extent that regulations permit, excess contributions (but not excess deferrals or excess aggregate contributions) may be recharacterized as employee contributions instead of being distributed in a corrective distribution. The employer or plan administrator must promptly notify the employees to whom the excess contributions are attributable that the excess amounts are being recharacterized and must inform them of the tax consequences of the recharacterization. The date of the recharacterization is the date on which the last affected employee is notified. If notification is provided by the plan administrator, the plan administrator must inform the employer of the date of the recharacterization not later than 30 days after such date.

Recharacterized excess contributions must be reported on the Form W-2P for the taxable year of the recipient in which a corrective distribution would have occurred but for the recharacterization. The appropriate distribution code must be specified to identify the year for which the recharacterized amounts are included in gross income. In the event of recharacterization, no income is allocated to the excess contributions.

SEPARATE FORM 1099-R FOR CORRECTIVE DISTRIBUTION

Notices 87-77 and 88-33 and Form 1099-R instructions contemplate that Form 1099-R, instead of Form W-2P, may be used to report a corrective distribution if a total distribution of the employee's account is made in the same year. Since no portion of a corrective distribution is subject to lump-sum or rollover treatment, two Forms 1099-R should be used. One Form 1099-R should be used for the corrective distribution and another should be used for the balance of the total distribution.

If a recipient has rolled over a corrective distribution to an individual retirement arrangement (IRA), the amount should be withdrawn from the IRA under sections 408(d)(4) or 408(d)(5) of the Code to avoid adverse tax consequences. For more information, see Publication 590, Individual Retirement Arrangements (IRAs).

FORM 1040

Excess deferrals, excess contributions, and excess aggregate contributions are treated as wages for income tax purposes, but not for withholding purposes. Thus, any excess deferrals, excess contributions, and excess aggregate contributions must be combined with the recipient's wage income and reported on Line 7, Form 1040, for the recipient's appropriate taxable year, though not included in the wages box (Box 10) on Form W-2.

Income allocable to excess deferrals, excess contributions, and excess aggregate contributions is generally not treated as wages for income tax or withholding purposes. However, many recipients of corrective distributions will be unable to distinguish the income distributed from the excess distributed. Therefore, the recipient should report income (except for losses on excess deferrals), as well as the excess, on Line 7, Form 1040, for the appropriate taxable year, whether or not the amount of the income can be separately identified. Losses on excess deferrals are reported as a bracketed amount on the Other Income line, Form 1040, for the appropriate taxable year.

RELIANCE

This document serves as an ''administrative pronouncement'' as that term is described in section 1.6661-3(b)(2) of the regulations and may be relied upon to the same extent as a revenue ruling or a revenue procedure.

Guidance to Taxpayers Concerning the Retroactive Extension and Amendment of Educational Assistance Prorams Under Section 127 of the Internal Revenue Code of 1986

Notice 89-33

This notice provides guidance regarding the proper tax treatment of educational assistance received by employees in 1988 under section 127, 117 or 132 of the Internal Revenue Code of 1986, as amended by the Technical and Miscellaneous Revenue Act of 1988, Pub. L. 100-647 (Act).

EMPLOYER-PROVIDED EDUCATION

Section 4001 of the Act retroactively restores for an employee's first taxable year beginning after December 31, 1987, the exclusion from gross income for up to $5,250 of educational assistance provided under an educational assistance program described in section 127 of the Code. The section 127 exclusion for such educational assistance is not available for taxable years beginning after December 31, 1988. In addition, section 4001 of the Act retroactively amends the definition of ''educational assistance'' to provide that for years beginning after 1987 such term does not apply to graduate level courses. Specifically, the exclusion does not apply to any payment for, or the provision of any benefits with respect to, any course taken by an employee who has a bachelor's degree or is receiving credit toward a more advanced degree, if the particular course can be taken for credit by any individual in a program leading to a law, business, medical, or other advanced academic or professional degree. Section 127(c)(1).

As a result of these changes and due to administrative considerations for facilitating the filing of income tax returns, for calendar year 1988, the following special rules will apply to educational assistance of a type defined in section 127(c), as in effect on December 31, 1987, provided under educational assistance programs as defined in section 127, as in effect on December 31, 1987. To the extent the amount of any employment-related education, described in section 1.162-5(a) of the Treasury Regulations (relating generally to deductible educational expenses), is included in an employee's income on Form W-2, Wage and Tax Statement, the employee may deduct such amount from gross income in computing adjusted gross income. Employees should file Form 1040 and attach Form 2106, Employee Business Expenses. The amount of such educational assistance included in the employee's wages on Form W-2 should be entered on line 4 of Form 2106. This amount is not subject to Federal employment taxes, including income tax withholding, and employers should correct any underpayment or overpayment pursuant to the instructions provided in Circular E (Employers Tax Guide).

For taxable years beginning after December 31, 1987, any tuition reduction received by a graduate student engaged in teaching or research activities is not included in the graduate student's gross income, subject to the limitation provided in section 117(c), if the tuition reduction meets the requirements of section 117(d), as amended by section 4001 of the Act.

Educational assistance that is not excludible under section 117, section 127, or section 132 and that is not employment related education, as described in section 1.162-5(a), is includible in gross income and subject to Federal income tax and employment taxes. If amounts that are properly excludible under section 117, section 127, or section 132 are erroneously included in the employee's gross income on Form W-2, the employee may deduct such amount in computing adjusted gross income using Form 2106 in the manner described above.

ADMINISTRATIVE PRONOUNCEMENT

This document serves as an ''administrative pronouncement'' as that term is described in section 1.6661-3(b)(2) of the Income Tax Regulations and may be relied upon to the same extent as a revenue ruling or revenue procedure.

Income Derived by Indians From Exercise of Fishing Rights

Notice 89-34

The purpose of this notice is to inform affected taxpayers that section 7873 of the Internal Revenue Code, added by section 3041 of the Technical and Miscellaneous Revenue Act of 1988 (the Act), Pub. L. No. 100-647, 102 Stat. 3342, exempts from federal income and employment taxes certain income derived by Indians from the exercise of their recognized tribal fishing rights. Under section 3042 of the Act, such income is also exempt from state and local taxation.

Section 7873 of the Code generally exempts from federal taxes income derived by an individual member of an Indian tribe, or by a ''qualified Indian entity'' of a tribe, from a ''fishing rights-related activity'' of the tribe, as these terms are defined below.

In general, a business entity is a qualified Indian entity of a tribe if it is (1) engaged in a fishing rights-related activity of the tribe, (2) 100% owned by one or more qualified Indian tribes, their members, or the spouses of members, and (3) managed by members of such tribes. If an entity is engaged in substantial processing or transporting of fish, it generally is not considered a qualified Indian entity unless 90 percent or more of its annual gross receipts are derived from fishing rights-related activities of one or more qualified Indian tribes each of which owns at least 10 percent of the equity interests in the entity. (For this purpose, ownership by members of a tribe and their spouses is treated as ownership by that tribe.)

An Indian tribe is a qualified Indian tribe with respect to an entity if the entity is engaged in a fishing rights-related activity of the tribe.

A fishing rights-related activity of an Indian tribe is any activity directly related to harvesting, processing, or transporting fish harvested in the exercise of a recognized fishing right of such tribe, or to selling such fish, if substantially all the harvesting was performed by members of such tribe.

Recognized fishing rights of an Indian tribe are fishing rights secured as of March 17, 1988, by a treaty, an executive order, or an Act of Congress.

In the case of a member of an Indian tribe having recognized fishing rights, income earned by that individual from a fishing rights-related activity of the tribe, either directly or through a qualified Indian entity, is exempt from both federal income tax and federal self-employment (SECA) tax. Any distribution with respect to an equity interest in a qualified Indian entity of an Indian tribe to a member of the tribe is treated as derived by the member from a fishing rights-related activity of the tribe, and thus is exempt from these taxes, to the extent the distribution is attributable to income derived by the entity from a fishing rights-related activity of the tribe. Income earned by a corporation, partnership, or other business entity from a fishing rights-related activity of a tribe also is exempt from federal income tax if the entity constitutes a qualified Indian entity of the tribe.

Wages paid to a member of a tribe employed by another member of the same tribe, or by a qualified Indian entity, for services performed in a fishing rights-related activity of the employee's tribe are exempt not only from federal income tax, but also from both the employer's and employee's share of social security (FICA) tax, and from unemployment compensation (FUTA) tax. Wages are not exempt from such taxes if paid by an employer who is not either a member of the same tribe or a qualified Indian entity, or if paid to an employee who is not a member of the tribe whose fishing rights are exercised.

The provisions of new section 7873 of the Code apply to all taxable periods beginning before, on, or after the date of enactment. Thus, all taxes with respect to which the period of limitations has not expired may be subject to claims for refund. In addition, the Internal Revenue Service will not collect any tax, penalty, or addition to tax, regardless of whether the period of limitations for assessing the underlying deficiency has expired, if the underlying deficiency is attributable to income that is exempt from tax under section 7873.

To recover income taxes or SECA taxes paid on fishing income that is now exempt, individual taxpayers should file Form 1040X, Amended U.S. Individual Income Tax Return. To recover income tax overpayments, corporations should file Form 1120X, Amended U.S. Corporation Income Tax Return. To obtain a refund of the employee and the employer portions of FICA taxes paid or withheld on remuneration to employees from fishing rights-related activities, the employer should obtain the employees' written consent to pursue such a refund and file Form 941c, Statement to Correct Information Previously Reported on the Employer's Federal Tax Return, and Form 843, Claim. Instead of filing for a refund, the employer may take an adjustment in the current quarter for the amount of overpaid FICA taxes by filing Form 941, Employer's Quarterly Federal Tax Return, and Form 941c. Regardless of whether the employer is taking an adjustment or pursuing a refund, the employer should file Form W-2c, Statement of Corrected Income and Tax Amounts, and Form W-3c, Transmittal of Corrected Income and Tax Statements, to correct wage information that was previously reported. If the employee does not consent to his or her employer's pursuit of a refund of FICA taxes on his or her behalf, such employee should individually file a refund claim using Form 843, and the employer's claim for refund or adjustment should cover only the employer's portion of the FICA tax.

To obtain a refund of the overpaid FUTA taxes, the employer should file Form 843. If the overpayment is in the current year, when filing Form 940, Employer's Annual Federal Unemployment (FUTA) Tax Return, for such year, the employer may apply the overpayment to the next year's return or request a refund.

This document serves as an ''administrative pronouncement'' as that term is described in section 1.6661-3(b)(2) of the Income Tax Regulations and may be relied upon to the same extent as a revenue ruling or revenue procedure.

Allocation of Interest Expense in Connection with Passthrough Entities and Modification of 15-day Rules in Section 1.163-8T (Extension of Guidance in Notice 88-20)

Notice 89-35

I. PURPOSE

This notice provides guidance with respect to the allocation of interest expense in connection with certain transactions involving partnerships and S corporations (''passthrough entities'') and the allocation of interest expense on debt proceeds received in cash or deposited in an account.

II. BACKGROUND

Section 1.163-8T of the Income Tax Regulations (T.D. 8145, 52 FR 24,996) provides rules for allocating interest expense for purposes of applying the passive activity loss limitation in section 469 of the Code, the investment interest limitation in section 163(d), and the personal interest limitation in section 163(h). The regulation provides that debt generally is allocated by tracing disbursements of the debt proceeds to specific expenditures and that interest expense on such debt is allocated in the same manner as the debt to which such interest expense relates. Section 1.163-8T does not address the treatment of debt allocated to expenditures for interests in passthrough entities and debt of passthrough entities allocated to distributions by such entities. For purposes of this notice, the term ''expenditure'' has the same meaning as when used in section 1.163-8T.

Notice 88-20, 1988-1 C.B. 487, provides guidance on the allocation of interest expense in connection with (a) debt-financed contributions to the capital of, and purchases of interests in, passthrough entities (''debt-financed acquisitions'') and (b) debt-financed distributions by passthrough entities to owners of such entities (''debt-financed distributions''), for taxable years ending on or before December 31, 1987. Notice 88-20 also modifies certain rules for tracing debt proceeds received in cash or deposited in an account on or before December 31, 1987. Notice 88-37, 1988-1 C.B. 522, provides guidance on the reporting of interest expense with respect to debt-financed acquisitions and debt-financed distributions for taxable years beginning after December 31, 1986.

This notice expands the guidance provided in Notice 88-20 and Notice 88-37.

III. EFFECTIVE DATES

In the case of debt-financed acquisitions, owners of passthrough entities may rely on the guidance provided in this notice for taxable years of such owners ending after December 31, 1987, and on or before the date on which further guidance is published. In the case of debt-financed distributions, taxpayers may rely on the guidance provided in this notice for taxable years of passthrough entities ending after December 31, 1987, and on or before the date on which further guidance is published.

The Internal Revenue Service intends to issue regulations concerning the allocation of interest expense in connection with debt-financed acquisitions and debt-financed distributions. For taxable years ending after the date on which such regulations are issued, the regulations may require the allocation of interest expense in connection with such transactions in a manner different from that provided in Notice 88-20 or this notice, without regard to when the debt was incurred.

The Service recognizes that the flexible rules provided in this notice regarding the allocation of interest expense in connection with passthrough entities could allow taxpayers to use passthrough entities to avoid or circumvent the interest allocation rules of section 1.163-8T. Accordingly, the regulations concerning the allocation of interest expense in connection with passthrough entities will provide that, for taxable years beginning on or after January 1, 1989, the special rules described in this notice will not apply in any case in which a passthrough entity is formed or availed of by a taxpayer with a principal purpose of avoiding or circumventing the rules of section 1.163-8T. In such a case, interest expense incurred in connection with a passthrough entity shall be allocated among the expenditures of the taxpayer and the passthrough entity in a manner that reflects the way in which such interest expense would have been allocated among such expenditures under section 1.163-8T if the passthrough entity had not been formed or availed of to avoid or circumvent the rules of that section.

In the case of expenditures made from debt proceeds received in cash or deposited in an account, taxpayers may rely on the guidance provided in this notice with respect to debt proceeds received in cash or deposited in an account after December 31, 1987, and on or before the date on which further guidance is published.

IV. TREATMENT OF DEBT OF OWNERS OF PASSTHROUGH ENTITIES ALLOCATED TO EXPENDITURES FOR CONTRIBUTIONS TO OR PURCHASES OF INTERESTS IN SUCH ENTITIES (DEBT-FINANCED ACQUISITIONS)

A. *Allocation Rules*

In the case of debt proceeds allocated under section 1.163-8T to the purchase of an interest in a passthrough entity (other than by way of a contribution to the capital of the entity), the debt proceeds and the associated interest expense shall be allocated among all the assets of the entity using any reasonable method. Reasonable methods of allocating debt among the assets of a passthrough entity ordinarily include a pro-rata allocation based on the fair market value, book value, or adjusted basis of the assets, reduced by any debt of the passthrough entity or the owner allocated to such assets.

Interest expense on debt proceeds allocated under section 1.163-8T to a contribution to the capital of a passthrough entity shall be allocated using any reasonable method. Reasonable methods for this purpose ordinarily include allocating the debt among all the assets of the entity or tracing the debt proceeds to the expenditures of the entity under the rules of section 1.163-8T as if the contributed debt proceeds were the proceeds of a debt incurred by the entity. For purposes of this notice, a purchase of an interest in a passthrough entity shall be treated as a contribution to the capital of the entity if and to the extent that the entity receives proceeds from the purchase.

For purposes of this notice, the determination of whether a particular method of allocating debt proceeds used to purchase an interest in or to make a capital contribution to a passthrough entity is reasonable depends on the facts and circumstances including, without limitation, whether the taxpayer consistently applies the method from year to year.

In general, to the extent that debt proceeds are allocated under this section IV among the assets of a passthrough entity, such proceeds shall be reallocated among the assets of the entity as the assets of such entity, or the use of such assets, changes. In general, to the extent that debt proceeds are allocated under this section IV by tracing the debt proceeds to the expenditures of the entity under the rules of section 1.163-8T, the debt proceeds shall be reallocated, when necessary, under the rules of section 1.163-8T.

B. *Reporting Rules*

Individuals should report allowable interest expense paid or incurred in connection with debt-financed acquisitions on either Schedule E or Schedule A of Form 1040, depending on the type of expenditure to which the interest expense is allocated. Subject to any applicable changes in the underlying forms and schedules (or their instructions), specific instructions contained in Notice 88-37 should be followed for (a) interest expense allocated to trade or business expenditures, (b) interest expense allocated to passive activity expenditures, (c) interest expense allocated to investment expenditures, and (d) interest expense allocated to personal expenditures.

Taxpayers other than individuals should report interest expense on debt-financed acquisitions on the line for interest expense on their returns, in accordance with section IV.B. of Notice 88-37.

V. TREATMENT OF DEBT OF PASSTHROUGH ENTITIES ALLOCATED TO DISTRIBUTIONS BY SUCH ENTITIES (DEBT-FINANCED DISTRIBUTIONS)

A. *General Allocation Rule*

Unless the optional allocation rule is used, debt of passthrough entities and the associated interest expense shall be allocated under the rules of section 1.163-8T. In general, when debt proceeds of a passthrough entity are allocated under section 1.163-8T to distributions to owners of the entity, the debt proceeds distributed to any owner and the associated interest expense shall be allocated under section 1.163-8T in accordance with such owner's use of such debt proceeds. For example, if the owner uses distributed debt proceeds to purchase an interest in a passive activity, the owner's share of the interest expense on such debt proceeds is allocated to a passive activity expenditure (within the meaning of section 1.163-8T(b)(4)).

An owner's share of a passthrough entity's interest expense on debt proceeds allocated to distributions to owners may exceed the entity's interest expense on the portion of the debt proceeds distributed to that particular owner. In such cases, the entity shall allocate the owner's excess interest expense using any reasonable method. The determination of whether a particular method of allocating such excess interest expense is reasonable depends on the facts and circumstances including, without limitation, whether the entity consistently applies the method from year to year.

B. *Optional Allocation Rule*

A passthrough entity may allocate distributed debt proceeds and the associated interest expense to one or more expenditures (other than distributions) of the entity that are made during the same taxable year of the entity as the distribution, to the extent that debt proceeds (including other distributed debt proceeds) are not otherwise allocated to such expenditures. However, distributed debt proceeds must be allocated under the general allocation rule to distributions to owners of the entity to the extent that such distributed debt proceeds exceed the entity's expenditures (other than distributions) for the taxable year to which debt proceeds are not otherwise allocated. Once debt proceeds are allocated under this section V.B., the debt proceeds shall be reallocated, when necessary, under the rules of section 1.163-8T.

C. *Coordination with Repayment Rule*

Paragraph (d) of section 1.163-8T provides rules governing the treatment of debt repayments. Any repayment of debt of a passthrough entity allocated to distributions to owners of the entity and to one or more other expenditures may, at the option of the passthrough entity, be treated first as a repayment of the portion of the debt allocated to such distributions.

D. *Reporting Rules*

1. *Reporting Under the General Allocation Rule*

To the extent that debt proceeds of a passthrough entity are allocated to distributions to owners of the entity, the portion of an owner's share of the entity's interest expense on debt proceeds allocated to distributions to owners that does not exceed the entity's interest expense on the portion of the debt proceeds distributed to such owner should be included on the line on Schedule K-1 for other deductions. This interest expense should be identified on an attached schedule as "Interest expense allocated to debt-financed distributions." The manner in which the owner should report such interest expense depends on the types of expenditures that the owner makes with the distributed debt proceeds. For example, if the owner uses the debt proceeds to make a personal expenditure (within the meaning of section 1.163-8T(b)(5)), the owner should report the interest expense as personal interest on Schedule A.

To the extent that an owner's share of a passthrough entity's interest expense on debt proceeds allocated to distributions to owners exceeds the entity's interest expense on the portion of the debt proceeds distributed to such owner, the excess interest expense should be reported on Schedule K-1 in a manner consistent with the allocation of such interest expense by such entity.

2. *Reporting Under the Optional Allocation Rule*

If the passthrough entity uses the optional rule to allocate distributed debt proceeds and associated interest expense, the entity's interest expense on debt proceeds allocated to such other expenditures should be reported on Schedule K-1 in a manner consistent with the allocation of the debt proceeds. For example, if the passthrough entity allocates distributed debt and the associated interest expense to an expenditure in connection with a rental activity, the entity should take the interest expense on the debt into account in computing the income or loss from the rental activity that is reported to the owner on Schedule K-1.

Notice 88-37 provides additional guidance on the reporting of interest expense in connection with debt-financed distributions.

VI. EXTENSION OF MODIFICATION OF SINGLE ACCOUNT AND 15-DAY RULES

Paragraph (c)(4)(iii)(B) of section 1.163-8T provides, among other things, that a taxpayer may treat any expenditure made from an account within 15 days after debt proceeds are deposited in such account as made from such proceeds to the extent thereof. Paragraph (c)(5)(i) of section 1.163-8T provides a similar rule with respect to debt proceeds received in cash. In the case of debt proceeds deposited in an account, taxpayers may treat any expenditure made from any account of the taxpayer, or from cash, within 30 days before or 30 days after debt proceeds are deposited in any account of the taxpayer as made from such proceeds to the extent thereof. Similarly, in the case of debt proceeds received in cash, taxpayers may treat any expenditure made from any account of the taxpayer, or from cash, within 30 days before or 30 days after debt proceeds are received in cash as made from such proceeds to the extent thereof.

VII. ADMINISTRATIVE PRONOUNCEMENT

This document serves as an "administrative pronouncement" as that term is described in section 1.6661-3(b)(2) of the regulations and may be relied upon to the same extent as a revenue ruling or revenue procedure.

Election to Treat Certain Pre-1987 Investment Interest as a Passive Activity Deduction

Notice 89-36

This notice provides guidance on making the election under section 1005(c)-(11) of the Technical and Miscellaneous Revenue Act of 1988 (the "1988 Act") to treat certain pre-1987 investment interest as interest expense properly allocable to a passive activity.

I. BACKGROUND

Prior to the Tax Reform Act of 1986 (the "1986 Act"), section 163(d) of the Internal Revenue Code limited a noncorporate taxpayer's deduction for investment interest for a taxable year to $10,000 ($5,000 in the case of a married individual filing a separate return), plus net investment income, plus the amount by which certain deductions attributable to property subject to a net lease exceeded the rental income from the property. Investment interest was defined as interest paid or accrued on indebtedness incurred or continued to purchase or carry property held for investment. For this purpose, property held for investment included certain property subject to a net lease. Investment interest that was disallowed for a taxable year was treated as investment interest paid or accrued in the succeeding taxable year.

The 1986 Act added section 469 to the Code. Section 469 disallows the passive activity loss of individuals, estates, nongrantor trusts, and certain corporations. The passive activity loss is the amount by which the taxpayer's passive activity deductions exceed the taxpayer's passive activity gross income for the taxable year (see section 1.469-2T(b) of the Income Tax Regulations). The 1986 Act also amended section 163(d) of the Code to provide that the amount allowed as a deduction for investment interest for any taxable year shall not exceed the taxpayer's net investment income for the taxable year.

Section 1.163-8T(a)(4)(i)(B) of the regulations provides that interest expense allocated to a passive activity expenditure is taken into account for purposes of section 469 of the Code in determining the income or loss from the activity to which the expenditure relates. Thus, interest expense allocated to a passive activity expenditure is treated as a passive activity deduction (within the meaning of section 1.469-2T(d)). Section 163(d)(3)(B)(ii) provides that the term "investment interest" shall not include any interest which is taken into account under section 469 in computing income or loss from a passive activity of the taxpayer.

As a result of the addition of section 469 to the Code and the amendments of section 163(d) by the 1986 Act, certain property that was treated as property held for investment before 1987 is now treated as property used in a passive activity, and interest expense paid or accrued after 1986 that is properly allocable to expenditures in connection with such property is treated as a passive activity deduction (see section 1.469-2T(d)(3) of the regulations). Section 163(d)(2) of the Code, however, treats investment interest that is disallowed for any taxable year as investment interest paid or accrued in the succeeding taxable year, and section 469 does not apply to any deduction carried forward from a taxable year beginning before January 1, 1987 (see section 501(c)(2) of the 1986 Act). Thus, under the 1986 Act, interest expense paid or accrued in a taxable year beginning before 1987 on indebtedness incurred or continued to purchase or carry property held for investment that was disallowed under section 163(d) of the Internal Revenue Code of 1954 (the "1954 Code") and carried forward to a taxable year beginning after 1986, continued to be treated as investment interest, even if the property is used in a passive activity for taxable years beginning after 1986.

II. 1988 ACT AMENDMENT

Section 1005(c)(11) of the 1988 Act provides that if—

(1) Any amount was disallowed as a deduction under section 163(d) of the 1954 Code (as in effect on the day before the date of the enactment of the 1986 Act);

(2) Such amount would (but for the making of an election under section 1005(c)(11)) be treated as investment interest paid or accrued by the taxpayer in the taxpayer's first taxable year beginning after December 31, 1986; and

(3) The taxpayer makes an election at such time and in such manner as the Secretary of the Treasury or his delegate shall prescribe,

to the extent such amount is attributable to an activity subject to the limitations of section 469 of the Code, such amount shall not be treated as investment interest but shall be treated as a deduction allocable to such activity for such first taxable year. Section 1005(c)(11) of the 1988 Act further provides that section 469(m) of the Code and section 501(c)(2) of the 1986 Act shall not apply to any amount so treated.

III. INTEREST EXPENSE TO WHICH ELECTION APPLIES

Section 1005(c)(11) of the 1988 Act applies to interest expense if and only if—

(1) A deduction for such interest expense was disallowed under section 163(d) of the 1954 Code for the taxpayer's last taxable year beginning before January 1, 1987; and

(2) Such interest expense was paid or accrued on indebtedness incurred or continued to purchase or carry property (the "related property") that—

(i) Was treated, in applying section 163(d) of the 1954 Code for any taxable year of the taxpayer beginning before January 1, 1987, as property held for investment; and

(ii) Was used in a passive activity (within the meaning of section 469(c) of the Code and section 1.469-1T(e) of the regulations) of the taxpayer for the taxpayer's first taxable year beginning after December 31, 1986.

In the case of a taxpayer having both interest expense to which section 1005(c)(11) of the 1988 Act applies and other investment interest expense the deduction for which was disallowed under section 163(d) of the 1954 Code for the taxpayer's last taxable year beginning before January 1, 1987, the amount of interest expense to which section 1005(c)(11) of the 1988 Act applies may be determined using any reasonable method. For purposes of this notice, the determination of whether a particular method of allocating such interest expense is reasonable depends on the facts and circumstances.

IV. REQUIREMENTS AND CONDITIONS FOR MAKING ELECTION

For the taxpayer's first taxable year beginning after December 31, 1986, the taxpayer may elect to treat interest expense to which section 1005(c)(11) of the 1988 Act applies as a passive activity deduction from the activity in which the related property was used for such year. No interest expense to which the election applies is treated as an item of deduction from a pre-enactment interest in a passive activity for purposes of computing the pre-enactment loss under section 1.469- 11T(b)(3) of the regulations. Thus, if the election is made, the interest expense is fully subject to the passive activity loss limitation without regard to the transition relief generally accorded losses and credits attributable to pre-enactment interests in activities. Furthermore, once the election is made, the interest expense is not treated as investment interest for any purpose. (Thus, for example, no amount of the interest is allowable under section 163(d)(6) of the Code (relating to the phase-in of section 163(d)) for taxable years beginning in 1987 through 1990.)

Only one election to treat investment interest as a passive activity deduction can be made, and the election applies to all interest expense of the taxpayer to which section 1005(c)(11) of the 1988 Act applies. Thus, no partial election relating to a portion of such interest expense is permitted. Because section 163(d) of the Code does not apply to corporate taxpayers, they are not eligible to make the election. The election is irrevocable. Making the election may affect the amount of the taxpayer's allowed and disallowed investment interest and passive activity deductions (and therefore tax liability) for taxable years subsequent to the taxable year for which the election is made.

V. ELECTION PROCEDURE AND DEADLINE

A noncorporate taxpayer that is subject to section 469 of the Code may make the election provided by section 1005(c)(11) of the 1988 Act by filing an amended return for (1) the taxpayer's first taxable year beginning after December 31, 1986, and (2) any subsequent taxable years with respect to which a return was filed prior to making the election. Individuals should file an amended return on Form 1040X, and estates and nongrantor trusts should file an amended return on Form 1041.

The amended return (or returns, as the case may be) must be filed on or before the later of (1) the due date (taking into account any extensions of time to file obtained by the taxpayer) for filing the income tax return of the taxpayer for the taxpayer's first taxable year beginning after December 31, 1987 (generally the taxpayer's 1988 return), or (2) August 15, 1989. The amended return (or returns, as the case may be) must reflect any change in tax liability that results from making the election. Any such change should be determined by adjusting Form 8582 (Passive Activity Loss Limitations) and Form 4952 (Investment Interest Expense Deduction) in the manner explained in the instructions to the 1988 versions of those forms.

VI. ADMINISTRATIVE PRONOUNCEMENT

This document serves as an "administrative pronouncement" as that term is described in section 1.6661-3(b)(2) of the regulations and may be relied upon to the same extent as a revenue ruling or revenue procedure.

Notice of Intent to Promulgate Regulations Addressing Use of Partnerships to Avoid *General Utilities* Repeal

Notice 89-37

Section 631 of the Tax Reform Act of 1986 (the "1986 Act") was intended to repeal the *General Utilities* doctrine which, under certain circumstances, permitted a corporation to distribute appreciated assets to its shareholders without recognizing gain. Following the 1986 Act, the Internal Revenue Code generally requires a corporation to recognize gain upon the distribution of appreciated property (*see* sections 311(b) and 336(a)). Section 631 of the 1986 Act also added section 337(d) to the Code, as amended by section 1006(e)(5) of the Technical and Miscellaneous Revenue Act of 1988, to protect the integrity of the repeal of the *General Utilities* doctrine. Section 337(d) directs the Secretary to prescribe the regulations that may be necessary or appropriate to carry out the purposes of the 1986 Act's repeal of the *General Utilities* doctrine, including regulations to ensure that such purposes are not circumvented through the use of any provision of law or regulations.

The Service has determined that, in certain circumstances, the acquisition (or mere ownership) by a partnership of stock in one of its corporate partners (or stock of any member of the affiliated group of which such partner is a member) results in avoidance of *General Utilities* repeal. These circumstances are present to the extent the corporate partner, in substance, relinquishes an interest in appreciated property in exchange for an interest in its stock (or the stock of any member of the affiliated group of which such partner is a member). The Service intends to prescribe regulations under its general rulemaking authority and section 337(d) to provide for gain recognition by a corporate partner in such circumstances.

Application of section 311(b) notwithstanding section 731

The Service has determined that, in order to carry out the purposes of the repeal of the *General Utilities* doctrine, a partnership distribution to a corporate partner of the stock of such corporation (or the stock of any member of the affiliated group of which such partner is a member) should be characterized as a redemption of the corporate partner's stock with property consisting of its partnership interest. Therefore, the Service will issue regulations providing that section 311(b), rather than the general nonrecognition rule of section 731(a), will be applicable whenever a partner receives a distribution of its own stock (or the stock of any member of the affiliated group of which such partner is a member). Accordingly, under section 311(b), gain (but not loss) with respect to the partner's partnership interest will be recognized. This rule will apply to all such distributions of corporate stock occurring after March 9, 1989.

Deemed redemption

The Service also intends to adopt rules under which gain will be recognized at the time of, and to the extent that, any transaction (or series of transactions) has the economic effect of an exchange by a corporate partner of its interest in appreciated property for an interest in its stock (or the stock of any member of the affiliated group of which such partner is a member) owned or acquired by the partnership. In general, the gain that would be required to be recognized by the corporate partner under this rule would include the gain attributable to appreciation accruing during the period (i) before the property was contributed by the corporate partner to the partnership, and (ii) after the property was contributed to, or acquired by, the partnership and prior to the deemed redemption.

For example, if a corporation contributes appreciated property to a partnership in exchange for a thirty percent interest in the partnership and another person exchanges stock of the corporate partner for the other seventy percent interest in the partnership, the corporate partner can properly be treated as having relinquished seventy percent of its interest in the appreciated property in exchange for a thirty percent interest in its own stock at the time of the acquisition of such stock, without regard to whether such stock is or will be distributed to the corporate partner. Other transactions to which the deemed redemption rule may apply include, but are not limited to, partnership purchases of a corporate partner's stock, disproportionate distributions, and amendments to the partnership agreement. The Service is considering whether any exceptions, such as a de minimis rule, might be appropriate. The deemed redemption rule will apply to any transaction (or series of transactions) with the above described economic effect occurring after March 9, 1989.

Other principles and rules

Certain transactions that would be subject to the regulations to be issued, as described in this Notice, also may be subject to taxation under the "substance over form" principle or section 707(a)(2)(B). For example, the "substance over form" principle and section 707(a)(2)(B) are each relevant to the analysis of any transaction in which a corporate partner contributes appreciated property to a partnership that acquires (or owns) stock of the corporate partner pursuant to an understanding that such stock will be distributed to the corporate partner by the partnership.

No inference should be made based upon this Notice regarding the scope of the "substance over form" principle or the disguised sale rules of section 707(a)(2)(B).

Administrative pronouncement

This document serves as an "administrative pronouncement" as that term is described in section 1.6661-3(b)(2) of the Income Tax Regulations and may be relied upon to the same extent as a revenue ruling or a revenue procedure. *See* Rev. Rul. 87-138, 1987-2 C.B. 287.

Modification of Notice 88-132

Notice 89-38

The purpose of this notice is to modify certain provisions of Notice 88-132.

1988-2 C.B. 552, including the definition of wholesale distributor. Notice 88-132 provides interim rules for the administration of the federal excise taxes on diesel and aviation fuel as amended by the Technical and Miscellaneous Revenue Act of 1988, P.L. 100-647.

I Requirements for Making Tax-Free and Tax-Reduced Sales

Section IV(A) of Notice 88-132 requires producers and importers to obtain and retain certain information in order to make tax-free or tax-reduced sales. Paragraph (3) of this section requires the producer or importer's record of sale to contain "a written statement clearly indicating that the entire quantity of the fuel purchased is purchased for the nontaxable use specified in the buyer's certification".

This provision does not permit producers to make a sale of fuel to a particular buyer for both taxable and nontaxable uses. Therefore, section IV(A)(3) is modified to read as follows:

"(3) The producer or importer's record of sale contains a written statement clearly stating the quantity of fuel that the buyer has bought for the nontaxable or tax-reduced use specified in the buyer's certification..."

II Definition of Wholesale Distributor

Section V(C) of Notice 88-132 defines the term "wholesale distributor" for purposes of the definition of the term "producer." This definition of wholesale distributor may exclude many distributors who sell substantial quantities of diesel fuel to farmers, fishermen, and other off-road users who are eligible to buy fuel tax free from producers. Therefore, section V(C) is modified to read as follows:

"C. Wholesale Distributor

"(1) Definition. For purposes of the definition of the term "producer," the regulations will provide that the term "wholesale distributor" includes any person who—

"(a) Holds itself out to the public as being engaged in the trade or business of selling taxable fuel to producers of taxable fuel (including wholesale distributors), to retailers, or to users of taxable fuel who purchase in bulk quantities and accept delivery into bulk storage tanks; and

"(b) Actually makes more than casual sales of taxable fuel to the producers, retailers, or users described in paragraph (a).

"(2) Special rules. For purposes of the definition of wholesale distributor, the regulations will further provide that—

"(a) The term "bulk storage tank" means a container that holds at least 50 gallons and is not the fuel supply tank of any engine that is mounted on, or attached to, a highway vehicle, a diesel-powered train, or an aircraft. Thus, for example, the term includes containers that hold at least 50 gallons and that serve as the fuel supply tank of a vessel or a home furnace, but the term does not include the fuel supply tank of an engine that powers a refrigeration unit mounted on a semi-trailer. For the definition of "highway vehicle," see section 48.4041-8(b) of the regulations. For the definition of "diesel-powered train," see section IV(D)(1) of Notice 88-30, 1988-1 C.B. 497.

"(b) The term "bulk quantities" means 25 gallons or more.

"(c) A person will be considered to make "more than casual sales" if—

"(i) At least 30 percent of its number of sales of taxable fuel during the preceding 12 month period (or some other period as determined by the District Director) is to the producers, retailers, or users described in paragraph (1)(a); or

"(ii) At least 50 percent of its volume of taxable fuel during the preceding 12 month period (or some other period as determined by the District Director) is sold to the producers, retailers, or users described in paragraph (1)(a), and at least 500 of its sales (or a proportional number if a period other than 12 months is used) are made to such buyers.

"(d) The term "wholesale distributor" also includes any person who holds itself out to the public as being engaged in the trade or business of selling taxable fuel to users for the nontaxable uses described in section II(D) of Notice 88-132 (for example, use on a farm for farming purposes or use as heating oil) and actually sells at least 70 percent of its volume of taxable fuel during the preceding 12 month period (or some other period as determined by the District Director) to such users.

"(e) A farmers' cooperative described in sections 521 or 1381 of the Code will be treated as holding "itself out to the public" even though it may sell taxable fuel only to its members.

"(3) Examples. The following examples illustrate these rules:

"*Example 1.* *A* operates a truck stop that sells diesel fuel at retail. *A* also advertises that it will make bulk sales of diesel fuel to farmers. During a representative period (as determined by the District Director), *A* made 1,000 sales of diesel fuel, 300 of which were to farmers for both on-road and off-road use. In each sale, *A* delivered at least 25 gallons into a 50 gallon tank in the bed of the buyer's pick-up truck. None of these tanks was the fuel supply tank to any engine on the truck. *A* meets the definition of wholesale distributor.

"*Example 2.* *B* operates a marina and advertises that it will make sales of diesel fuel to boaters. During the preceding 12 month period, *B* sold 85 percent of its volume of diesel fuel to fishermen and other boaters. *B* sold the remaining 15 percent of its volume at its convenience store to truckers. *B* meets the definition of wholesale distributor.

"*Example 3.* *C* sells diesel fuel at an unattended location through a "cardlock" system and advertises that it will make sales of diesel fuel for farming purposes. Each of *C*'s buyers has a "taxable" card (used to buy fuel for highway use) and a "nontaxable" card (used to buy fuel for off-highway use). During a representative period (as determined by the District Director), *C* sold 70 percent of its volume of diesel fuel to users of the "nontaxable" card. *C* meets the definition of wholesale distributor.

"*Example 4.* *D* operates a truck stop that sells diesel fuel at retail. *D* also advertises that it will make bulk sales of diesel fuel for off-road uses. During a representative 6 month period (as determined by the District Director), *D* made 6,000 sales of diesel fuel, 250 of which were to construction companies for their off-road use. In each sale to a construction company, *D* delivered 1,000 gallons into its buyer's 1,500 gallon tank trailer. The remaining 5,750 sales during the period were to truckers for their on-road use. In each of these sales, *D* delivered at least 60 gallons into its buyer's 70 gallon vehicle fuel supply tank. Although *D* made the requisite number of bulk sales to users during this period (250 in 6 months), less than 50 percent of its volume of diesel fuel was sold in bulk to users. Also, less than 70 percent of its volume was sold for nontaxable uses. Thus, *D* does not meet the definition of wholesale distributor."

III Taxable Fuel on Hand

Notice 88-132 does not describe the tax consequences of a producer's sale of tax-paid taxable fuel that such producer had in inventory at the time it received its Certificate of Registry. Therefore, Section V is amended by adding the following immediately after section V(C):

"D. Producer's Taxable Fuel On Hand

"A person is treated as a producer of all of the taxable fuel it has on hand as of the effective date of its Certificate of Registry even though tax has already been paid on such fuel. If an ultimate purchaser subsequently buys taxable fuel from a producer at a price that includes the tax and then uses the fuel in a nontaxable use, such purchaser may claim a credit or refund of the tax under section 6427 of the Code. Alternatively, a producer that has tax-paid taxable fuel on hand as of the effective date of its Certificate of Registry may claim a credit up to the amount of tax included in the price it paid for such fuel, but only against liability the producer incurs under section 4091 of the Code on its later sale of any taxable fuel, This credit must be claimed on Part II, Line 2, ("Adjustments") on Form 720, Quarterly Federal Excise Tax Return, and must be supported by records to substantiate the amount of tax paid fuel on hand."

IV Correction of Typographical Error

The first sentence of section VII(B) of Notice 88-132 contains an incorrect date. Thus, it is corrected to read as follows:

"Exempt users of diesel and aviation fuel bought and used tax paid after 1988 may claim a quarterly refund of such tax if—. . .

EFFECTIVE DATE

The rules of this notice are effective January 1, 1989.

EFFECT ON OTHER DOCUMENTS

Notice 88-132 is modified.

ADMINISTRATIVE PRONOUNCEMENT

This document serves as an "administrative pronouncement" as that term is described in section 1.6661-3(b)(2) of the Income Tax Regulations and may be relied upon to the same extent as a revenue ruling or revenue procedure.

At Risk Rules—Aggregation of Partnership and S Corporation Activities

Notice 89-39

Announcement 88-58, 1988-15 I.R.S. 46, informed taxpayers that they would be allowed to aggregate certain partnership and S corporation activities for purposes of the at-risk rules under section 465 of the Internal Revenue Code, based upon the rule contained in section 1.465-1T of the Income Tax Regulations, for taxable years that began in 1987. This notice extends the aggregation rule contained in section 1.465-1T to taxable years ending on or before the date on which further guidance is published.

Thus, as with taxable years beginning in 1985, 1986, and 1987, aggregation of partnership or S corporation activities in the manner described in section 1.465-1T will be allowed within each of four categories for taxable years ending in 1988 (and for any subsequent taxable year ending on or before the date on which further guidance is published). Those categories are films and video tapes, farms, oil and gas properties, and geothermal properties. For example, in applying the at-risk rules for 1988, partners and S corporation shareholders will be permitted to treat all of the partnership's or S corporation's films and video tapes as a single activity. Moreover, any additional rules imposing limits or conditions on the ability of taxpayers to aggregate activities within the four categories will apply only to taxable years ending after the date on which further guidance is published.

This document serves as an "administrative pronouncement" as that term is described in section 1.6661-3(b)(2) of the regulations and may be relied upon to the same extent as a revenue ruling or revenue procedure.

Rules for Determining the Source of Gain from the Sale of Personal Property by Bona Fide Puerto Rican Residents

Notice 89-40

SECTION 1. PURPOSE

This notice provides guidance under section 865 of the Internal Revenue Code concerning the sourcing of gain from sales of nondepreciable personal property by bona fide Puerto Rican residents. The rules contained in this notice will be incorporated in regulations to be promulgated under section 865 of the Code. This document serves as an "administrative pronouncement" as that term is described in section 1.6661-3(b)(2) of the Income Tax Regulations and may be relied upon to the same extent as a revenue ruling or procedure. Any modification of the rules contained herein will be prospective only.

SEC. 2. BACKGROUND

Section 865(g)(2) of the Code provides that gains of a U.S. citizen resident outside the United States are U.S. sourced unless a foreign income tax of at least ten percent is imposed. Section 1012(d)(6)(B) of the Technical and Miscellaneous Revenue Act of 1988 (TAMRA), 102 Stat. 3497, added section 865(j)(3) to the Code. Section 865(j)(3) authorizes the Secretary to prescribe regulations providing that, subject to certain conditions (which may include provisions comparable to section 877) as may be provided in such regulations, section 865(g)(2) shall not apply for purposes of sections 931, 933, and 936.

SEC. 3. PERSONS COVERED

This notice applies only to bona fide Puerto Rican residents as defined in section 933 of the Code and the regulations thereunder. It does not apply to U.S. citizens or residents who are temporarily residents of Puerto Rico. For this purpose, rules analogous to section 877 will be applied to prohibit persons from establishing residency in Puerto Rico for the purpose of avoiding U.S. tax.

SEC. 4. SALES BY BONA FIDE RESIDENTS OF PUERTO RICO

Regulations issued under section 865(j)(3) of the Code will provide that section 865(g)(2) shall not apply to a person that is a bona fide resident of Puerto Rico for the entire taxable year. The source of income from the sale of personal property by such bona fide residents shall be determined under section 865 without regard to section 865(g)(2). Thus, for example, a bona fide resident of Puerto Rico who sells stock (that does not constitute inventory) will not be subject to the ten percent tax payment rule of section 865(g)(2), but, instead, will be subject to the general residence of the seller rule under section 865(a). Therefore, regardless of whether a tax equal to 10 percent of the gain is paid to Puerto Rico, the income from the stock sale will be treated as Puerto Rican (*i.e.*, foreign source) income.

The example on page 1 of Publication 1321, Special Instructions for Bona Fide Residents of Puerto Rico, which concludes that a bona fide Puerto Rican resident who sells nondepreciable personal property is subject to U.S. taxation under section 865(g)(2) of the Code, is incorrect for sales subject to the rules described in this notice.

SEC. 5. EFFECTIVE DATE

This notice is effective for taxable years beginning after December 31, 1986.

Procedures for Use by Partnerships and S Corporations Claiming a Refund Under Section 7519 of the Code for Taxable Years Beginning in 1988

Notice 89-41

The Internal Revenue Service understands that a number of partnerships and S corporations will be claiming a refund under section 7519 of the Internal Revenue Code (relating to payments required for the use of a taxable year elected under section 444 of the Code) with respect to a taxable year beginning in 1988. This notice provides procedural guidance to taxpayers regarding refunds of required payments under section 7519 of the Code claimed for taxable years beginning in 1988. Forthcoming regulations or other form of guidance will provide procedural rules for taxable years beginning after 1988.

I. Background

Sections 444, 7519 and 280H were added to the Internal Revenue Code by Section 10206 of the Revenue Act of 1987 (Pub. L. No. 100-203, 101 Stat. 1330) (the "1987 Act"). Section 444 allows certain partnerships, S corporations, and personal service corporations to make an election (a "section 444 election") to use a taxable year that is different from the taxable year that such entities would otherwise be required to use. Electing partnerships and S corporations are required to make payments under section 7519 ("required payments") to the federal government. Required payments are intended to represent the value of the tax deferral obtained by the owners of those entities through the use of a taxable year different from the required taxable year.

After an electing partnership or S corporation makes a required payment for a taxable year, the partnership or S corporation may be eligible for a refund of all or part of the required payment if there is a decrease in the deferral in a subsequent taxable year. Section 2004(e)(5) of the Technical and Miscellaneous Revenue Act of 1988 ("TAMPA") (Pub. L. No. 100-647, 102 Stat. 3342) made several changes to the refund rules of section 7519. Section 2004(e)(5) of TAMPA clarified that an electing partnership or S corporation will be eligible for a refund of required payments if the partnership or S corporation terminates its section 444 election or liquidates. In addition, section 2004(e)(5) of TAMRA specified the date on which a refund becomes payable.

On May 24, 1988, the Internal Revenue Service issued temporary regulations, T.D. 8205, 53 F.R. 19688, interpreting section 10206 of the 1987 Act. This notice provides procedural guidance for taxpayers eligible to claim a refund of a required payment. The guidance provided in this notice will be incorporated in forthcoming regulations.

II. Refund eligibility and procedure

A. In General

An electing partnership or S corporation is eligible for a refund of required payments to the extent that the amount determine under section 7519(b)(1) of the Code ("gross required payment") is less than the cumulative required payments for preceding years. In addition, if an electing partnership or S corporation terminates its section 444 election, the partnership or corporation is eligible for a refund of required payments.

A refund of a required payment shall be payable on the later of April 15 of the applicable calendar year, or 90 days after the date on which the claim for refund is filed.

In the case of a refund resulting from a termination of the section 444 election, the term "applicable calendar year" means the calendar year following the calendar year in which the final applicable election year ends. In the case of all other refunds, the term "applicable calendar year" means the calendar year following the calendar year in which the applicable election year giving rise to the refund begins.

Unlike, for example, a refund of a properly claimed overpayment of income tax by an individual on Form 1040, which can be paid at any time during the normal filing season, the Service is precluded by law from refunding a required payment before April 15 of the applicable calendar year, no matter how much earlier a taxpayer has the information necessary to determine that a refund may be claimed.

As provided in section IIB of this notice, partnerships and S corporations must use Form 720 (revised January 1989) to claim a refund of a required payment. The first-quarter 1989 Form 720 (labelled "Rev. January 1989") should be available to taxpayers in March 1989. Taxpayers should not attempt to file for a refund in any other manner (such as by using a prior version of the Form 720 or by using Form 843).

Because taxpayers did not receive the devised form before January 15, 1989, the Internal Revenue Service waives the 90-day period but only for first-quarter 1989 Forms 720 that are filed on or before April 30, 1989, for the 1989 applicable calendar year. Instead, properly completed first-quarter 1989 Forms 720 (filed on or before April 30, 1989) will be processed in the normal manner for such form. This should result in the payment of refunds before the end of the 90-day period.

B. Form 720 procedures

A partnership or S corporation that is entitled to make a claim for refund of a required payment for an applicable election year beginning in 1988, should file a first-quarter 1989 Form 720, "Quarterly Federal Excise Tax Return" (revised January 1989). In addition, the taxpayer must type or legibly print, at the top of the Form 720, whichever one of the following statements applies:

[A] "TERMINATION OF §444 ELECTION BY CHANGE TO REQUIRED YEAR"

[B] "TERMINATION OF §444 ELECTION OTHER THAN BY CHANGE TO REQUIRED YEAR"

[C] "CONTINUING SECTION 444 ELECTION"

In the case of any termination of a section 444 election, the taxpayer indicates its eligibility for a complete refund of any required payment currently on deposit by typing or printing "zero" on the line for "IRS No. 11" and including the amount paid with respect to the applicable election year beginning in 1987 on line 4(d), Part II of Form 720.

C. Form 843 previously filed

The Internal Revenue Service understands that prior to issuance of this notice certain taxpayers may have already pursued some other means of attempting to claim a refund under section 7519(c) of the Code (such as filing a Form 843). If the Form 843 (or other form of claim) is processible, such claim will be processed in the normal manner. However, if the Form 843 (or other form of claim) does not have sufficient information to allow the Service to process the claim, the Service will return the form used for the attempted claim. After the taxpayer receives the returned form, the taxpayer should file Form 720 (Rev. January 1989) pursuant to the procedures set forth in this notice.

D. Interest

Under Section 7519(f)(3) of the Code, no interest shall be allowed with respect to any refund of a required payment.

III. Examples

Example (1). Assume that XYZ, Inc. is an S corporation (and has been for all years in issue) that has historically used a June 30 taxable year. Also assume that XYZ, Inc. made a valid section 444 election to retain a year ending June 30, 1988 (its first "applicable election year"). Assume further that XYZ, Inc. properly filed Form 720, for the second quarter of 1988, on July 29, 1988, and transmitted therewith a check for $12,000, the amount of the required payment for the applicable election year July 1, 1987-June 30, 1988. Finally, assume that for its taxable year beginning July 1, 1988, XYZ, Inc. changes to a calendar year, its required year. Under section 1.444-1T(a)(5)(ii)(A) of the Income Tax Regulations, XYZ Inc.'s section 444 election is terminated effective July 1, 1988. XYZ, Inc. is eligible to claim a refund of the $12,000 amount on deposit by filing a first-quarter 1989 Form 720 (Rev. January 1989), in accordance with the procedures provided in this notice. The year ended June 30, 1988, is the last election year of XYZ, Inc. Therefore, for purposes of determining when a refund is payable, the applicable calendar year is 1989. Under the general rule provided in section IIA of this notice, the refund of $12,000 becomes payable on the later of (i) April 15, 1989, or (ii) 90 days after the date on which the claim for refund is filed. However, as also provided in section IIA of this notice, if XYZ, Inc. files its first-quarter 1989 Form 720 on or before April 30, 1989, the refund becomes payable on the date that follows the normal processing period for that Form 720.

Example (2). Assume the facts are the same as in example 1, except that instead of changing to the required year, XYZ, Inc. continues the section 444 election for the taxable year July 1, 1988 - June 30, 1989 (its second applicable election year). In addition, assume that XYZ, Inc.'s required payment for such year is $10,000. Accordingly, XYZ, Inc. is eligible to claim a refund of the $2,000 excess amount paid with respect to the first applicable election year. The current applicable election year is the year beginning July 1, 1988. Under section IIA of this notice, the applicable calendar year is 1989, the year following the year in which the applicable election year giving rise to the refund began. Under the general rule provided in section IIA of this notice, the refund of $2,000 becomes payable on the later of (i) April 15, 1989, or (ii) 90 days after the date on which the claim for refund is filed. However, as also provided in section IIA of this notice, if XYZ, Inc. files its first-quarter 1989 Form 720 on or before April 30, 1989, the refund becomes payable on the date that follows the normal processing period for that Form 720.

Example (3). The facts are the same as in example 2, except that XYZ, Inc. liquidates completely, for tax purposes, on January 15, 1989. The liquidation is a terminating event and is effective January 15, 1989. Although XYZ, Inc. liquidates, it is subject to section 7519 for the taxable year beginning July 1, 1988 (its second applicable election year). XYZ, Inc. is eligible to make a claim for the $2,000 excess payment for the applicable election year that began July 1, 1988. The $2,000 refund becomes payable on the date described in example 2.

In addition, XYZ, Inc. is eligible to make a separate claim for the $10,000 amount on deposit. Because XYZ, Inc. is terminating its election, the applicable calendar year is 1990, the calendar year following the calendar year in which the final applicable election year ends (1989). Accordingly, under the general rule provided in section IIA of this notice, a refund of the $10,000 will become payable the later of (i) April 15, 1990 or (ii) 90 days after the claim for refund is made.

IV. Administrative pronouncement

This document serves as an "administrative pronouncement" as that term is described in section 1.6661-3(b)(2) of the Income Tax Regulations and may be relied upon to the same extent as a revenue ruling or revenue procedure.

Required Beginning Date Under Section 401(a)(9)

Notice 89-42

This notice provides guidance with respect to the required beginning date for distributions mandated by section 401(a)(9) of the Internal Revenue Code of 1986 (the Code) for certain individuals who attained age 70½ in 1988 and had not separated from service by January 1, 1989.

BACKGROUND

Prior to the Tax Reform Act of 1986 (TRA 86), distributions from qualified plans for employees who were not 5 percent owners were required to begin not later than the April 1 of the calendar year following the later of (1) the calendar year in which the employee attained age 70½ or (2) the calendar year in which the employee retired. For 5 percent owners and for IRA participants, who are treated the same as 5 percent owners for purposes of the required beginning date, the required beginning date was, and remains, April 1 of the calendar year following the calendar year in which the owner attains age 70½, even if the owner remains employed.

TRA 86 amended section 401(a)(9) of the Code to provide a uniform required beginning date for all plan, IRA, and tax sheltered annuity participants. Under this rule, distributions from qualified plans and tax sheltered annuities are required to begin not later than April 1 of the calendar year following the calendar year in which the employee attains age 70½. This rule is generally effective for years beginning after December 31, 1988. However, the uniform required beginning date enacted under TRA 86 does not apply to an employee who attained age 70½ before January 1, 1988, unless the employee is a 5 percent owner. Under a grandfather rule provided in section 1121(d)(4) of TRA 86, an employee who is not a 5 percent owner is permitted to use the pre-TRA 86 required beginning date. Section 1.401(a)(9)-1B-2 of proposed regulations published in the Federal Register on July 27, 1987 (52 FR 28070) sets forth the rules on the required beginning dates specified under TRA 86. Proposed regulations section 1.401(a)(9)-1B-2(a) indicates that employees attaining age 70½ in 1988 must begin receiving distributions by April 1, 1989, even if they have not separated from service.

ANALYSIS

The grandfather rule of section 1121(d)(4) of TRA 86 for employees who are not 5 percent owners does not apply to employees who attained age 70½ during 1988. However, the retirement year delay under section 401(a)(9)(C)(ii) of the Code is not repealed until January 1, 1989, for calendar year taxpayers. Therefore, final regulations under section 401(a)(9) will provide that the effect of the repeal of the retirement year delay on January 1, 1989, is to treat an employee who attained age 70½ in 1988, who is not a 5 percent owner, and who had not retired by January 1, 1989, as having retired on January 1, 1989. Thus, 1989 is the first possible distribution calendar year for the employee, and April 1, 1990, is the employee's required beginning date. However, the employee's actual age in 1989 must be used in calculating the employee's life expectancy.

It should be noted that the required beginning date rules in section 1.401(a)(9)-1B-2(b) and (c) of the proposed regulations, for employees who attained age 70½ before January 1, 1988, remain unchanged, and the rule in section 1.401(a)(9)-1B-2(a), for employees who attain age 70½ after December 31, 1987, remains unchanged except as modified herein.

RELIANCE

This document serves as an "administrative pronouncement" as that term is described in section 1.6661-3(b)(2) of the Income Tax Regulations and may be relied upon to the same extent as a revenue ruling or revenue procedure.

Weighted Average Interest Rate Update

Notice 89-43

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 section 412(c)(7) of the Internal Revenue Code as amended by the Omnibus Budget Reconciliation Act of 1987 (OBRA 1987).

The notice also provides that an announcement will be published monthly to provide the weighted average and the permissible range for the plan years beginning each month. The following rates were determined for the plan years beginning in the months shown below.

Month	Year	Weighted Average	Permissible Range
March	1989	8.78	7.90 to 9.66

Administrative Pronouncement

This document serves as an "administrative pronouncement" as that term is described in section 1.6661-3(b)(2) of the Income Tax Regulations and may be relied upon to the same extent as a revenue ruling or revenue procedure.

Filing of Protective Claims Under Rev. Proc. 89-24, 1989-12 I.R.B. 22, for Quarters Ended March 31, 1986 and June 30, 1986

Notice 89-44

Rev. Proc. 89-24, page 845, this Bulletin, provides instructions for claiming a refund of an overpayment of excise tax on insurance policies when the claim is based on the provisions of the Convention Between The Government Of The United Kingdom Of Great Britain And Northern Ireland (On Behalf Of The Government Of Bermuda) And The Government Of The United States Of America Relating To The Taxation Of Insurance Enterprises And Mutual Assistance In Tax Matters (the Treaty), signed at Washington, D.C. on July 11, 1986, and effective January 1, 1986, with respect to the excise tax on certain insurance premiums.

The Internal Revenue Service has concluded that it is appropriate to allow protective claims to be filed for refund of excise tax paid for quarters ended March 31, 1986, and June 30, 1986, so long as the protective claims are perfected in a timely manner to comply with the requirements set forth in Rev. Proc. 89-24. In order to qualify for refund of the excise tax, the Treaty requires a claimant to establish, inter alia, that the Bermuda insurance company, to which the insurance premiums were paid, qualified for benefits under the Treaty and also that the premiums constituted subpart F income of the insurance company.

The Internal Revenue Service will permit the filing of protective claims for the first and second quarters of 1986. The protective claim should be submitted on a Claim, Form 843, to the following address:

Philadelphia Service Center
P.O. Box 245
Bensalem, PA 19020
Drop Point 102C

A protective claim must be filed on or before the date that the statute of limitations expires for filing claims for these quarters and must state that the claimant is filing a protective claim for refund of insurance premium excise tax under the Treaty, the name of the Bermuda insurance company to which the premium was paid, and the name of the United States insured or broker that paid the premium. A protective claim may be filed by the insured or broker, depending on which is the taxpayer, or by the Bermuda insurance company. Although a protective claim must be filed within the statute of limitations for filing a claim for refund, the Internal Revenue Service will allow the taxpayer six months from the date a protective claim is filed to perfect the protective claim by submitting the information required by Rev. Proc. 89-24 to the address previously shown. After this six month period, the Internal Revenue Service will follow its normal administrative practices with respect to the claim, including possible disallowance.

ADMINISTRATIVE PRONOUNCEMENT

This document serves as an "administrative pronouncement" as that term is described in section 1.6661-3(b)(2) of the Income Tax Regulations and may be relied upon to the same extent as a revenue ruling or revenue procedure.

Employee Plans—Application of Section 415(b)(5)(D)

Notice 89-45

Background

Section 415(b) of the Code limits the amount of retirement-type benefits that may be provided from qualified defined benefit plans. Thus, benefits may not be paid or accrued that are in excess of the limitations of section 415(b). Section 415(b)(5) provides that the dollar limitation of section 415(b)(1)(A) is reduced for participants with less than 10 years of participation in a defined benefit plan. In a given year, the dollar limitation applicable to a participant with less than ten years of participation is equal to the dollar limitation of section 415(b)(1)(A) in effect for such year multiplied by a fraction (not to exceed one), the numerator of which is the number of years (computed to fractional parts of a year) of participation in the plan, and the denominator of which is 10. (The resulting limitation for such year will be referred to as the initial ten-year phase-in limitation.) Thus, a participant's accrued benefit in any year may not exceed the initial ten-year phase-in limitation for such year. For example, assume that the section 415(b)(1)(A) dollar limitation in effect for a given year is $90,000. In the case of a participant who has 3 years of participation, the initial ten-year phase-in limitation for such participant would be $90,000 times 3/10, or $27,000.

Section 415(b)(5)(B) provides that the compensation limitation of section 415(b)(1)(B) and the special $10,000 benefit limitation of section 415(b)(4) are reduced for participants with less than 10 years of service with the employer. However, in no event will such adjustments for years of participation or service, as applicable, reduce the limitations of section 415(b)(1)(A), 415(b)(1)(B), or 415(b)(4) to amounts less than 1/10 of such limitation without such adjustments.

In addition, section 415(b)(5)(D) provides that the reductions specified in section 415(b)(5) apply separately to each change in benefit structure of a plan, to the extent specified in regulations. Q&A-7 of Notice 87-21 provided that any change in the benefit structure of a plan that is adopted and made effective prior to the issuance of regulations under section 415(b)(5)(D) would not be subject to section 415(b)(5)(D) , but that changes in benefit structure effective after regulations are issued would be subject to section 415(b)(5)(D) even if the change in benefit structure is adopted prior to the issuance of regulations.

Explanation of Section 415(b)(5)(D)

The initial ten-year phase-in limitation applies to a participant's total accrued benefit in the plan. If there is a change in the benefit structure applicable to such participant that increases the participant's benefits under the plan, then, pursuant to section 415(b)(5)(D), benefits attributable to such change are subject to a separate ten-year phase-in limitation that operates independently of the initial ten-year phase-in limitation. Thus, as of any year, benefits attributable to a change in benefit structure may not exceed the ten-year phase-in limitation for such change. Similarly, where there are multiple changes to the benefit structure applicable to a participant the effect of section 415(b)(5)(D) is to impose a separate ten-year phase-in limitation on benefits attributable to each such change so that as of any year, benefits attributable to each change in benefit structure may not exceed the ten-year phase-in limitation for such change.

Change in benefit structure. A change in the benefit structure of the plan generally includes any change increasing benefits subject to the limitation of section 415. A change is one that increases benefits if either the change has the effect of immediately increasing a participant's accrued benefit, or greater benefits accrue after the change than would have accrued had the change not been made. Examples of such changes include changes in the plan's benefit formula, rate(s) of accrual, definition of compensation, and definition of years of participation, except to the extent provided in regulations. Thus, for example, if a plan provides for accruals of 2 percent of each year's compensation and is amended effective with years beginning after 1989 to provide for accruals of 3 percent of compensation for years after 1989, the plan will be considered to have a change in benefit structure effective for years after 1989. A plan will not be considered to have a change in benefit structure merely because a participant's rate of accrual under the plan formula increases with increasing years of service or participation (as for example, in a plan that is backloaded to the extent permitted under section 411(b)(1)(B)).

Benefits attributable to a change in benefit structure. As of a date, a participants benefits attributable to a change in benefit structure equal the participant's accrued benefit under the plan as of such date reduced by the benefits that the participant would have accrued as of such date had the formula in effect under the plan immediately prior to the change in benefit structure remained in effect through such date. Thus, benefits attributable to a change in benefit structure as of a given date may be determined as follows: Step 1: determine the participant's accrued benefit under the plan (without regard to the limitation applicable to the change in benefit structure being tested). Step 2: determine the benefit that the participant would have accrued (subject to any applicable section 415(b)(5) phase-in limitations) as of such date had the formula in effect under the plan immediately prior to the change in benefit structure remained in effect through such date. The benefit attributable to the change in benefit structure is determined by subtracting the amount determined in step 2 from the amount determined in step 1. This benefit may not exceed the ten-year phase-in limitation for the change in benefit structure.

Ten-year phase-in for a change in benefit structure. For a given year, the ten-year phase-in limitation for a change in benefit structure is equal to the 415(b)(1)(A) limitation in effect for such year times a fraction (not to exceed one), the numerator of which is the participant's years (computed to fractional parts of a year) of participation in the plan subsequent to the first day of the plan year in which the change in benefit structure is effective, and the denominator of which is 10. However, with respect to an amendment changing the benefit structure of a plan, a year of participation will not be included in the numerator of the fraction in the preceding sentence unless the amendment is adopted no later than 2½ months after the end of the plan year in which the amendment is effective.

Multiple changes in benefit structure. Where there has been more than one change in benefit structure within a ten year period, the rules above apply in the same manner to each separate change in benefit structure. The benefit attributable to a change in benefit structure includes benefits attributable to such change and any subsequent change. Thus, as of a given year, the benefit attributable to a change in benefit structure equals the participant's benefit under the plan for such year (determined subject to phase-in limitations applicable to previous changes in benefit structures) reduced by the benefit that the participant would have accrued (subject to any applicable section 415(b)(5) phase-in limitations) as of such date had the formula in effect under the plan immediately prior to the change in benefit structure remained in effect through such date. The ten-year phase-in limitation is determined in the same manner as indicated above.

The effect of the ten-year phase-in limitations is that as of any given year, a participant's accrued benefit under the plan in such year may not exceed the lesser of (i) the initial ten-year phase-in limitation, and (ii) the smallest of the sums, determined separately for each change in benefit structure effective as of the current year or any of the preceding nine years, of (I) the ten-year phase in limitation for such change applicable to such participant in such year, and (II) the accrued benefit that the participant would have accrued (subject to any applicable section 415(b)(5) phase-in limitations) as of such year had the formula in effect under the plan immediately prior to the change in benefit structure remained in effect through such year.

Application of Section 415(b)(5)(D) to Funding. Pursuant to sections 404(j) and 415(b)(5), an accrual that exceeds the lesser of 1/10 of the dollar limitation of section 415(b)(1)(A) or 1/10 of the compensation limitation of section 415(b)(1)(B) (such amount is referred to as 1/10 of the applicable 415 limitation) may occur only if a participant has past years of participation or service, as applicable, and only to the extent permitted by section 415(b)(5). Under the unit credit funding method, the normal cost for a plan year is determined as the present value of benefits accruing under the method for the year. However, section 1.412(c)(3)-1(c)(5) of the regulations provides that under a reasonable funding method that allocates liabilities among different elements of past and future service, the allocation of liabilities must be reasonable. Thus, if the actual benefit accrual for a participant in a plan that uses the unit credit funding method exceeds 1/10 of the applicable 415 limitation, the benefit accrual which may be taken into account in determining the normal cost is limited to 1/10 of the applicable 415 limitation. The portion of the actual benefit accrual in excess of such amount is permitted solely due to the participant's past participation, or service, as applicable, and must be allocated to past service for funding and deduction purposes to meet the requirement that the allocation of liabilities among different elements of past and future service must be reasonable. See Rev. Rul. 85-131, 1985-2 C.B. 138.

The result of the separate phase-in rule for each change in benefit structure is to limit not only the total accrual benefit resulting from each amendment but also the total benefit that may be provided for past-service. Furthermore, under the application of the unit credit method, the result is to limit the amount of past service liability that may be provided at any point because the amount of the increase in past service benefits is limited by the phase-in limitations.

EXAMPLE: An employer establishes a plan in 1988 with a calendar plan year that provides a benefit equal to the sum of 1% of compensation for each year of service after 1987. Employee A commences participation in the plan beginning in 1988. Assume that A receives $200,000 in compensation for all years under the plan, and that the limitation in effect under 415(b)(1)(A) is $90,000 for all years. As of the end of 1988, A's accrued benefit under the plan (prior to application of the phase-in limitations) would be $2,000. This benefit would not exceed the initial ten-year phase-in limitation applicable to A, or $9,000 ($90,000 times 1/10).

Effective 1992, the plan is amended to provide a benefit equal to sum of 1% of compensation for each year of service after 1987 but before 1992, and 4% of compensation for each year of service after 1991. As of the end of 1992, A's accrued benefit under the plan (prior to application of the phase-in limitations) would be $16,000. This benefit would not exceed the initial ten-year phase-in limitation applicable to A, or $45,000 ($90,000 times 5/10). In addition, the benefit attributable to the change in benefit structure effective in 1992 may not exceed the ten-year phase-in limitation for such change applicable to A. This limitation is $9,000 in 1992 ($90,000 times 1/10). A's benefit attributable to such change is equal to $6,000: A's accrued benefit in 1992 ($16,000) less the benefit A would have accrued under the plan in effect prior to such change (1% time $200,000 times 5 years, or $10,000). Since the benefit attributable to the change ($6,000) is less than the separate ten-year phase-in limitation applicable to such change ($9,000), the limitation is satisfied.

Effective 1993, the plan is amended to provide a benefit equal to sum of 1% of compensation for each year of service after 1987 but before 1992, and 4% of compensation for each year of service after 1991 but before 1993, and 8% of compensation for each year of service after 1992. As of the end of 1993, A's accrued benefit under the plan (prior to application of the phase-in limitations) would be $32,000. This benefit would not exceed the initial ten-year phase-in limitation applicable to A, of $54,000 ($90,000 times 6/10). In addition, the benefit attributable to the change in benefit structure effective in 1992 may not exceed the ten-year phase-in limitation for such change applicable to A. This limitation is $18,000 in 1993 ($90,000 times 2/10) A's benefit attributable to such change is equal to $20,000: A's accrued benefit in 1993, determined without regard to the limitations of section 415(b)(5)(D), ($32,000) less the benefit A would have accrued under the plan in effect prior to such change (1% time $200,000 times 6 years, or $12,000). Since the benefit attributable to the change ($20,000) would exceed the separate ten-year phase-in limitation, A cannot accrue the full benefit. The plan must limit A's benefit attributable to the change in benefit structure to $18,000 instead of $20,000, which means that A's total accrued benefit as of the year cannot exceed $30,000.

Finally, the benefit attributable to the change in benefit structure effective in 1993 may not exceed the ten-year phase-in limitation for such change applicable to A. This limitation is $9,000 in 1993 ($90,000 times 1/10). A's benefit attributable to such change is equal to $6,000: A's accrued benefit in 1993 ($30,000)(determined after application of the relevant phase- in limitations to prior changes in benefit structure) less the benefit A would have accrued under the plan in effect prior to such change (1% times $200,000 times 4 years plus 4% times $200,000 times 2 years, or $24,000). Since the benefit attributable to the change ($6,000) does not exceed the separate ten-year phase-in limitation, the limitation is satisfied.

If the plan is funded using the unit credit method, only $9,000 of the increase in accrued benefit during 1993 is used to determine the normal cost of the plan. The remaining $5,000 is allocated to past service liability and gives rise to an amortization base for purposes of sections 404 and 412 of the Code.

Modification of Notice 87-21 Regarding Section 415(b)(5)(D)

Except to the extent otherwise specified in future regulations, the 10-year phase-in of section 415(b)(5)(D) will apply under future regulations to all changes in the benefit structure of a plan, other than changes adopted and made effective prior to the later of May 17, 1989, or the effective date of the amendments to section 415 of the Code made by TRA '86. Future regulations under section 415 may except certain changes increasing benefits which are not primarily for the benefit of highly compensated participants from the application of section 415(b)(5)(D). Thus, except as provided in future regulations, a plan amendment changing the benefit structure of a plan that is effective on or after the later of May 17, 1989, or the effective date of the amendments to section 415 of the Code made by TRA '86 will be subject to section 415(b)(5)(D) even if the amendment is adopted prior to such date.

Administrative Pronouncement

This document serves as an ''administrative pronouncement'' as that term is described in section 1.6661-3(b)(2) of the Income Tax Regulations and may be relied upon to the same extent as a revenue ruling or revenue procedure

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Nonconventional Source Fuel Credit; Publication of Inflation Adjustment Factor and Reference Price for Calendar Year 1988

Notice 89-46

AGENCY: Internal Revenue Service, Treasury.

ACTION: Publication of inflation adjustment factor and reference price for calendar year 1988 as required by section 29(d)(2)(A) of the Internal Revenue Code (26 U.S.C. 29(d)(2)(A)) (formerly section 44D, renumbered by the Deficit Reduction Act of 1984).

SUMMARY: The inflation adjustment factor and reference price are used in determining the availability of the tax credit for production of fuel from nonconventional sources under section 29 of the Internal Revenue Code.

DATE: The 1988 inflation adjustment factor and reference price apply to qualified fuels sold during calendar year 1988.

Inflation factor: The inflation adjustment factor for calendar year 1988 is 1.5483.

*Price:*The reference price for all qualified fuels is $12.57 per equivalent barrel for the 1988 calendar year.

Because the above reference price does not exceed $23.50 multiplied by the inflation adjustment factor, the phaseout of credit provided for in section 29(b)(1) of the Internal Revenue Code does not occur for any qualified fuel based on the above reference price.

Kenneth Klein,

Acting Associate Chief Counsel (Technical).

(Filed by the Office of the Federal Register on March 20, 1989, 8:45 a.m., and published in the Issue of the Federal Register for March 21, 1989, 54 F.R. 11604)

Additional to Tax—Overstatement of Pension Liabilities

Notice 89-47

This Notice provides guidance in the form of questions and answers with respect to the addition to tax for the overstatement of pension liabilities imposed under section 6659A of the Internal Revenue Code of 1986 ("Code").

Q-1. *What does section 6659A of the Code provide?*

A-1. Section 6659A of the Code, which was added by section 1138 of the Tax Reform Act of 1986, Public Law 99-514, 1986-3 (Vol. 1) C.B. 1, 403, imposes an addition to tax on the taxpayer equal to a specified percentage of any income tax underpayment attributable to deductions for employer contributions to a defined benefit plan or retirement annuity plan where such deductions are based on an overstatement of liabilities under the plan.

Q-2. *When are pension liabilities considered to be overstated for purposes of applying the addition to tax imposed under section 6659A of the Code?*

A-2. There is an overstatement of pension liabilities if the actuarial determination of pension liabilities taken into account for deduction purposes, under section 404(a)(1) or (2) of the Code, exceeds the amount determined to be the correct amount of such liability. Pension liabilities are overstated, for example when the valuation of such liabilities is based on unreasonable actuarial assumptions or methods that accelerate deductions either in a manner that is inconsistent with the regulations under section 412 relating to acceptable funding methods, or by taking into account benefits in excess of those permitted under section 415. Also, an overstatement of pension liabilities may occur in any case where the Service has determined that deductions are to be disallowed because liabilities are overstated for other reasons based on the facts and circumstances.

Q-3. *How is the amount of the underpayment of income tax attributable to the overstatement of liabilities determined?*

A-3. The underpayment of income tax resulting from an overstatement of pension liabilities is the excess of the taxpayer's (1) tax liability (recalculated by substituting an acceptable valuation of pension liabilities for the overstated valuation) over (2) the tax liability including the deduction based on the overstated pension liabilities. The underpayment is to be determined after taking into account all other proper adjustments.

Q-4. *How is the applicable percentage that is applied to the underpayment of income tax for purposes of calculating the addition to tax determined?*

A-4. The applicable percentage is based on the magnitude of the disallowed excess deduction resulting from the overstatement of liabilities. The applicable percentage is determined by calculating what the "deduction claimed" is as a percentage of the "correct deduction". Thus, the deduction claimed is divided by the correct deduction. The "deduction claimed" is as a percentage of the "correct deduction". Thus, the deduction claimed is divided by the correct deduction. The "deduction claimed" is the deduction actually claimed on the taxpayer's return for contributions to a defined benefit plan or retirement annuity plan based on an overstatement of liabilities under the plan. The "correct deduction" is the maximum deduction that may be claimed for the contributions made to a plan under section 404(a)(1) or 404(a)(2) of the Code, based on an acceptable valuation of pension liabilities under the plan.

The applicable percentage of underpayment of tax due to the overstatement of pension liabilities is determined from the following table:

If the deduction claimed is the following percent of the correct deduction:	— the applicable — percentage is:
Less than 150 percent	0
150 percent or more but not more than 200 percent	10
More than 200 percent but not more than 250 percent	20
More than 250 percent	30

Q-5. *How is the addition to tax computed?*

A-5. The addition to tax is computed by multiplying the underpayment of tax attributable to the overstatement of pension liabilities described in Q-3 by the applicable percentage described in Q-4. The following example illustrates the calculation of the addition to tax.

Assume that the taxpayer's taxable income stated in Form 1120 is $300,000, and the tax liability on such income is $100,250.

In determining the amount of taxable income, the taxpayer accounted for various deductions including an $80,000 deduction for contributions to a defined benefit pension plan that the employer maintains for its employees. This deduction was calculated based on pension liabilities that were valued using a 5 percent interest assumption.

Upon examination of the taxpayer's return, the Service determined that the appropriate interest assumption for valuing liabilities under the plan was 8 percent. Based on an 8 percent interest assumption the taxpayer's maximum deduction for contributions to its plan was $45,000. There were no other adjustments to the return.

Step I. Calculate the Underpayment of Tax Attributable to the Overstatement of Pension Liabilities.

(a)	Taxable Income (as stated on the return)	$300,000
(b)	Tax Liability on (a)	$100,250
(c)	Amount of Overstated Pension Liability:	
	$80,000 ("deduction claimed")	
	− 45,000 ("correct deduction")	
	$35,000	$35,000
(d)	Adjusted Taxable Income (a) + (c)	$335,000
(e)	Tax Liability on (d)	$113,900
(f)	Underpayment of Tax (e) - (b)	$13,650

Step II. Calculate the Applicable Percentage.

(a)	Deduction Claimed	\$80,000
(b)	Correct Deduction	\$45,000
(c)	Deduction Claimed as a Percentage of the Correct Deduction ((a) divided by (b))	177.78%
(d)	Applicable Percentage of Underpayment of Tax (derived from table in Q-4)	10%

Step III. Calculate the Addition to Tax.

[Understatement of Tax Attributable to the Overstatement of Pension Liabilities]	multiplied by	[Applicable Percentage]	
		(\$13,650 × 10%)	\$1,365

Q-6. *Is the 10 percent excise tax on nondeductible contributions imposed under section 4972 of the Code applicable to contributions for which deductions are disallowed and which are subject to the addition to tax imposed under section 6659A?*

A-6. Yes, section 4972 of the Code provides for the imposition of a 10 percent excise tax on contributions to a qualified employee benefit plan that are in excess of the amount allowable as a deduction under section 404. No portion of the 10 percent excise tax may be offset against the addition to tax imposed under section 6659A. It should be noted that the mere acceptance of the payment of this addition to tax by the Service does not, of itself, constitute a determination by the Service that a deduction has been disallowed for purposes of determining whether any amounts may be returned to the employer.

Q-7. *Is there a de minimis exception to the addition to tax under section 6659A of the Code?*

A-7. Yes, if the underpayment of tax for a taxable year due to an overstatement of pension liabilities is less than \$1,000, then there is no addition to tax imposed by section 6659A of the Code.

Q-8. *Can the addition to tax be waived?*

A-8. Yes, the Secretary may waive all or any part of the addition to tax provided by section 6659A of the Code if the taxpayer can show to the satisfaction of the Service that there was a reasonable basis for the deduction claimed on the return and that such deduction was claimed in good faith.

Q-9. *Would the reliance on an enrolled actuary be considered a claim made in good faith?*

A-9. No, reliance on an enrolled actuary or another professional by an employer with respect to the proper amount of the deduction does not, of itself, constitute a reasonable basis or a good faith claim.

Q-10. *When does section 6659A of the Code become effective?*

A-10. The addition to tax imposed under section 6659A of the Code is effective for overstatements of pension liabilities made after October 22, 1986. An overstatement is made when an income tax return or amended income tax return is filed claiming a deduction for contributions made to fund overstated pension liabilities. Thus, the addition to tax applies to a deduction claimed on a tax return filed after October 22, 1986, whether or not the plan year upon which the deduction was based ended before October 22, 1986.

Administrative Pronouncement

This document serves as an "administrative pronouncement" as that term is described in section 1.6661-3(b)(2) of the Income Tax Regulations and may be relied upon to the same extent as a revenue ruling or revenue procedure.

Penalty for Failure by Income Tax Return Preparer to Sign Return—Facsimile Signatures

Notice 89-48

The Service is in the process of amending the regulations under section 6695(b) of the Internal Revenue Code to permit the use of facsimile signatures by preparers of Forms 1041, U.S. Fiduciary Income Tax Return. Section 6695(b) of the Code provides that income tax return preparers who are required by regulations to sign returns or claims for refund prepared by them and fail to do so, shall pay a penalty of \$25.00 for each such failure unless the failure is due to reasonable cause. Currently, section 1.6695-1(b)(1) of the Income Tax Regulations generally provides that income tax return preparers must manually sign returns or claims for refund prepared by them.

The Service is aware that the manual signature requirement can create hardships for income tax return preparers responsible for the preparation of large numbers of 1041 returns that, by virtue of section 645 of the Code, must be filed on a calendar year basis. Accordingly, in Notice 88-48, 1988-1 C.B. 531, the Service announced that, under certain conditions, a facsimile signature for signing Forms 1041 would be accepted. By its terms, Notice 88-48 applied only to 1987 Forms 1041.

Pending the revision of the regulations under section 6695(b) of the Code, the Service will continue the procedures outlined in Notice 88-48. Accordingly, with respect to Forms 1041 filed for taxable years ending after December 31, 1987, and on or before the date on which further guidance is published, the Service will not assert the penalty contained in section 6695(b) against a preparer of Forms 1041 for failure to sign a return provided the preparer uses a facsimile signature in signing the returns and meets the following conditions:

(1) the preparer submits to the Service with the Forms 1041 bearing the preparer's facsimile signature, a letter manually signed by the preparer (a) listing the taxpayer's name and identification number shown on each Form 1041 bearing the facsimile signature, and (b) containing a declaration, under penalties of perjury, that the facsimile signature appearing on each return is the signature used by the preparer to sign the return;

(2) after the facsimile signature is affixed, no person other than the preparer may alter any entries on the Form 1041 other than to correct arithmetic errors discernible on the return; and

(3)(a) the employer of the preparer, or (b) the partnership in which the preparer is a member, or (c) the preparer (if neither (a) nor (b) applies), retains and makes available, upon request by the Service, a manually signed copy of the letter submitted to the Service with the returns and a record of any arithmetic errors corrected.

This document serves as an "administrative pronouncement" as that term is described in section 1.6661-3(b)(2) of the regulations and may be relied upon to the same extent as a revenue ruling or revenue procedure.

Business Use of Automobiles by Rural Mail Carriers

Notice 89-49

PURPOSE

This notice provides guidance to employees of the United States Postal Service regarding the tax deduction for the costs of operating an automobile in the collection and delivery of mail on a rural route.

BACKGROUND

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 section 162(a)(and subject to any applicable limitations and restrictions in other provisions of the Code), an employee may deduct the cost of operating an automobile to the extent that it is used in a trade or business.

In order to relieve taxpayers of the burden of maintaining the detailed records necessary to compute the actual expense of operating an automobile for business purposes, the Internal Revenue Service allows taxpayers to compute the deductible costs of operating passenger automobiles (including vans, pickups, or panel trucks) under a simplified, optional method based on standard mileage rates.

Rev. Proc. 82-61, 1982-2 C.B. 849, contains the basic rules for using the optional method based on standard mileage rates. It provides that the costs attributable to business use of an automobile are computed by multiplying the business-use mileage by the cost per mile of use determined at the standard mileage rates for the period in which the use occurs.

Two standard mileage rates apply to the business use of an automobile. The business-use mileage to which the higher rate (the basic standard mileage rate) applies is limited to 15,000 miles per year (the 15,000-mile annual limitation) and to 60,000 miles over the life of the automobile (the 60,000-mile cumulative limitation). The lower rate (the lesser standard mileage rate) applies to business-use mileage that exceeds either of these limitations. The Service periodically issues revenue procedures adjusting the standard mileage rates. For 1988, Rev. Proc. 88-52, 1988-2 C.B. 711, provides that the basic standard mileage rate is 24 cents a mile and the lesser standard mileage rate is 11 cents a mile.

AMOUNT OF DEDUCTION FOR RURAL MAIL CARRIERS

For taxable years beginning after December 31, 1987, section 6008 of the Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, 102 Stat. 3342 (the Act), allows employees of the United States Postal Service to use a special mileage rate in computing the amount allowable as a deduction for business use of an automobile in performing qualifying services. Qualifying services are services involving the collection and delivery of mail on a "rural route," as that term is defined by the Postal Service. The special mileage rate is equal to 150 percent of the basic standard mileage rate, and is 36 cents per mile for 1988 (150 percent of the basic standard mileage rate of 24 cents per mile). The special mileage rate applies to all business use of an automobile while performing qualifying services, including use that exceeds the 15,000-mile annual limitation or 60,000-mile cumulative limitation.

If an automobile that is used by a Postal Service employee to perform qualifying services is also used in another trade or business, the standard mileage rates may be used in computing the deductible automobile expenses attributable to that other trade or business. The mileage for which deductions are computed at the special mileage rate, although not subject to the 15,000-mile annual and 60,000-mile cumulative limitations, is counted against those limitations in determining the extent to which business-use mileage in the other trade or business qualifies for the basic standard mileage rate. For example, assume that Postal Service employee *A*, a calendar year taxpayer, owns an automobile and that deductions for 8,000 miles of business use of the automobile were computed at the basic standard mileage rate for taxable years prior to 1988. During 1988, *A* drives the automobile 9,000 miles in performing qualifying services and 7,000 miles in another trade or business, for a total of 16,000 miles of business use. For taxable year 1988, *A* may use the special mileage rate of 36 cents per mile for 9,000 miles, the basic standard mileage rate of 24 cents per mile for 6,000 (15,000 - 9,000) miles, and the lesser standard mileage rate of 11 cents per mile for 1,000 (16,000 - 15,000) miles. At the end of 1988, 23,000 (8,000 + 15,000) miles of business use are counted against the 60,000-mile cumulative limitation in determining the extent to which business-use mileage in the other trade or business qualifies for the basic standard mileage rate. If, for 1988, *A* had instead driven the automobile 18,000 miles in performing qualifying services and 2,000 miles in another trade or business, *A* would be able to use the special mileage rate of 36 cents per mile for 18,000 miles and the lesser standard mileage rate of 11 cents per mile for 2,000 miles. At the end of 1988, 26,000 (8,000 + 18,000) miles of business use would be counted against the 60,000-mile cumulative limitation in determining the extent to which business-use mileage in the other trade or business qualifies for the basic standard mileage rate.

A deduction computed using the special mileage rate is in lieu of all operating and fixed costs of the automobile allocable to business use of an automobile in performing qualifying services. Such items as depreciation, maintenance and repairs, tires, gasoline, oil, insurance, and registration fees are included in operating and fixed costs, and may not be deducted as separate items. However, interest and state and local taxes on the automobile are deductible as separate items to the extent they are otherwise allowable under sections 163 and 164 of the Code, respectively.

In determining the adjusted basis of an automobile used to perform qualifying services, depreciation is considered to be allowed only with respect to business-use mileage that qualifies for either the basic standard mileage rate or the special mileage rate. Depreciation with respect to such business-use mileage is considered to be allowed at the depreciation rate specified by the Service in the revenue procedure establishing the standard mileage rates for the period in which the use occurs. For 1988, section 2.02 of Rev. Proc. 88-52 provides that the depreciation rate is 10.5 cents a mile. An automobile will be considered fully depreciated, and no further adjustments for depreciation will be required, when its adjusted basis is reduced to zero.

AVAILABILITY OF THE SPECIAL MILEAGE RATE

Section 6008 of the Act provides that the special mileage rate is not available for any automobile if, for any taxable year beginning after December 31, 1987, the employee claims depreciation for such automobile. Depreciation means the deduction of any amount under section 167, 168, or 179 of the Code (including any such deduction attributable to use in a trade or business that does not involve the performance of qualifying services). The availability of the special rate is not affected by depreciation claimed for taxable years beginning before January 1, 1988. Thus, the special mileage rate is available even if the automobile was fully depreciated in taxable years beginning before January 1, 1988, and regardless of the year the automobile was placed in service.

For purposes of using the special mileage rate, the term ''automobile'' includes vans, pickups, or panel trucks. The employee must own the automobile for which the special mileage rate is claimed. If the employee uses more than one automobile to perform the qualifying services, the special mileage rate may be used to compute the amount allowable as a deduction for all such use of each of the automobiles.

MANNER OF DEDUCTION

Eligible Postal Service employees should file Form 2106, Employed Business Expenses, to use the special mileage rate. If other employee business expenses are to be claimed, the employee should file one Form 2106 for the other business expenses and a separate Form 2106 for the use of the special mileage rate. Form 2106 has not been amended to accommodate the use of the special mileage rate so the instructions contained in this notice should be followed insofar as they conflict with language on Form 2106 or in its instructions. The following modifications apply in the preparation of Form 2106 for use of the special mileage rate: (1) the total number of miles driven to perform qualifying services in the taxable year should be entered on line 3 of Part II Section A and also on line 11 of Part II Section B of Form 2106 even if that total number of miles is more than 15,000 miles; (2) on line 13 of Part II Section B, the total number of miles on line 11 should be multiplied by 36 cents rather than by 24 cents; (3) zeroes should be entered on lines 12 and 14 of Part II Section B.

SCOPE

The special mileage rate of 36 cents per mile is applicable to the business use of an automobile to perform qualifying services during 1988. As stated above, the amount of the basic standard mileage rate, on which the special mileage rate is based, is subject to periodic adjustment, and thus the special mileage rate is subject to a corresponding periodic adjustment.

PROCEDURAL INFORMATION

This notice serves as an ''administrative pronouncement'' as that term is described in section 1.6661-3(b)(2) of the Income Tax Regulations and may be relied upon to the same extent as a revenue ruling or revenue procedure.

Foreign Government Statement Claiming Exemption from Withholding

Notice 89-50

The purpose of this notice is to provide further guidance to taxpayers regarding the temporary and proposed regulations under sections 892 and 1441 of the Internal Revenue Code of 1986 that were published in the Federal Register as T.D. 8211 on June 27, 1988 (53 Fed. Reg. 24060).

Effective Date

The notice of proposed rulemaking by cross-reference to temporary regulations published in the Federal Register on June 27, 1988 (53 Fed. Reg. 24100), and the preamble to T.D. 8211 erroneously state that the temporary regulations are effective for taxable years beginning after June 30, 1986. As set forth in section 1.892.1T(b) of the Temporary Income Tax Regulations, the final regulations will clarify that they are effective with respect to income received after June 30, 1986.

Withholding

Sections 1.892-7T and 1.1441-8T(a) of the temporary regulations provide rules concerning the application of certain withholding taxes to foreign governments and international organizations (Foreign Governments). The regulations generally provide that no withholding is required under sections 1441 and 1442 of the Code on income exempt from taxation under section 892. The final regulations, when published, will modify and clarify the provisions of section 1.1441-8T(b) concerning the statements provided by Foreign Governments to withholding agents with regard to income that is exempt from taxation under section 892. In particular, the final regulations will provide the following:

1. Except in the circumstances described in (2) below, a withholding agent that obtains, pursuant to section 1.1441-8T(b) of the temporary regulations, a statement under penalties of perjury or a form prescribed by the Internal Revenue Service (Statement) from a Foreign Government is excused from any liability otherwise imposed under section 1461 with respect to the income covered by the Statement (even if it is later determined that the income was not in fact exempt). The Statement must describe the nature of the item(s) of income to which it applies. It does not have to specify the amount of income nor identify the income on an investment by investment basis.
2. A Statement does not protect a withholding agent from liability if the withholding agent knows or has reason to know at the time the payment is made that the income is not in fact exempt from taxation under section 892.
3. While, the receipt of a Statement is not mandatory, a withholding agent that fails to obtain a Statement and that fails to establish otherwise that the income was exempt under section 892 will remain fully liable under section 1461.
4. A withholding agent may demand that a Foreign Government provide a Statement as specified in the regulations (and modified by the above provisions) rather than relying on other means to determine that income qualifies for exemption under section 892. If a Foreign Government does not provide a Statement, the withholding agent may withhold tax under section 1441 or 1442, and will be considered for purposes of sections 1461 through 1463 to have been required to withhold such tax.

Prior to the issuance of final regulations, a taxpayer may rely on the above provisions regarding the filing of Statements claiming exemption from withholding under section 1.1441-8T(b) of the temporary regulations. The Internal

Revenue Service has developed Form 8709 for use by Foreign Governments in lieu of the written statement described in the regulations. Form 8709 is currently available and may be obtained by contacting the appropriate IRS Forms Distribution Center for the taxpayer's state.

Pension Trusts

Pursuant to section 1.892-5T(b)(3) of the temporary regulations a pension trust described in section 1.892-2T(c) shall not be treated as a controlled commercial entity if none of its income would be considered unrelated business taxable income (UBTI) (as defined in section 512(a)(1) of the Code) if the trust were a qualified trust described in section 401(a). If some, but not all of the income of the pension trust consists of UBTI, the determination of whether or not the trust is a controlled commercial entity will be made by applying the rules of section 1.892-4T taking into account all the facts and circumstances surrounding the activities of the trust.

This document serves as an "administrative pronouncement" as that term is described in section 1.6661-3(b)(2) of the Income Tax Regulations and may be relied on to the same extent as a revenue ruling or revenue procedure.

Procedures Involving Taxpayer Interviews

Notice 89-51

This notice provides guidance with respect to the definition of a "taxpayer interview" and procedures for audio recording by taxpayers of taxpayer interviews, as authorized by section 7520 of the Internal Revenue Code. Section 7520 was enacted by the Technical and Miscellaneous Revenue Act of 1988 (TAMRA), Public Law 100-647, as part of the Omnibus Taxpayer Bill of Rights, and is effective for taxpayer interviews conducted after February 9, 1989. Pursuant to section 7520, regulations are to be issued in 1989 to provide guidance with respect to "time and place of examination" as provided in section 7605(a).

Section 7520(a) of the Code provides that any officer or employee of the Internal Revenue Service, in connection with any in-person interview with any taxpayer relating to the determination or collection of any tax, shall, upon the advance request of such taxpayer, allow the taxpayer to make an audio recording of such interview at the taxpayer's own expense and with the taxpayer's own equipment. This section also provides for recording by Service personnel if the taxpayer is notified prior to the interview. The Service must provide the taxpayer with a transcript or copy of such recording upon request, but only if the taxpayer provides reimbursement for the cost of the transcript and reproduction of such transcript or copy.

In the case of an in-person interview relating to the determination or collection of any tax, section 7520(b)(1) of the Code provides that an employee of the Service must provide the taxpayer with an explanation of the audit process or the collection process, and the taxpayer's rights thereunder, prior to or at the initial interview.

Section 7520(b)(2) of the Code provides that if the taxpayer clearly states to an officer or employee of the Service at any time during any interview (other than an interview initiated by an administrative summons) that he or she wishes to consult with an attorney, certified public accountant, enrolled agent, enrolled actuary, or any other person permitted to represent the taxpayer before the Service, then such officer or employee must suspend the interview regardless of whether the taxpayer has answered one or more questions up to that point.

For purposes of section 7520 of the Code, the term "taxpayer interview" means a meeting between an officer or employee of the Examination function, the Employee Plans and Exempt Organization function, or the Collection function of the Service, and a taxpayer or authorized representative, as defined in section 7520(b)(2), when the determination or the collection of any tax is at issue.

PROCEDURES FOR AUDIO RECORDINGS OF TAXPAYER INTERVIEWS DURING EXAMINATION AND COLLECTION PROCEEDINGS:

(1) Requests by taxpayers or their authorized representatives to make audio recordings of examination or collection proceedings, will be approved by the Service official or employee conducting the interview under the following conditions:

(a) the taxpayer or authorized representative supplies the recording equipment;

(b) the Service may produce its own recording of the proceedings;

(c) the recording takes place in a suitable location, ordinarily in an Internal Revenue Service office where equipment is available to produce the Service's recording; and

(d) All participants in the proceeding other than Service personnel must consent to the making of the audio recording and all participants must identify themselves and their roles in the proceeding.

(2) Requests by taxpayers or authorized representatives to make audio recordings of examination proceedings or collection proceedings must be addressed to the officer or employee of the Service who is conducting the interview and must be received by the Service no later than 10 calendar days prior to the interview that is to be recorded. If 10 calendar days' advance notice of intent to record is not given, the Service may, in its discretion, conduct the interview as scheduled or set a new date.

(3) When the Service intends to record a taxpayer interview that is part of an examination or collection proceeding, it will so inform the taxpayer or authorized representative no later than 10 calendar days prior to the interview that is to be recorded. This requirement does not apply where the taxpayer has already submitted a request to make a recording and the Service is merely seeking to make its own recording.

(4) Requests by taxpayers or their authorized representatives for a copy or transcript of an audio recording produced by the Service must be addressed to the official or representative conducting the interview and must be received by the Service no later than 30 calendar days after the date of the recording. However, the Service will attempt to accommodate requests received at a later date. All requests must be accompanied by payment of the costs of duplication or transcription.

(5) At the outset of the recording, the official or employee conducting an examination or meeting that is to be recorded will identify himself or herself, the date, the time, the place, and the purpose of the proceeding.

(6) When written records are presented or discussed during the proceeding, they must be described in sufficient detail to make the audio recording a meaningful record when matched with the other documentation contained in the case file.

(7) At the conclusion of the proceeding, the Service official or employee will state that the proceeding has been completed and that the recording is ended.

LEGAL EFFECT: This document serves as an ''administrative pronouncement'' as that term is described in section 1.6661-3(b)(2) of the Income Tax Regulations and may be relied upon to the same extent as a revenue ruling or revenue procedure.

Required Quarterly Contributions; Amortization of Experience Losses (Gains)

Notice 89-52

This notice provides guidance, in the form of questions and answers, with respect to the requirement that contributions to pension plans be made in quarterly installments under section 412(m) of the Internal Revenue Code as added by section 9304(b) of the Omnibus Budget Reconciliation Act of 1987 (OBRA '87). In addition, this notice provides a transitional rule regarding the amortization period for experience gains and losses determined in the valuation for plan years beginning on January 1, 1988.

BACKGROUND

Section 9304(a) of OBRA '87 amended section 412(c)(10) for plan years beginning after December 31, 1987, to provide that the minimum funding requirements for pension plans that are not multiemployer plans (''nonmultiemployer plans'') for a plan year is satisfied as of the last day of such plan year if the required payment is made within eight and one-half months after the last day of such plan year.

Section 9304(b) of OBRA '87 added section 412(m) for plan years beginning after December 31, 1988 to require that a portion of the required minimum funding for a nonmultiemployer plan for a plan year be contributed by the employer in quarterly installments within 15 days after the end of each quarter of the plan year.

Section 412(m)(2)(C) provides that contributions are credited against unpaid required installments in the order in which such installments are required to be paid.

Section 9307(a)(1) of OBRA '87 also amended section 412(b) for plan years beginning after December 31, 1987 to provide that experience losses and gains for nonmultiemployer plans be amortized over a 5-year period instead of a 15-year period.

QUESTIONS AND ANSWERS

Q-1: When are quarterly installments due?

A-1: Section 412(m)(3) requires that starting with the first plan year beginning in 1989, quarterly installments are due 15 days after the end of each quarter. For example, in the case of a calendar year plan, the first installment for the current plan year is due April 15th of such year.

Subsequent installments are due July 15th and October 15th of the current year and January 15th of the following plan year.

Q-2: What are the consequences of a late payment of a quarterly installment?

A-2: Section 412(b)(5) requires that the funding standard account (''FSA'') be charged with interest at the appropriate rate, consistent with the rate or rates of interest used under the plan to determine costs (the ''applicable interest rate for the FSA''). However, if there is a late payment of a quarterly installment, a portion of the interest charged to the FSA is based on the rate required under section 412(m)(1). The amount of interest charged to the FSA attributable to the late amount is based on 175% of the Federal mid-term rate (as in effect under section 1274 for the first month of the plan year) or if greater, the otherwise applicable interest rate for the FSA. The interest is charged from the due date to the date the late amount is actually contributed (regardless of the date such contribution is deemed to have been contributed under section 412(c)(10)). However, with respect to the first quarterly installment for the 1989 plan year, the interest rate under section 412(m)(1)-(A) (i.e., 175% of the Federal mid-term rate) will not apply until 30 days after the publication of this notice in the Internal Revenue Bulletin.

Furthermore, for a nonmultiemployer defined benefit plan, if the aggregate amount of all underpayments of quarterly installments and other payments required under section 412 exceeds $1,000,000, a lien in favor of the plan may arise under section 412(n) on the property of the person who failed to make the payment to the plan.

Example 1 — Assume for a calendar year plan year, a required installment of $6,250 is due April 15, 1989, but is not actually contributed until June 15, 1989. Further, assume that the interest rate under section 412(b)(5) is 8.00% and 175% of the Federal mid-term rate in effect on January 1, 1989 is 16.41%. (For purposes of this example, the extension of the date from which 412(m)(1)(A) applies is not considered.) The interest charge to the 1989 FSA, before reflecting the requirements of section 412(m), is based on 8.00%. However, for the two-month period of underpayment of the quarterly installment the rate used to determine the interest charge on the late installment is 16.41%. The amount of interest charged to the 1989 FSA, attributable to the two month period of underpayment of the $6,250 required installment, is $160 [($6,250 times $1.1641^{2/12}$) minus $6,250]. Had the required installment been timely contributed, the charge would have been $81 [($6,250 times $1.08^{2/12}$) minus $6,250]. (Of course, there would also have been an interest credit in the 1989 FSA of $81 on account of such contribution.) Therefore, an additional $79 [$160 — $81] is charged to the 1989 FSA as a result of the late payment.

Example 2 — Assume the same facts as in Example 1, except that the April 15th required installment of $6,250 is not paid until September 15, 1990. (For purposes of this example, the extension of the date from which section 412(m)(1)(A) applies is not considered.) Under section 412(b) interest is charged to the FSA only to the end of the plan year. Under section 412(m)(1), however, interest is charged for the full period of underpayment, or in this case, seventeen months. By applying the higher interest rate for the entire period of underpayment, the interest charged to the 1989 FSA attributable to the late installment is $1,501 [($6,250 times $1.1641^{17/12}$) minus $6,250]. Had the required installment been timely contributed, the charge would have been $350 [($6,250 times $1.08^{8.5/12}$) minus $6,250]. (Of course, there would also have been an interest credit in the 1989 FSA of $350 on account of such contribution.) Therefore, an additional $1,151 [$1,501 — $350] is charged to the FSA as a result of the late payment.

Q-3: Does the interest charge on late quarterly installments apply to money purchase pension plans?

A-3: No interest is charged under section 412(m)(1) on late or unpaid quarterly installments required for money purchase pension plans (including target benefit defined contribution plans).

Q-4: What is the amount of a quarterly installment?

A-4: In general, each quarterly installment is equal to the applicable percentage of the Required Annual Payment (''RAP''). Additional adjustments may be required in the case of a plan with an unpredictable contingent event liability. The RAP for any plan year is the lesser of 90% of the amount required to be contributed to the plan under section 412 for the current plan year (adjusted to the beginning of the plan year) or 100% of the amount required to be contributed to the plan for the preceding plan year. If the preceding plan year was not a twelve-month plan year, the RAP for the plan year is 90% of the amount required to be contributed under section 412 for the current plan year (See Example 3, Q&A-10).

The amount required to be contributed to the plan for a plan year (''minimum funding requirement'') is the amount necessary to avoid a funding deficiency as of the end of that plan year. This amount is generally determined by reference to the Schedule B filed for the applicable plan year. If the amount required to be contributed is restricted by the full funding limitation of section 412(c)(7), such limitation is the minimum funding requirement for such plan year. Contributions made for the preceding year are disregarded in determining 100% of the preceding year's minimum funding requirement and contributions made for the current year are disregarded in determining 90% of the current year's minimum funding requirement.

An example of the calculation of the amount of a quarterly installment is provided in Q&A-10.

Q-5: What is the applicable percentage of the RAP that must be paid in each quarterly installment?

A-5: Section 412(m)(4)(C) defines the applicable percentage to be 6.25% for plan years beginning in 1989, 12.5% for plan years beginning in 1990, 18.75% for plan years beginning in 1991 and 25% for plan years beginning after 1991.

Q-6: Is a credit balance taken into account in determining the RAP?

A-6: The minimum funding requirement for a plan year is determined without regard to any credit balance as of the beginning of such plan year.

For example, to calculate the RAP for a 1989 calendar plan year, a credit balance as of December 31, 1987 is disregarded in determining 100% of the preceding plan year's minimum funding requirement and a credit balance as of December 31, 1988 is disregarded in determining 90% of the current year's minimum funding requirement.

Q&A-12 addresses the issue of treating a credit balance as payment of all or a portion of a quarterly installment.

Q-7: Is an accumulated funding deficiency taken into account in determining the RAP?

A-7: In determining 100% of the preceding year's minimum funding requirement, the employer must take into account any accumulated funding deficiency that existed as of the beginning of such preceding plan year.

In determining 90% of the current year's minimum funding requirement, the employer must take into account any accumulated funding deficiency that existed at the beginning of the current plan year. However, because the first two quarterly installments are due before the end of the 8½ month period during which contributions may be made for the preceding plan year, the quarterly installment may be determined without reflecting such deficiency. If at the end of the 8½ month period, it is established that an accumulated funding deficiency did exist at the beginning of the current plan year, the employer must recalculate the quarterly installment amount taking into account such deficiency. To the extent that this recalculation indicates an underpayment of any installment previously made, the rules regarding interest charges and liens under section 412(m)(1) and (n) apply.

For example, for a plan year beginning on January 1, 1989, an employer may disregard an accumulated funding deficiency existing on such date in calculating the amount of the 1989 quarterly installments as long as the employer contributes an amount necessary to cure the deficiency on or before September 15, 1989. If the accumulated funding deficiency has not been cured on or before September 15, 1989, the amount of the quarterly installments for 1989 must be recalculated so that the 1989 minimum funding requirement will reflect any accumulated funding deficiency existing on January 1, 1989.

Q-8: Is a minimum funding requirement that was waived in accordance with section 412(d) taken into account in determining the RAP?

A-8: If the minimum funding requirement for the preceding plan year has been waived, the determination of 100% of the preceding year's minimum funding requirement is made as if no amount was waived. In addition, any amortization charges resulting from a funding waiver for an earlier plan year are included in the determination of the minimum funding requirement for both the current plan year and the preceding plan year.

For example, to calculate the RAP for a 1989 calendar plan year assuming a waiver was granted for a portion of the minimum funding requirement for 1988, such waiver is disregarded in determining 100% of the preceding year's minimum funding requirement. The amortization of the waived amount is included in determining 90% of the current year's minimum funding requirement.

The determination of 90% of the current year's minimum funding requirement should generally be made assuming that no waiver will be granted for the current plan year. If any amount is disregarded in anticipation of a waiver of such amount for the current plan year, and such waiver is subsequently denied, the rules regarding interest charges and liens under section 412(m)(1) and (n) apply.

Q-9: How is the current year's RAP determined if a plan used the alternative minimum funding standard described in section 412(g) in either the preceding plan year or the current plan year?

A-9: The RAP for any plan year is based on the funding standards used for the preceding plan year and current plan year. For example, assume that a plan uses the alternative minimum funding standard in 1988 and uses the regular funding standard in 1989. The 1989 RAP is the lesser of 100% of the minimum funding requirement for 1988, based on the alternative funding standard or 90% of the minimum funding requirement for 1989, based on the regular minimum funding standard.

Q-10: How is the amount of the first quarterly installment, as well as subsequent required installments, determined?

A-10: In general, the amount of each quarterly installment for a plan year is determined by multiplying the RAP by the applicable percentage for the plan year. Each installment made during the plan year is credited with the appropriate amount of interest to the FSA from the contribution date to the end of the plan year.

To the extent that a quarterly installment is made before the due date, interest credited for the period before such installment was due may be used to reduce the amount necessary to meet a future installment for the same plan year. Similarly, if an amount in excess of the quarterly installment is contributed, such excess (and interest credited with respect to such excess) may be used to reduce the amount needed to meet a future installment. Q&A-14 illustrates how this is done.

Example 3 — In determining the amount of the quarterly installments for the 1989 plan year for a calendar year plan, assume the 1988 minimum funding requirement as of December 31, 1988 is $100,000, and the 1989 minimum requirement as of December 31, 1989 is $125,000. First, adjust the $125,000 amount for 1989 by discounting at the appropriate interest rate(s) to determine the minimum funding requirement at the beginning of the plan year (8% for purposes of this example). Next determine the lesser of 90% of the discounted $125,000 amount for 1989 or 100% of the $100,000 amount for 1988. The final step is to multiply the lesser amount, the 1989 RAP, by the applicable percentage.

A summary follows:

(1) 1988 amount due 12/31/88 ...	.. $100,000
(2) 1989 amount due 12/31/89	$125,000
(3) 1989 amount discounted to 1/1/89 [(2)/1.08]	$115,741
(4) 90% of (3)	.. $104,167
(5) 1989 RAP [lesser of (1) or (4)]	... $100,000
(6) Applicable percentage	6.25%
(7) Amount of each quarterly installment [(5)x(6)]	$ 6,250

In this case, the amount of each quarterly installment for 1989 is equal to $6,250. The first installment is due on or before April 15, 1989. The required amount of each subsequent installment is also $6,250 and the respective due dates are July 15, 1989, October 15, 1989, and January 15, 1990.

Q-11: Are contributions made during the 8½ month period following the end of a plan year considered contributions for the prior plan year or the current plan year?

A-11: Contributions for a plan year may be contributed at any time during that plan year. In addition, section 412(c)(10) allows contributions made within the 8½ month period following the end of a plan year to be deemed to have been made on the last day of such plan year.

An employer may designate whether contributions made during the 8½ month period following the end of a plan year are made for the current plan year (the year in which the contributions were made) or the prior plan year, but not for a future plan year. Contributions may be designated for only one plan year. This designation is reported on Schedule B of Form 5500. If no designation is made, a contribution is treated as designated for the plan year in which it is made. The FSA for a plan year is credited with all contributions designated to be made for such plan year.

Example 4 — Assume the same facts as in Example 3. In addition, assume that the employer did not make any contribution for the 1988 plan year by the end of 1988. The employer contributed $6,250 on April 10, 1989, $6,250 on July 10, 1989, and $100,000 on September 10, 1989. The employer designated the first two of these contributions as being made for the 1989 plan year (amounts necessary to meet the requirements of section 412(m) for the 1989 plan year) and the third contribution as being made for the 1988 plan year.

Only the third contribution (the September 10, 1989 contribution) is credited to the 1988 FSA. The first two contributions are reported on the 1989 Schedule B and are credited to the 1989 FSA with the applicable interest adjustments.

This notice does not consider and has no effect on the designation of the year with respect to employer contributions for purposes of section 404(a)(1) or (6).

Q-12: May an employer treat all or a portion of a credit balance in a plan's FSA as a payment of a quarterly installment?

A-12: An employer may treat all or a portion of a credit balance in a plan's FSA as a payment of a quarterly installment.

Example 5 — Assume the same facts as Example 3, except that an amount in excess of the 1988 minimum funding requirement was contributed during 1988 and that such contribution resulted in a credit balance of $10,000 on December 31, 1988. It was determined in Example 3 that the amount of the first quarterly installment due on April 15, 1989 is $6,250. At that time, the credit balance, with three and a half months' interest, equals $10,227. Even if no contribution is made by April 15, 1989, the first installment requirement is satisfied because the credit balance with interest exceeds the amount of the quarterly installment due. The amount of excess, $3,977, with three months' interest to the due date of the second installment, is $4,054 and may be used to reduce the amount required to be contributed for the second installment. Therefore, as long as $2,196 [$6,250 — $4,054] is contributed by July 15, 1989, the second installment requirement will be satisfied. The full $6,250 must be contributed for the third and fourth installments unless additional contributions are made for the 1988 plan year on or before September 15, 1989.

Contributions for the prior plan year will not be reflected in the determination of any credit balance until they are actually contributed to the plan. The intent to contribute the required amount within 8½ months after the end of the prior plan year is not sufficient. For example, in the previous example, if no contribution for the 1988 plan year had been made by April 15, 1989, no credit balance could have been taken into account in determining the amount needed to satisfy the first installment requirement, unless the amount of credit balance as of December 31, 1987 was greater than the 1988 minimum required contribution.

Q-13: Are quarterly installments required for the first plan year to which section 412 applies?

A-13: Quarterly installments are not required for the first plan year to which section 412 applies.

Q-14: If the amount contributed is in excess of the required quarterly installment (either due to an overpayment or a contribution made prior to the due date with no interest adjustment), may such overpayment be used to reduce the payment of a subsequent quarterly installment?

A-14: The overpayment of a quarterly installment may be used to reduce the payment necessary to satisfy a subsequent quarterly installment for the same plan year.

Example 6 — Assume the same facts as in Example 3, except that the amount of a quarterly installment was initially determined based only on the prior year's minimum funding requirement, because the current year's requirement was not yet determined by April 15, 1989. In addition, assume that the fisrt two quarterly installments of $6,250 were contributed on April 15, 1989 and July 15, 1989. It is subsequently determined (upon completion of the current year's valuation) that the 1989 minimum funding requirement as of December 31, 1989 is $75,000 (instead of $125,000 as in Example 3). The correct quarterly installment amount is $3,906 [90% of($75,000 divided by 1.08) times .0625]. The first installment of $6,250 exceeded the required $3,906 by $2,344 as did the second. Reflecting the interest to be credited in the FSA to October 15, 1989 (the due date of the third installment), a total of $4,825 [$2,344 $\times$ $1.08^{6/12}$ plus $2,344 $\times$ $1.08^{3/12}$] has been overpaid. The third installment of $3,906 is entirely satisfied by such overpayment; the amount of overpayment is reduced to $919. After reflecting interest to December 31, 1989 (no interest is credited in the FSA after the end of the plan year), the overpayment is $934. The amount required to satisfy the final installment on January 15, 1989 is $2,972 [$3,906 − $934].

Q-15: If the 1989 valuation for a plan indicates that the quarterly installments made for the 1989 plan year exceed the deductible amount for the 1989 plan year, may the excess of the amount contributed over the deductible limit be designated as a contribution for the 1988 or 1990 plan year?

A-15: To the extent that the payments were made within the period allowed by section 412(c)(10) for the 1988 plan year, such contributions may be designated for the 1988 plan year. Contributions so designated are included in the determination of the maximum deductible amount for the 1988 plan year. Further, contributions of quarterly installments made in the 1990 plan year may be designated as contributions for the 1990 plan year.

Q-16: May all or part of the payment of a quarterly installment be returned to the employer as a mistake of fact merely because such payment is in excess of the deductible limits?

A-16: Rev. Rul. 77-200, 1977-1 C.B. 98, allows for the reversion of certain nondeductible contributions only if the amount to be returned was contributed as a result of a good faith mistake of fact. Nondeductibility is not a mistake of fact.

Future guidance will provide limited relief permitting reversions to employers of certain contributions.

Q-17: Because the first quarterly installment for any plan year is due 3½ months after the end of the preceding plan year and the amount of such installment is based on the minimum funding requirement for the preceding plan year, must the valuation for the preceding plan year be finalized within such 3½ month period, even though contributions for such plan year are not required to be made until 8½ months after the end of such plan year?

A-17: Valuations need not be finalized within the 3½ month period. However, if the final valuation indicates that a previously made installment was not sufficient to meet the requirements of section 412(m), the rules regarding interest charges and liens under section 412(m)-(1) and (n) apply.

Q-18: What is the amortization period for experience gains or losses determined in valuations for plan years beginning after December 31, 1987?

A-18: Prior to OBRA '87, experience gains and losses were amortized (in equal annual installments) over 15 plan years until fully amortized for purposes of the minimum funding standards for pension plans under section 412. OBRA'87 amended sections 412(b)(2)-(B)(iv) and 412(b)(3)(B)(ii) to provide that experience gains and losses are amortized (in equal annual installments) over 5 plan years until fully amortized (15 plan years in the case of a multi-employer plan). This change is effective for plan years beginning after December 31, 1987, and applies to experience gains and losses determined in valuations of a plan's liabilities for such years. Previously determined experience gains and losses continue to be amortized over 15 plan years.

For example, for a plan with a calendar plan year, the gain or loss determined in the valuation for the 1988 plan year is amortized over 5 plan years beginning with the 1988 plan year.

There has been some uncertainty regarding the effective date of the change to a 5-year amortization period for experience gains and losses for calendar year plans. Accordingly, an employer may apply an optional transitional rule with respect to to the amortization in the funding standard account of the experience gain or loss determined in the valuation for the plan year beginning in 1988 ("the transition loss (gain)"). This transitional rule may be used only if the plan had a calendar year plan year for 1988 and the valuation date for the 1988 plan year was January 1, 1988.

Under the transition rule, the amount charged (or credited in the case of an experience gain) to the 1988 funding standard account to amortize the transition loss (gain) may be based on a 15-year amortization period instead of a 5-year period. For plan years beginning in 1989, or later, the amount charged (or credited) to the funding standard account for the amortization of the transition loss (gain) shall be determined by amortizing the outstanding balance of the transition loss (gain) as of January 1, 1989, over 4 years (in equal annual installments) until fully amortized.

Example 7 — Assume a calendar year plan has a January 1, 1988 valuation date for the 1988 plan year. An experience loss of $100,000 was determined in the valuation as of such date. Under the transitional rule, the amount charged to the funding standard account for 1988 is a 15-year amortization of $100,000. Assuming an interest rate of 8%, this amount is $10,818 as of the beginning of 1988. The outstanding balance of the transition loss as of January 1, 1989 is $96,317 [($100,000 — $10,818) x 1.08]. The amount charged to the funding standard account for each of the years 1989-92 is a 4-year amortization of $96,317, or $26,926 (as of the beginning of the year).

If the transition rule is not used, the amount charged to the funding standard account for each of the years 1988-92 is a 5-year amortization of $100,000, or $23,190 as of the beginning of the year.

Q-19: What effect does the use of the transitional rule described above have on the determination of the required quarterly installment amount?

A-19: If the transitional rule is used, the required quarterly installments for the 1989 plan year are determined in the following manner. In determining 100% of the minimum funding requirement for the preceding plan year, the 15-year amortization of the transition loss(gain) is used. In determining 90% of the minimum funding requirement for the current plan year, the 4-year reamortized amount is used. However, as an element of the transitional rule, the first quarterly installment for the 1989 plan year may be determined as if 90% of the current year's minimum funding requirement included a 15-year amortization of the transition loss(gain) rather than the 4-year reamortized amount, provided the difference between the two is contributed to the plan (in addition to the second quarterly installment).

RELIANCE

Until further guidance is published by the Service, plan sponsors and participants may rely on this notice. If further guidance is more restrictive than the guidance provided by this notice, such further guidance will not have retroactive effect.

This document serves as an "administrative pronouncement" as that term is described in section 1.6661-3(b)(2) of the Income Tax Regulations and may be relied upon to the same extent as a revenue ruling or revenue procedure.

Weighted Average Interest Rate Update

Notice 89-53

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 section 412(c)(7) of the Internal Revenue Code as amended by the Omnibus Budget Reconciliation Act of 1987 (OBRA 1987).

The notice also provides that an announcement will be published monthly to provide the weighted average and the permissible range for the plan years beginning each month. The following rates were determined for the plan years beginning in the months shown below.

Month	Year	Weighted Average	Permissible Range
April	1989	8.79	7.91 to 9.67

Administrative Pronouncement

This document serves as an "administrative pronouncement" as that term is described in section 1.6661-3(b)(2) of the Income Tax Regulations and may be relied upon to the same extent as a revenue ruling or revenue procedure.

Weighted Average Interest Rate Update

Notice 89-54

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The notice also provides that an announcement will be published monthly to provide the weighted average and the permissible range for the plan years beginning each month. The following rates were determined for the plan years beginning in the months shown below.

Month	Year	Weighted Average	Permissible Range
May	1989	8.79	7.91 to 9.67

Administrative Pronouncement

This document serves as an "administrative pronouncement" as that term is described in section 1.6661-3(b)(2) of the Income Tax Regulations and may be relied upon to the same extent as a revenue ruling or revenue procedure.

Year of Inclusion — Income Received on Account of Drought

Notice 89-55

The purpose of this notice is to provide guidance to farmers regarding the tax treatment of certain income received on account of drought.

I. *Background*

Section 451 of the Internal Revenue Code provides rules that govern the proper taxable year in which to include items in gross income. Generally, income is reported in the year it is received unless, under the method of accounting used to compute taxable income, the item is properly includible in another taxable year. However, section 451 also contains special rules permitting deferrals of income for certain amounts received by farmers for crops and livestock because of natural disaster and drought.

Specifically, section 451(d) of the Code allows taxpayers, in certain circumstances, to defer the reporting of insurance proceeds received as a result of the destruction of or damage to crops. Similarly, section 451(e) allows taxpayers to defer the reporting of income derived from the sale of livestock sold on account of drought, if certain requirements are met. Alternatively, section 1033(e) allows for nonrecognition of the gain realized on the sale of livestock sold solely on account of drought if the livestock are replaced and the requirements of section 1033 are met.

The Disaster Assistance Act of 1988 (Pub. L. No. 100-387, 102 Stat. 924), in part, provides for payments to farmers affected by drought. Under Title I of the Act, livestock producers may receive assistance in the form of cash reimbursements for feed and certain transportation expenses, and in the form of donations and below market purchases of feed. Under Title II of the Act, crop producers may receive payments for destroyed or damaged crops. Section 321 of Title III of the Act provides, in effect, for cost-sharing payments for approved conservation practices.

This notice explains the extent to which payments under the Disaster Assistance Act of 1988 and certain other income recognized on account of drought qualify for deferral under sections 451(d) and 451(e) of the Code. This notice also addresses the proper tax treatment of payments and other benefits received under the Act.

II. *Crop Loss Assistance*

Section 451(d) of the Code and section 1.451-6 of the Income Tax Regulations allow a taxpayer on the cash receipts and disbursements method of accounting who receives insurance proceeds for the destruction of or damage to crops to elect to include such proceeds in income for the taxable year following the year of destruction or damage if the taxpayer establishes that, under its normal business practice, income from the crops would have been reported in a year following the year of destruction or damage.

In order for a payment to constitute insurance for the destruction of or damage to crops, the insured must suffer actual loss. Agreements with insurance companies that provide for payments without regard to actual losses of the insured, *e.g.*, in the event that certain weather conditions occur or do not occur, do not constitute insurance payments for the destruction of or damage to crops. Accordingly, payments under such contracts will not qualify for deferral under section 451(d) of the Code.

Under section 451(d) of the Code, certain government payments for crop damage are treated as insurance proceeds. Specifically, payments received under the Agricultural Act of 1949 (as amended) for the destruction of or damage to crops caused by drought, flood, or other natural disaster, or the inability to plant crops because of such a natural disaster, will be treated as insurance proceeds received for the destruction of or damage to crops. Further, section 6033 of the Technical and Miscellaneous Revenue Act of 1988 (Pub. L. No. 100-647, 102 Stat. 3342) amended section 451(d) to provide that payments received under Title II of the Disaster Assistance Act of 1988 as compensation for the destruction of or damage to crops, or the inability to plant crops, because of drought or any other natural disaster shall also be treated as insurance proceeds received as a result of the destruction of or damage to crops. Therefore, these payments may qualify for deferral under section 451(d).

Title II of the Disaster Assistance Act of 1988 establishes disaster payment programs for eligible farmers that, as a result of drought, hail, or related condition in 1988, are unable to harvest sufficient quantities of various crops. Accordingly, a cash method taxpayer may elect to include in gross income for 1989 such Title II payments that are received in 1988, if the taxpayer establishes that, under its normal business practice, the income from such crops would have been included in its gross income for any taxable year following 1988. All Title II payments are eligible for this elective deferral under section 451(d) of the Code, regardless of whether they are received before or after November 11, 1988, the date of enactment of the Technical and Miscellaneous Revenue Act of 1988.

A taxpayer must make an affirmative election to defer recognition of eligible payments under section 451(d) of the Code. A taxpayer receiving multiple eligible payments that are attributable to a single trade or business must treat those amounts in a consistent manner, either including the amounts in income in the year of receipt or electing to include the amounts in income in the year following the year of destruction or damage. The time and manner of making the election were not changed by the Technical and Miscellaneous Revenue Act of 1988 and are set forth in section 1.451-6(b) of the regulations. These rules are also generally explained in Publication 225, *Farmer's Tax Guide*. Rev. Rul. 74-145, 1974-1 C.B. 113, also provides guidance as to the manner of making this election. This election may also be made on an amended return.

III. *Gain from the Sale or Exchange of Livestock*

Section 451(e) of the Code and section 1.451-7 of the regulations allow a cash method taxpayer, whose principal trade or business is farming, to elect to defer for one year gain realized from the sale of livestock solely on account of drought. The amount of income that may be deferred is the income attributable to the excess of the number of livestock sold or exchanged over the number that would have been sold, following usual business practices, in the absence of a drought. See section 1.451-7(a) of the regulations for details of this computation.

The Technical and Miscellaneous Revenue Act of 1988 extends this one-year elective deferral to the gain realized from sales after December 31, 1987, of livestock held for draft, breeding, dairy, or sporting purposes regardless of the period of time that the livestock have been held. Before this change, a producer could not defer the gain realized from such sales if the livestock had been held for these purposes for 12 months or more (24 months in the case of cattle and horses).

For the sale to qualify under section 451(e) of the Code, the drought that caused the sale must have resulted in an area being designated as eligible for assistance by the Federal Government. The designation may be made by the President or by an agency or department of the Federal Government. Determinations by the Department of Agriculture or agencies within the Department of Agriculture, such as the Farmer's Home Administration or the Agriculture Stabilization and Conservation Service, are sufficient designations. Similarly, determinations by other federal agencies such as the Federal Emergency Management Agency or the Small Business Administration also satisfy the requirement.

The livestock may be sold before an area is designated as eligible for federal assistance so long as the drought that caused the sale also caused the area to be so designated. Evidence must be submitted, pursuant to section 1.451-7(g) of the regulations, explaining the relationship of the designated drought area to the taxpayer's early sale of the livestock.

To qualify for the one-year elective deferral, the livestock need not be raised, and the sale need not take place, in a drought area. The sale must occur, however, solely on account of drought conditions in the designated area, the existence of which affected the water, grazing, or other requirements of the livestock so as to necessitate the sale. This requirement generally will not be met if the costs of food, water, or other requirements of the livestock affected by the drought are not substantial in relation to the total costs of holding the livestock.

As an alternative to the one-year deferral of gain under section 451(e) of the Code, a producer may be eligible to defer gain under section 1033(e). Under the rules of section 1033, a taxpayer that disposes of an asset in an involuntary conversion and replaces it in a timely manner with qualifying replacement property may defer the gain from the involuntary conversion until the replacement property is disposed of. Section 1033(e) treats as an involuntary conversion the sale of livestock (other than poultry) held by a taxpayer for draft, breeding, or dairy purposes in excess of the number that the taxpayer would sell under usual business practices if such livestock is sold by the taxpayer solely on account of drought. Accordingly, the taxpayer may elect not to recognize the gain realized on the sale of the excess livestock if qualifying replacement property is purchased in a timely manner and the other requirements of section 1033 are met.

For details concerning other income eligible for deferral and for general information on other tax issues affecting farmers, see Publication 225, *Farmer's Tax Guide*.

IV. *Treatment of Feed Assistance, Payments and Other Benefits*

Title I of the Disaster Assistance Act of 1988 authorizes programs to provide feed assistance, reimbursement payments, and other benefits to qualifying livestock producers if, because of a natural disaster (such as drought, fire, hurricane, or earthquake), the Secretary of Agriculture determines that a livestock emergency exists. These programs include partial reimbursement for expenses incurred in purchasing feed and for certain transportation expenses, and the donation or sale at a below market price of feed owned by the Commodity Credit Corporation.

Title I payments are not proceeds from the sale of livestock and are not eligible for deferral under section 451(e) of the Code. Similarly, Title I payments are not eligible for deferral under section 451(d), which allows a one-year deferral for certain payments received for the destruction of or damage to crops raised by a taxpayer for sale, or for the inability to plant such crops because of a natural disaster. Although some Title I payments may be received for the loss of feed produced by a farmer for such farmer's livestock, no Title I payments are received for the destruction of or damage to crops raised for sale, or the inability to plant such crops. Thus, Title I payments are not compensation for the loss of crops the income from which would have been reported in a later taxable year and are not eligible for deferral under section 451(d).

In general, the reimbursement payments under Title I programs are includible in gross income in accordance with the recipient's method of accounting. A limited exception applies in the case of a taxpayer on the cash receipts and disbursements method of accounting whose application for reimbursement is approved prior to paying an expense that would be currently deductible under section 162 of the Code. Under these circumstances, a taxpayer is not required to include the reimbursement payment in gross income; the deduction for the expense, however, is limited to the amount that is not reimbursed. *See* Rev. Rul. 79-263, 1979-2 C.B. 82. In other circumstances, the reimbursement payment is includible in gross income, and the deduction for the expense is not so limited.

Donations and below market sales of feed under Title I are not arm's length transactions; the purpose of the programs is to confer relief benefits on the recipients and purchasers. Accordingly, the market value of donated feed is includible in gross income in accordance with the recipient's method of accounting. Similarly, a purchaser of feed at below market prices must include in gross income the difference between the price paid and the market value of the feed. In either case, however, a deduction is allowable for the market value of the feed to the extent that the farmer would have been permitted to deduct currently the cost of purchasing the feed at market value. *Cf.* Rev. Rul. 73-13, 1973-1 C.B. 42. Thus, to the extent that the farmer is permitted a current deduction for the purchase of the feed, inclusion of the value of the conferred benefit in the farmer's income is offset by a current deduction and has no tax effect other than increasing the amount of the gross receipts from farming. If, on the other hand, the farmer would have been required to capitalize the cost of purchased feed, the value of the donated feed or the amount of the price reduction must also be capitalized.

Treatment of these benefits in this manner is consistent with the treatment of cost-sharing payments under other government programs. For example, cost-sharing payments under a government conservation, restoration, or reclamation program are generally includible in gross income unless the program is specified in section 126 of the Code, in which case a recipient may exclude all or a portion of the payments. If payments are not excluded from gross income under section 126, a taxpayer is treated as paying or incurring a cost equal in amount to the payment and may recover this cost through deduction, or through depreciation, cost of goods sold, depletion, or amortization (as in the case of a capitalized cost), to the extent provided for in the Code. *See* Rev. Rul. 84-67, 1984-1 C.B. 28.

Prior to the Disaster Assistance Act of 1988, owners and operators of farms and ranches may have entered into contracts with the Secretary of Agriculture (under subtitle D of title XII of the Food Security Act of 1985, 16 U.S.C. 3831 *et seq.*) to devote croplands normally used for agricultural production to a less intensive use, such as pasture or permanent grass. In return, the owner or operator receives rental payments as compensation for devoting the land to a less intensive use. In an emergency, such as a drought, the Secretary may authorize the harvesting of the croplands that are subject to these contracts, in which case the rental payments for the harvested land are reduced.

Section 321 of Title III of the Disaster Assistance Act of 1988 provides that, with respect to any authorized harvesting of hay during the 1988 crop year on croplands subject to a conservation reserve program contract,there shall be no reduction in the rental payments, which would otherwise occur as a result of the harvesting, to the extent that the producer pays for additional approved conservation practices. The amount of the avoided reduction is limited to one-half of the costs incurred for the new conservation measures. For example, assume that a producer entitled to rental payments of \$100*x* per year would normally be subject to a reduction of \$25*x* in 1989 (and thus would receive only \$75*x*) if the producer harvested hay during 1988 pursuant to the emergency authorization. If the producer, however, pays at least \$50*x* for additional approved conservation measures, the producer will receive the full \$100*x* in 1989.

In effect, the avoided-reduction portion of the rental payment is a cost-sharing payment for the additional conservation measures. This portion, however, is not excludible from gross income because it is not made pursuant to a program specified in section 126 of the Code. The balance of the rental payment is also not excludible from gross income under section 126. A producer, therefore, should include the full rental payment in gross income. The conservation costs that the producer pays or incurs may be recovered under the normal rules applicable to costs incurred for such conservation measures (*e.g.*, through current deduction, depreciation, amortization or upon disposition). See section 175, which permits a current deduction of soil or water conservation expenses if certain requirements are met.

PROCEDURAL INFORMATION

This notice serves as an "administrative pronouncement" as that term is described in section 1.6661-3(b)(2) of the regulations and may be relied upon to the same extent as a revenue ruling or revenue procedure.

Waiver of Qualified Appraisal for Certain Charitable Contributions by Certain Corporations

Notice 89-56

This notice provides that, pursuant to authority granted under section 6281 of the Technical and Miscellaneous Revenue Act of 1988, 102 Stat. 3342, 3755, the requirement of a qualified appraisal from a third party in the case of certain charitable contributions of property by closely held corporations and personal service corporations will be waived under final regulations to be issued under section 170(a)(1) of the Internal Revenue Code.

These final regulations will include a special rule for certain contributions (which are "qualified contributions" for the care of the ill, the needy, or infants within the meaning of section 170(e)(3)-(A) of the Code) of inventory and other property described in section 1221(1) with a claimed value in excess of \$5000 that are made by closely held corporations and personal service corporations on or after November 10, 1988. This special rule will not require such a donor corporation to obtain a qualified appraisal from a third party, but instead will require that the donor's annual return contain certain summary information, such as a description of the inventory contributed and the method used to value the contribution.

As previously announced, these final regulations will also include a similar special rule for contributions by C corporations (other than closely held corporations or personal service corporations) of inventory and other property to which section 170(e)(3) or 170(e)(4) of the Code applies.

PROCEDURAL INFORMATION

This document serves as an "administrative pronouncement" as that term is described in section 1.6661-3(b)(2) of the Income Tax Regulations and may be relied upon to the same extent as a revenue ruling or revenue procedure.

Revision of Temporary Regulations Pending Issuance of Final Regulations under Section 897 of the Internal Revenue Code of 1986

Notice 89-57

The purpose of this notice is to announce the temporary suspension of a requirement contained in the Temporary Income Tax Regulations issued under section 897(d) and (e) of the Internal Revenue Code. The temporary regulations under section 897(d) and (e) were published in the Federal Register for Thursday, May 5, 1988 (53 FR 16233).

Background

The temporary regulations under section 897(d) and (e) of the Code concern the transfer or distribution of U.S. real property interests by nonresident alien individuals or foreign corporations in dispositions that otherwise qualify for nonrecognition under the Code. Under the temporary regulations a condition of nonrecognition is that the filing requirements of paragraph (d)(1)(iii) of section 1.897-5T must be satisfied.

Section 1.897-5T(d)(1)(iii) of the temporary regulations provides that if a U.S. real property interest is distributed or transferred after December 31, 1987, the foreign transferor or distributor shall file an income tax return for the taxable year of the distribution or transfer in order to receive the nonrecognition treatment. It also provides that if a U.S. real property interest is distributed or transferred in a transaction before January 1, 1988, with respect to which nonrecognition treatment would not have been available under the express provisions of section 897(d) or (e) of the Code but is available under the provisions of section 1.897-5T or section 1.897-6T, then the person that would otherwise be subject to tax by reason of the operation of section 897 must file an income tax return or an amended return for the taxable year of the distribution or transfer by May 5, 1989, or by the date that the filing of the return is otherwise required. A statement providing certain information is required to be attached to the return.

Suspension of return filing requirement

The return filing requirement of section 1.897-5T(d)(1)(iii) of the temporary regulations is temporarily suspended for nonrecognition transfers and distributions by foreign transferors or distributors where (1) the transfer or distribution otherwise qualifies in its entirety for nonrecognition under the temporary regulations under section 897(d) and (e) of the Code; (2) the transferor or distributor does not have any other income that is effectively connected with a U.S. trade or business during the taxable year that includes the transfer or distribution subject to the temporary regulations under section 897(d) and (e); and (3) one of the following conditions is satisfied: (A) a withholding certificate is obtained pursuant to section 1.1445-3(a) of the regulations, (B) a notice of nonrecognition is submitted to the Service pursuant to the provisions of section 1.1445-2(d)(2) (or section 1.1445-2T(d)(2) of former temporary regulations), or (C) the transfer or distribution occurred before January 1, 1985. Additional guidance concerning the return filing requirement will be provided in the future.

ADMINISTRATIVE PRONOUNCEMENT

This document serves as an ''administrative pronouncement'' as that term is described in section 1.6661-3(b)(2) of the regulations and may be relied upon to the same extent as a revenue ruling or revenue procedure.

Rules for Determining the Allocation of Bank Loan Losses under Section 865 of the Internal Revenue Code as Added by the Tax Reform Act of 1986

Notice 89-58

SECTION 1. PURPOSE

This notice provides guidance under section 865 of the Internal Revenue Code concerning the allocation and apportionment of losses incurred by banks with respect to certain loans made in the ordinary course of the bank's trade or business. Generally, this notice provides that losses recognized with respect to such loans shall be allocated to the class of interest income generated by such instruments, and shall be apportioned between U.S. source interest income and one or more separate limitation categories of foreign source interest income included within the class of interest income. The losses must be apportioned according to an asset method of apportionment that is based on the outstanding amount of loans generating interest income in such groupings.

The rules contained in this notice will be incorporated in regulations to be promulgated under section 865 of the Code. This document serves as an ''administrative pronouncement'' as that term is described in section 1.6661-3(b)(2) of the Income Tax Regulations and may be relied upon to the same extent as a revenue ruling or procedure Any modification of the rules contained herein will be prospective only.

SEC. 2. BACKGROUND

Section 1211 of the Tax Reform Act of 1986, 1986-3 (Vol. 1) C.B. 1, 450, added section 865 to the Code. Section 865(j) directs the Secretary to prescribe regulations that may be necessary or appropriate to carry out the purpose of section 865 relating to the treatment of losses from sales of personal property.

SEC. 3. PERSONS COVERED

This notice applies only to banks as defined in section 4(a) of this notice.

SEC. 4. DEFINITIONS AND GENERAL RULES

(a) *Bank.* Solely for purposes of this notice, the term ''bank'' shall mean any bank as defined in section 585(a)(2) of the Code. In the case of a separate affiliated group consisting solely of banks as described in subsection (b) of this section 4, such separate affiliated group shall be treated as a ''bank'' that is a single corporation. With respect to banks described in section 585(a)(2)(B) (U.S. branches of foreign corporations), the rules of this notice apply only for purposes of determining the allocation and apportionment of losses incurred on loans, the interest on which is effectively connected with the conduct of a banking business within the United States. Therefore, as an initial matter, whether a loss incurred by a U.S. branch is subject to the rules of this notice depends upon whether the interest on the loan is effectively connected income.

(b) *Affiliated corporations.* Two or more banks that are members of an affiliated group (as defined in section 1.861-11T(d)(1) of the regulations) shall for purposes of this notice be treated as a separate affiliated group consisting solely of such banks.

(c) *Eligible loan.* Solely for purposes of this notice, the term ''eligible loan'' shall mean any eligible loan as defined in section 585(b)(4) of the Code and the regulations thereunder.

(d) *Special rules.* The Commissioner, by a ruling issued to the taxpayer, may include in an affiliated group of banks described in section 4(b) of this notice corporations that are financial service entities within the meaning of section 1.904-4(e)(3) of the regulations and that are members of the affiliated group under section 1.861-11T(d)(1). Regardless of whether a ruling is issued pursuant to the preceding sentence, the Commissioner, by ruling issued to the taxpayer, may make appropriate adjustments to the asset apportionment method described in section 5 of this notice as applied to any member of the affiliated group to include debt instruments other than eligible loans as assets includable in the apportionment formula. In considering either type of ruling request as described above, the Commissioner will consider whether the requested adjustments result in a distortion of income.

(e) *Priority.* The source of any foreign currency loss attributable to an eligible loan shall be determined under the rules of section 988 and the regulations thereunder and not under the rules of this notice.

SEC. 5. ALLOCATION AND APPORTIONMENT OF LOSSES

A loss derived by a bank from the disposition, or specific charge-off under section 166 of the Code, of an eligible loan shall be allocated to the class of gross interest income derived by the bank from its portfolio of eligible loans. Where such interest income includes both U.S. and foreign source income, or foreign source income includable within more than one separate limitation category under section 904(d)(1), such loss must be apportioned between or among these residual and statutory groupings. The apportionment shall be made according to the tax book value asset method as described in section 1.861-9T(g) of the regulations (relating to the apportionment of interest expense), subject to the following rules:

(a) In applying the asset apportionment method, the average value of eligible loans held by a bank shall be treated as its only assets. Accordingly, losses realized with respect to eligible loans will be apportioned among the statutory and residual groupings based on the proportion of the average value of eligible loans giving rise to income in such groupings.

(b) The average value of eligible loans outstanding within each statutory or residual grouping will be determined by utilizing the beginning of the year and end of the year averaging method described in section 1.861-9T(g)(2) of the regulations. The average value of eligible loans, however, shall not be computed utilizing the fair market value method of apportionment.

(c) The transition rules contained in section 1012(h)(7) of the Technical Corrections and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, related to allocation and apportionment of interest expense are not applicable for purposes of this notice.

(d) Any loan that qualifies as an exempt asset as defined in section 1.861-8T(d)(2)(ii)(A) of the regulations shall not be treated as an eligible loan as defined in section 4, paragraph (c) of this notice.

(e) Eligible loans attributable to a foreign branch of a domestic corporation shall be taken into account as assets in a manner that is consistent with section 1.861-9T(f)(2) of the regulations, and losses on such loans shall be included in the amount of losses subject to allocation and apportionment under this notice.

(f) A loan to a related person within the meaning of section 267(b) shall not be treated as an eligible loan.

(g) In the case of an affiliated group that is eligible to file, but does not file, a consolidated return, allocation and apportionment of losses on eligible loans will be subject to adjustments similar to those described in section 1.861-11T(g) of the regulations.

SEC. 6. EFFECTIVE DATE

This notice shall be effective for taxable years beginning after December 31, 1986.

Deadline for Practical Capacity Extension Requests

Notice 89-59

Under section 1.9100-1(a) of the Income Tax Regulations, the Commissioner has discretionary authority to grant extensions of the time fixed by the regulations for making an election or application for relief. This authority applies to accounting method change requests filed more than 180 days after the beginning of the taxable year in which it is desired to make the change (the due date set in regulations section 1.446-1(e)(3)(i)).

Prior to the enactment of the Tax Reform Act of 1986, 1986-3 (Vol. 1) C.B. 1, section 1.471-11(d)(4) of the regulations permitted manufacturers of inventory to use the "practical capacity concept" in determining the amounts of fixed indirect production costs which were subject to inclusion in ending inventory. Section 1.263A-1T(b)(2)(vii) of the temporary regulations provides that the use, directly or indirectly, of the practical capacity concept is not permitted under section 263A of the Internal Revenue Code and the temporary regulations thereunder. Accordingly, use of the practical capacity method is prohibited. Section 263A of the Code is effective for costs incurred after December 31, 1986, and, in the case of property that is inventory in the hands of the taxpayer, for taxable years beginning after December 31, 1986.

A number of taxpayers have indicated their intent to litigate the repeal of the practical capacity method. Forms 3115, Applications for Change in Accounting Method, have been submitted to exhaust the taxpayers' administrative remedies prior to a formal challenge.

Since April of 1988, we have been accepting late Forms 3115 requesting permission to use the practical capacity method, effective for tax years to which Code section 263A applies, under the provisions of section 1.9100-1(a) of the regulations. As a matter of administrative practice, these extensions have been approved, principally because issuance of the temporary regulations prohibiting use of the practical capacity method did not occur until August 7, 1987, and, subsequently, a hearing with respect to such regulations was not held until December 7, 1987. Although the requests for extension have been approved, the underlying accounting method requests have been denied pursuant to the temporary regulations cited above.

Due to the period of time that has passed, effective July 31, 1989, approval of an extension with respect to the filing of a request to use the practical capacity method for the first tax year to which section 263A of the Code applies will generally not be granted. Such an extension request will only be granted if the taxpayer demonstrates unusual and compelling circumstances for not filing the request within this time period. See Rev. Proc. 79-63, 1979-2 C.B. 578, for information that must be provided.

Valuation Tables

Notice 89-60

In accordance with section 7520 of the Internal Revenue Code, this notice provides tables containing actuarial factors to be used in determining the present value of an annuity, an interest for life or for a term of years, or a remainder or reversionary interest. The tables set forth in this notice apply for valuation purposes under several Code provisions including sections 170, 642, 664, 2031, 2055, 2512, 2522, and 2624. A complete set of tables will be published by the Internal Revenue Service in the near future.

BACKGROUND

Section 5031 of the Technical and Miscellaneous Revenue Act of 1988 (Pub. L. No. 100-647, 102 Stat. 3342 (1988)) amended the Internal Revenue Code by adding section 7520. Generally, under section 7520, the value of an annuity, interest for life or for a term of years, or remainder or reversionary interest is determined under new tables that are to be prescribed by the Secretary. Section 7520 is applicable to gifts and certain other transfers made after April 30, 1989, and to estates of decedents dying after April 30, 1989. The new tables prescribed by section 7520 are to be based on an interest rate that is 120 percent of the applicable federal midterm rate for the month in which the valuation date falls and the most recent mortality experience available. Section 7520(c)(3) provides that, no later than December 31, 1989, the Service must revise existing tables to take into account the most recent mortality experience available as of the time of such revision. The Service published Notice 89-24, page 660, this Bulletin, on March 6, 1989, to provide temporary guidance to taxpayers in planning transfers that would take place after April 30, 1989. Notice 89-24 provides formulas for computing the value of transferred interests based on the appropriate applicable federal midterm interest rate and the prior mortality experience.

INTEREST RATES AND TABLES FOR TRANSFERS AFTER APRIL 30, 1989

The tables set forth below include many single life and term certain factors that are to be used for valuing interests in the case of gifts and certain other transfers taking place after April 30, 1989, and estates of decedents dying after that date. These new tables reflect the mortality experience based on the 1980 census. A complete set of tables, including two life and additional single life factors, will be published by the Service in the near future and will be available for purchase from the Superintendent of Documents, United States Government Printing Office, Washington, D.C. 20404.

The new tables contain factors that are based upon several different interest rates. The appropriate factor for any particular transaction will be based on the interest rate the Service announces monthly in a news release and publishes in a revenue ruling in the Internal Revenue Bulletin. The interest rate for a particular month is the rate that is published as 120 percent of the applicable federal midterm rate (compounded annually) in effect under section 1274(d)(1) of the Code for the month in which the valuation date falls. That rate is then rounded to the nearest two-tenths of one percent. For example, the rate that is published as 120 percent of the applicable federal midterm rate (compounded annually) for May 1989 is 11.68 percent. That rate is then rounded to the nearest two-tenths of one percent, or 11.6 percent, for purposes of section 7520 of the Code.

As stated in Notice 89-24, if an income, estate, or gift tax charitable contribution deduction is allowed for any part of the property transferred, the taxpayer may use the federal midterm rate for the month of the transfer or for either of the two months preceding the month in which the valuation date falls. For charitable contributions made in May or June 1989, if the taxpayer elects to use the federal midterm rate for either of the preceding two months, which may include March and April, the valuation factors for March and April for interests based on the lives of one or more individuals will be computed on the basis of Table 1 of United States Life Tables: 1969-71 and interest at 120 percent of the applicable federal midterm rate for March or April. Thus, the March and April actuarial factors (in the case of charitable contributions made in May or June 1989) will not be based on the new term certain factors and mortality experience. The rates equal to 120 percent of the applicable federal midterm rate for March, April, and May 1989 are:

Valuation Month	*120 Percent of Applicable Federal Midterm Rate* *Compounded Annually*	*Rounded*
March	11.22	11.2
April	11.58	11.6
May	11.68	11.6

The following tables are included in this notice:

1. *Table 80CNSMT* — Mortality Table based on the 1980 census. This table supersedes Table LN, which is set forth in section 20.2031-7(f) of the Estate Tax Regulations.

2. *Table R(1)* — Single Life Remainder Factors for determining the present worth of a remainder interest based on a single life with interest rates between 8.2 percent and 12 percent. This table supersedes Table A, which is set forth in section 20.2031-7(f) of the regulations and section 25.2512-5(f) of the Gift Tax Regulations. Any remainder factor in Table R(1) may be converted to a factor for determining the present worth of an income interest or an annuity interest based on a single life by the method set forth in Notice 89-24. The remainder factors in Table R(1) are also applicable for determining the present worth of the remainder interest in property transferred to a pooled income fund having a yearly rate of return equal to the interest rates specified in the table. If a pooled income fund has been in existence less than three taxable years immediately preceding the taxable year in which the transfer of property to the fund is made, the highest yearly rate of return shall be deemed to be one percent less than the highest annual average of the monthly rates (prescribed by section 7520(a)(2) of the Code) for the 3 calendar years immediately preceding the year in which the fund is created (rounded to the nearest two-tenths of one percent). For funds created after April 30, 1989, and before January 1, 1990, the deemed rate of return is 9.4 percent. Table R(1) also supersedes Table G, which is set forth in section 1.642(c)-6(d)(3) of the Income Tax Regulations.

3. *Table K* — Adjustment factors based on timing and frequency of payments for annuities payable at the end of each interval. Table K supersedes the payout frequency factors set forth in sections 20.2031-7(b)(2) and 25.2512-5(b)(2) of the regulations.

4. *Table B* — Term Certain Remainder Factors for determining the present worth of a remainder interest postponed for a term certain. This table supersedes Table B, which is set forth in sections 20.2031-7(f) and 25.2512-5(f) of the regulations. A remainder factor may be converted to factors for determining the present worth of both an income interest and an annuity interest postponed for a term of years by the method set forth in Notice 89-24.

5. *Table U(1)* — Unitrust Single Life Remainder Factors for determining the present worth of a remainder interest in property based on a single life in the case of a transfer to a charitable remainder unitrust with an adjusted payout rate ranging from 4.2 percent to 6 percent. This table supersedes Table E, which is set forth in section 1.664-4(b)(5) of the regulations.

6. *Tables F(10.2-12.0)* — Tables of factors for computing the adjusted payout rate for certain charitable remainder unitrust valuations based on interest rates ranging from 10.2 to 12 percent.

Table D, which is not attached, is set forth in section 1.664-4(b)(5) of the regulations, and will continue to be effective for determining the present worth of a remainder interest postponed for a term of years in a charitable remainder unitrust for transfers made after April 30, 1989.

EFFECTIVE DATE

The tables and formulas contained in this notice apply to the valuation of interests in property for income, estate, gift, and generation-skipping transfer tax purposes in the cases of decedents dying after April 30, 1989, and gifts and certain other transfers made after that date.

ADMINISTRATIVE PRONOUNCEMENT

This document serves as an "administrative pronouncement" as that term is described in section 1.6661-3(b)(2) of the regulations and may be relied upon to the same extent as a revenue ruling or revenue procedure.

TABLE 80CNSMT

x	l(x)	x	l(x)	x	l(x)
0	100000	37	95492	74	59279
1	98740	38	95317	75	56799
2	98648	39	95129	76	54239
3	98584	40	94926	77	51599
4	98535	41	94706	78	48878
5	98495	42	94465	79	46071
6	98459	43	94201	80	43180
7	98426	44	93913	81	40208
8	98396	45	93599	82	37172
9	98370	46	93256	83	34095
10	98347	47	92882	84	31012
11	98328	48	92472	85	27960
12	98309	49	92021	86	24961
13	98285	50	91526	87	22038
14	98248	51	90986	88	19235
15	98196	52	90402	89	16598
16	98129	53	89771	90	14154
17	98047	54	89087	91	11908
18	97953	55	88348	92	9863
19	97851	56	87551	93	8032
20	97741	57	86695	94	6424
21	97623	58	85776	95	5043
22	97499	59	84789	96	3884
23	97370	60	83726	97	2939
24	97240	61	82581	98	2185
25	97110	62	81348	99	1598
26	96982	63	80024	100	1150
27	96856	64	78609	101	815
28	96730	65	77107	102	570
29	96604	66	75520	103	393
30	96477	67	73846	104	267
31	96350	68	72082	105	179
32	96220	69	70218	106	119
33	96088	70	68248	107	78
34	95951	71	66165	108	51
35	95808	72	63972	109	33
36	95655	73	61673	110	0

TABLE R(1), BASED ON LIFE TABLE 80CNSMT
SINGLE LIFE REMAINDER FACTORS
INTEREST RATE

AGE	8.2%	8.4%	8.6%	8.8%	9.0%	9.2%	9.4%	9.6%	9.8%	10.0%
0	.02341	.02276	.02217	.02163	.02114	.02069	.02027	.01989	.01954	.01922
1	.01237	.01170	.01108	.01052	.01000	.00953	.00910	.00871	.00834	.00801
2	.01243	.01172	.01107	.01048	.00994	.00944	.00899	.00857	.00819	.00784
3	.01278	.01203	.01135	.01073	.01016	.00964	.00916	.00872	.00832	.00795
4	.01332	.01253	.01182	.01116	.01056	.01001	.00951	.00904	.00862	.00822
5	.01400	.01317	.01241	.01172	.01109	.01051	.00998	.00949	.00904	.00862
6	.01477	.01390	.01310	.01238	.01171	.01110	.01054	.01002	.00954	.00910
7	.01563	.01472	.01389	.01312	.01242	.01178	.01118	.01064	.01013	.00966
8	.01660	.01564	.01477	.01396	.01322	.01254	.01192	.01134	.01081	.01031
9	.01770	.01669	.01577	.01492	.01414	.01342	.01276	.01216	.01159	.01107
10	.01891	.01785	.01688	.01599	.01517	.01442	.01372	.01308	.01249	.01194
11	.02026	.01915	.01814	.01720	.01634	.01555	.01481	.01414	.01351	.01293
12	.02173	.02056	.01950	.01852	.01761	.01678	.01601	.01529	.01463	.01402
13	.02326	.02204	.02092	.01989	.01895	.01807	.01726	.01651	.01582	.01517
14	.02478	.02351	.02234	.02126	.02027	.01935	.01850	.01771	.01698	.01630
15	.02628	.02495	.02372	.02259	.02155	.02058	.01969	.01886	.01810	.01738
16	.02774	.02635	.02507	.02388	.02279	.02178	.02084	.01997	.01917	.01842
17	.02917	.02772	.02637	.02513	.02399	.02293	.02194	.02103	.02018	.01940
18	.03059	.02907	.02767	.02637	.02517	.02406	.02302	.02207	.02118	.02035
19	.03205	.03046	.02899	.02763	.02637	.02521	.02412	.02312	.02218	.02131
20	.03355	.03188	.03035	.02892	.02760	.02638	.02524	.02419	.02320	.02229
21	.03509	.03334	.03173	.03024	.02886	.02758	.02638	.02527	.02424	.02328
22	.03669	.03487	.03318	.03162	.03017	.02882	.02757	.02640	.02532	.02430
23	.03837	.03646	.03470	.03306	.03154	.03013	.02881	.02759	.02644	.02538
24	.04018	.03819	.03634	.03463	.03303	.03155	.03016	.02888	.02767	.02655
25	.04214	.04006	.03812	.03633	.03465	.03309	.03164	.03029	.02902	.02784
26	.04428	.04210	.04008	.03820	.03644	.03481	.03328	.03186	.03052	.02928
27	.04662	.04434	.04223	.04025	.03841	.03670	.03509	.03360	.03219	.03088
28	.04915	.04677	.04456	.04249	.04056	.03876	.03708	.03550	.03403	.03264
29	.05189	.04941	.04709	.04493	.04291	.04102	.03925	.03760	.03604	.03458
30	.05485	.05226	.04984	.04757	.04546	.04348	.04162	.03988	.03825	.03671
31	.05805	.05535	.05282	.05045	.04824	.04616	.04421	.04238	.04067	.03905
32	.06149	.05867	.05603	.05356	.05124	.04906	.04702	.04510	.04329	.04160
33	.06520	.06226	.05950	.05692	.05449	.05221	.05007	.04806	.04616	.04438
34	.06916	.06609	.06322	.06052	.05799	.05560	.05336	.05125	.04926	.04738
35	.07339	.07020	.06720	.06439	.06174	.05925	.05690	.05469	.05260	.05063
36	.07787	.07455	.07143	.06850	.06573	.06313	.06068	.05836	.05617	.05411
37	.08262	.07917	.07593	.07287	.06999	.06727	.06470	.06228	.05999	.05783
38	.08765	.08407	.08069	.07751	.07451	.07167	.06899	.06646	.06407	.06180
39	.09296	.08925	.08574	.08243	.07931	.07635	.07356	.07092	.06841	.06604
40	.09858	.09472	.09109	.08765	.08440	.08132	.07841	.07565	.07303	.07055
41	.10449	.10050	.09673	.09316	.08978	.08658	.08355	.08067	.07794	.07535
42	.11069	.10656	.10265	.09895	.09544	.09212	.08896	.08596	.08312	.08041
43	.11718	.11291	.10887	.10503	.10140	.09794	.09466	.09154	.08858	.08576
44	.12399	.11958	.11540	.11143	.10766	.10407	.10067	.09743	.09434	.09141
45	.13111	.12656	.12224	.11814	.11423	.11052	.10699	.10362	.10042	.09736
46	.13856	.13387	.12941	.12516	.12113	.11728	.11362	.11013	.10680	.10363
47	.14633	.14150	.13690	.13252	.12835	.12438	.12059	.11697	.11352	.11022
48	.15442	.14945	.14471	.14020	.13589	.13179	.12787	.12412	.12055	.11713
49	.16280	.15769	.15281	.14816	.14373	.13949	.13544	.13157	.12787	.12433
50	.17147	.16622	.16121	.15643	.15186	.14749	.14331	.13931	.13548	.13182
51	.18045	.17507	.16993	.16501	.16030	.15580	.15150	.14737	.14342	.13963
52	.18979	.18427	.17899	.17394	.16911	.16448	.16004	.15579	.15172	.14780
53	.19947	.19383	.18842	.18324	.17828	.17352	.16896	.16458	.16038	.15635
54	.20950	.20372	.19819	.19288	.18779	.18291	.17822	.17372	.16940	.16524
55	.21986	.21397	.20831	.20288	.19767	.19266	.18785	.18322	.17878	.17450

TABLE R(1), BASED ON LIFE TABLE 80CNSMT
SINGLE LIFE REMAINDER FACTORS
INTEREST RATE

AGE	8.2%	8.4%	8.6%	8.8%	9.0%	9.2%	9.4%	9.6%	9.8%	10.0%
56	.23058	.22457	.21879	.21324	.20791	.20278	.19785	.19310	.18854	.18414
57	.24167	.23554	.22965	.22399	.21854	.21329	.20824	.20338	.19870	.19419
58	.25314	.24690	.24090	.23512	.22956	.22420	.21904	.21407	.20927	.20464
59	.26497	.25863	.25252	.24664	.24097	.23550	.23023	.22515	.22024	.21551
60	.27712	.27068	.26448	.25849	.25272	.24716	.24178	.23659	.23158	.22674
61	.28956	.28304	.27674	.27067	.26480	.25913	.25366	.24837	.24325	.23831
62	.30228	.29567	.28929	.28312	.27717	.27141	.26584	.26045	.25524	.25020
63	.31525	.30857	.30211	.29586	.28982	.28397	.27832	.27284	.26754	.26240
64	.32851	.32176	.31522	.30890	.30278	.29685	.29111	.28555	.28016	.27493
65	.34209	.33528	.32868	.32229	.31610	.31010	.30429	.29865	.29317	.28787
66	.35604	.34918	.34253	.33609	.32983	.32377	.31788	.31217	.30663	.30124
67	.37037	.36347	.35678	.35028	.34398	.33786	.33191	.32614	.32053	.31508
68	.38508	.37815	.37142	.36489	.35854	.35237	.34638	.34055	.33488	.32937
69	.40008	.39313	.38638	.37982	.37344	.36724	.36120	.35533	.34961	.34405
70	.41533	.40838	.40162	.39504	.38864	.38241	.37634	.37043	.36468	.35907
71	.43076	.42382	.41705	.41047	.40405	.39780	.39171	.38578	.38000	.37436
72	.44638	.43945	.43269	.42611	.41969	.41344	.40733	.40138	.39558	.38991
73	.46218	.45527	.44854	.44197	.43556	.42931	.42321	.41725	.41143	.40575
74	.47823	.47137	.46466	.45812	.45173	.44549	.43940	.43345	.42763	.42195
75	.49459	.48777	.48112	.47462	.46826	.46205	.45598	.45004	.44424	.43856
76	.51127	.50452	.49793	.49148	.48517	.47900	.47297	.46706	.46129	.45563
77	.52823	.52157	.51505	.50867	.50243	.49632	.49033	.48447	.47873	.47311
78	.54541	.53885	.53242	.52613	.51996	.51392	.50800	.50220	.49652	.49094
79	.56267	.55621	.54989	.54369	.53762	.53166	.52582	.52009	.51448	.50897
80	.57987	.57354	.56733	.56125	.55527	.54941	.54366	.53802	.53248	.52705
81	.59685	.59065	.58457	.57860	.57274	.56699	.56134	.55579	.55035	.54499
82	.61351	.60746	.60151	.59567	.58993	.58429	.57875	.57331	.56796	.56270
83	.62978	.62387	.61806	.61236	.60675	.60123	.59581	.59047	.58523	.58007
84	.64567	.63992	.63426	.62869	.62321	.61783	.61253	.60731	.60218	.59713
85	.66125	.65565	.65014	.64472	.63938	.63413	.62896	.62387	.61886	.61392
86	.67636	.67092	.66557	.66030	.65511	.65000	.64496	.64000	.63511	.63030
87	.69081	.68554	.68034	.67522	.67018	.66520	.66031	.65548	.65071	.64602
88	.70468	.69957	.69453	.68956	.68466	.67983	.67507	.67037	.66574	.66117
89	.71821	.71326	.70838	.70357	.69882	.69414	.68952	.68495	.68045	.67601
90	.73153	.72676	.72204	.71739	.71280	.70827	.70379	.69938	.69502	.69071
91	.74447	.73986	.73532	.73083	.72640	.72202	.71770	.71343	.70921	.70504
92	.75669	.75225	.74787	.74354	.73927	.73504	.73087	.72674	.72267	.71864
93	.76807	.76379	.75957	.75540	.75127	.74719	.74317	.73918	.73524	.73135
94	.77849	.77437	.77030	.76627	.76229	.75835	.75446	.75061	.74680	.74303
95	.78792	.78394	.78001	.77611	.77226	.76845	.76468	.76096	.75727	.75362
96	.79630	.79244	.78863	.78485	.78112	.77742	.77377	.77015	.76657	.76303
97	.80391	.80016	.79646	.79280	.78917	.78559	.78203	.77852	.77504	.77160
98	.81076	.80712	.80352	.79996	.79643	.79294	.78948	.78606	.78267	.77931
99	.81709	.81354	.81004	.80657	.80313	.79972	.79635	.79302	.78971	.78644
100	.82296	.81950	.81609	.81270	.80934	.80602	.80273	.79947	.79624	.79304
101	.82855	.82518	.82185	.81854	.81526	.81201	.80880	.80561	.80245	.79932
102	.83438	.83110	.82785	.82462	.82142	.81826	.81512	.81200	.80892	.80586
103	.84056	.83737	.83420	.83106	.82795	.82487	.82181	.81878	.81577	.81279
104	.84743	.84433	.84127	.83822	.83521	.83221	.82924	.82630	.82338	.82048
105	.85591	.85295	.85001	.84709	.84419	.84132	.83846	.83563	.83282	.83003
106	.86816	.86540	.86266	.85993	.85723	.85454	.85187	.84922	.84659	.84397
107	.88592	.88348	.88105	.87863	.87623	.87384	.87147	.86911	.86676	.86443
108	.91493	.91306	.91119	.90934	.90749	.90566	.90383	.90201	.90020	.89840
109	.96211	.96125	.96041	.95956	.95872	.95788	.95704	.95620	.95537	.95455

TABLE R(1), BASED ON LIFE TABLE 80CNSMT
SINGLE LIFE REMAINDER FACTORS
INTEREST RATE

AGE	10.2%	10.4%	10.6%	10.8%	11.0%	11.2%	11.4%	11.6%	11.8%	12.0%
0	.01891	.01864	.01838	.01814	.01791	.01770	.01750	.01732	.01715	.01698
1	.00770	.00741	.00715	.00690	.00667	.00646	.00626	.00608	.00590	.00574
2	.00751	.00721	.00693	.00667	.00643	.00620	.00600	.00580	.00562	.00544
3	.00760	.00728	.00699	.00671	.00646	.00622	.00600	.00579	.00560	.00541
4	.00786	.00752	.00721	.00692	.00665	.00639	.00616	.00594	.00573	.00554
5	.00824	.00788	.00755	.00724	.00695	.00668	.00643	.00620	.00598	.00578
6	.00869	.00832	.00796	.00764	.00733	.00705	.00678	.00654	.00630	.00608
7	.00923	.00883	.00846	.00811	.00779	.00749	.00720	.00694	.00669	.00646
8	.00986	.00943	.00904	.00867	.00833	.00801	.00771	.00743	.00716	.00692
9	.01059	.01014	.00972	.00933	.00897	.00863	.00831	.00801	.00773	.00747
10	.01142	.01095	.01051	.01009	.00971	.005	.00901	.00869	.00840	.00812
11	.01239	.01189	.01142	.01098	.01057	.01019	.00983	.00950	.00918	.00889
12	.01345	.01292	.01243	.01197	.01154	.01113	.01075	.01040	.01007	.00975
13	.01457	.01401	.01349	.01300	.01255	.01212	.01172	.01135	.01100	.01067
14	.01567	.01508	.01453	.01402	.01354	.01309	.01267	.01227	.01190	.01155
15	.01672	.01610	.01552	.01498	.01448	.01400	.01356	.01314	.01275	.01238
16	.01772	.01707	.01646	.01589	.01536	.01486	.01439	.01396	.01354	.01315
17	.01866	.01798	.01734	.01674	.01618	.01566	.01516	.01470	.01427	.01386
18	.01958	.01886	.01818	.01755	.01697	.01641	.01590	.01541	.01495	.01452
19	.02050	.01974	.01903	.01837	.01775	.01717	.01662	.01611	.01563	.01517
20	.02143	.02064	.01989	.01919	.01854	.01793	.01735	.01681	.01630	.01582
21	.02238	.02154	.02075	.02002	.01933	.01868	.01807	.01750	.01696	.01646
22	.02336	.02247	.02164	.02087	.02014	.01946	.01882	.01821	.01764	.01711
23	.02438	.02345	.02257	.02176	.02099	.02027	.01959	.01895	.01835	.01778
24	.02550	.02451	.02359	.02273	.02192	.02115	.02044	.01976	.01913	.01853
25	.02673	.02569	.02472	.02381	.02295	.02214	.02138	.02067	.01999	.01936
26	.02811	.02701	.02598	.02502	.02411	.02326	.02246	.02170	.02098	.02031
27	.02965	.02849	.02741	.02639	.02543	.02452	.02367	.02287	.02211	.02140
28	.03134	.03013	.02898	.02790	.02689	.02593	.02503	.02418	.02338	.02262
29	.03322	.03193	.03072	.02958	.02851	.02750	.02654	.02564	.02479	.02398
30	.03527	.03391	.03264	.03143	.03030	.02923	.02821	.02726	.02635	.02550
31	.03753	.03610	.03475	.03348	.03228	.03115	.03008	.02907	.02811	.02720
32	.04000	.03849	.03707	.03573	.03446	.03326	.03213	.03105	.03004	.02907
33	.04269	.04111	.03961	.03819	.03685	.03558	.03438	.03325	.03217	.03115
34	.04561	.04394	.04236	.04087	.03946	.03812	.03685	.03565	.03451	.03342
35	.04877	.04702	.04535	.04378	.04229	.04087	.03953	.03826	.03706	.03591
36	.05215	.05031	.04856	.04690	.04533	.04384	.04242	.04108	.03980	.03859
37	.05578	.05384	.05200	.05025	.04860	.04703	.04553	.04411	.04276	.04148
38	.05965	.05761	.05568	.05385	.05211	.05045	.04888	.04738	.04595	.04460
39	.06379	.06165	.05962	.05770	.05587	.05412	.05247	.05089	.04939	.04795
40	.06820	.06596	.06383	.06181	.05989	.05806	.05631	.05465	.05307	.05155
41	.07288	.07054	.06832	.06620	.06418	.06226	.06042	.05868	.05701	.05541
42	.07784	.07539	.07306	.07085	.06873	.06671	.06479	.06295	.06119	.05952
43	.08308	.08052	.07808	.07576	.07355	.07143	.06941	.06748	.06564	.06387
44	.08861	.08594	.08340	.08097	.07865	.07644	.07432	.07230	.07036	.06851
45	.09445	.09167	.08901	.08648	.08406	.08174	.07953	.07741	.07538	.07343
46	.10060	.09770	.09494	.09230	.08977	.08735	.08503	.08281	.08068	.07865
47	.10707	.10406	.10119	.09843	.09579	.09327	.09085	.08853	.08630	.08417
48	.11386	.11073	.10774	.10487	.10213	.09949	.09697	.09455	.09222	.08999
49	.12094	.11769	.11458	.11160	.10874	.10600	.10337	.10084	.09842	.09609
50	.12831	.12494	.12172	.11862	.11565	.11280	.11006	.10743	.10490	.10247
51	.13600	.13251	.12917	.12596	.12288	.11991	.11706	.11432	.11169	.10915
52	.14405	.14044	.13698	.13366	.13046	.12738	.12442	.12157	.11883	.11619
53	.15247	.14875	.14517	.14172	.13841	.13522	.13215	.12919	.12635	.12360
54	.16124	.15740	.15370	.15014	.14671	.14341	.14023	.13717	.13421	.13136
55	.17039	.16642	.16261	.15893	.15539	.15198	.14868	.14551	.14244	.13948
56	.17991	.17583	.17190	.16811	.16445	.16092	.15752	.15423	.15106	.14799

TABLE R(1), BASED ON LIFE TABLE 80CNSMT
SINGLE LIFE REMAINDER FACTORS
INTEREST RATE

AGE	10.2%	10.4%	10.6%	10.8%	11.0%	11.2%	11.4%	11.6%	11.8%	12.0%
57	.18984	.18564	.18160	.17769	.17392	.17029	.16677	.16338	.16010	.15692
58	.20018	.19587	.19172	.18770	.18382	.18007	.17645	.17295	.16956	.16628
59	.21093	.20652	.20225	.19812	.19414	.19028	.18655	.18294	.17945	.17606
60	.22206	.21753	.21316	.20893	.20483	.20087	.19703	.19332	.18972	.18624
61	.23353	.22890	.22442	.22009	.21589	.21182	.20788	.20407	.20037	.19678
62	.24532	.24059	.23601	.23158	.22728	.22311	.21907	.21515	.21135	.20767
63	.25742	.25260	.24793	.24339	.23900	.23473	.23060	.22658	.22268	.21890
64	.26987	.26495	.26019	.25556	.25107	.24671	.24248	.23837	.23438	.23050
65	.28271	.27771	.27286	.26815	.26357	.25912	.25480	.25059	.24651	.24254
66	.29601	.29093	.28600	.28120	.27654	.27200	.26760	.26331	.25913	.25507
67	.30978	.30462	.29961	.29474	.29000	.28539	.28090	.27653	.27227	.26813
68	.32401	.31879	.31371	.30877	.30396	.29927	.29471	.29027	.28593	.28171
69	.33863	.33336	.32822	.32322	.31835	.31359	.30896	.30445	.30005	.29576
70	.35361	.34829	.34310	.33804	.33311	.32830	.32361	.31903	.31457	.31021
71	.36886	.36349	.35826	.35316	.34818	.34332	.33858	.33394	.32942	.32500
72	.38439	.37899	.37373	.36858	.36356	.35866	.35387	.34919	.34461	.34015
73	.40021	.39479	.38950	.38432	.37927	.37433	.36950	.36478	.36016	.35565
74	.41639	.41096	.40565	.40046	.39538	.39042	.38556	.38081	.37616	.37161
75	.43301	.42758	.42226	.41706	.41198	.40699	.40212	.39734	.39267	.38809
76	.45009	.44467	.43937	.43417	.42908	.42410	.41921	.41443	.40974	.40514
77	.46761	.46221	.45693	.45175	.44667	.44170	.43682	.43203	.42734	.42274
78	.48548	.48013	.47488	.46973	.46468	.45972	.45486	.45009	.44541	.44082
79	.50356	.49826	.49306	.48795	.48294	.47802	.47319	.46845	.46379	.45922
80	.52171	.51647	.51133	.50628	.50132	.49644	.49166	.48695	.48233	.47779
81	.53974	.53457	.52950	.52451	.51961	.51479	.51006	.50541	.50083	.49633
82	.55753	.55245	.54745	.54254	.53771	.53296	.52828	.52369	.51917	.51472
83	.57500	.57001	.56510	.56026	.55551	.55083	.54623	.54170	.53724	.53285
84	.59216	.58726	.58245	.57770	.57304	.56844	.56391	.55945	.55506	.55074
85	.60906	.60428	.59956	.59492	.59034	.58583	.58139	.57702	.57270	.56845
86	.62555	.62088	.61627	.61173	.60725	.60284	.59849	.59420	.58997	.58580
87	.64139	.63683	.63233	.62790	.62352	.61921	.61495	.61076	.60661	.60253
88	.65666	.65221	.64783	.64350	.63923	.63502	.63086	.62675	.62270	.61871
89	.67163	.66730	.66304	.65882	.65466	.65055	.64650	.64249	.63854	.63463
90	.68646	.68226	.67812	.67402	.66998	.66599	.66204	.65814	.65430	.65049
91	.70093	.69686	.69285	.68888	.68496	.68108	.67725	.67347	.66973	.66604
92	.71466	.71073	.70684	.70300	.69920	.69545	.69173	.68806	.68444	.68085
93	.72750	.72370	.71994	.71622	.71254	.70890	.70530	.70174	.69822	.69474
94	.73931	.73562	.73198	.72838	.72481	.72129	.71780	.71434	.71093	.70755
95	.75001	.74644	.74291	.73941	.73595	.73253	.72914	.72579	.72247	.71919
96	.75953	.75606	.75262	.74923	.74586	.74253	.73924	.73598	.73275	.72955
97	.76819	.76481	.76147	.75816	.75489	.75165	.74844	.74526	.74211	.73899
98	.77599	.77270	.76944	.76621	.76302	.75986	.75672	.75362	.75054	.74750
99	.78319	.77998	.77680	.77365	.77053	.76744	.76437	.76134	.75833	.75535
100	.78987	.78673	.78362	.78054	.77748	.77446	.77146	.76849	.76555	.76263
101	.79622	.79315	.79010	.78708	.78409	.78113	.77819	.77528	.77239	.76953
102	.80283	.79983	.79685	.79390	.79097	.78807	.78519	.78234	.77951	.77671
103	.80983	.80690	.80399	.80111	.79825	.79541	.79260	.78981	.78705	.78430
104	.81760	.81475	.81192	.80912	.80633	.80357	.80083	.79810	.79541	.79273
105	.82726	.82451	.82178	.81907	.81638	.81371	.81106	.80843	.80582	.80322
106	.84137	.83879	.83623	.83368	.83115	.82863	.82614	.82366	.82119	.81874
107	.86211	.85981	.85751	.85523	.85297	.85071	.84847	.84624	.84403	.84182
108	.89660	.89481	.89304	.89127	.88950	.88775	.88601	.88427	.88254	.88081
109	.95372	.95290	.95208	.95126	.95045	.94964	.94883	.94803	.94723	.94643

TABLE K
ADJUSTMENT FACTORS FOR ANNUITIES
PAYABLE AT THE END OF EACH INTERVAL

FREQUENCY OF PAYMENTS

INT. RATE	ANNUALLY	SEMIANNUALLY	QUARTERLY	MONTHLY	WEEKLY
8.2	1.0000	1.0201	1.0302	1.0370	1.0397
8.4	1.0000	1.0206	1.0310	1.0379	1.0406
8.6	1.0000	1.0211	1.0317	1.0388	1.0416
8.8	1.0000	1.0215	1.0324	1.0397	1.0425
9.0	1.0000	1.0220	1.0331	1.0406	1.0435
9.2	1.0000	1.0225	1.0339	1.0415	1.0444
9.4	1.0000	1.0230	1.0346	1.0424	1.0454
9.6	1.0000	1.0235	1.0353	1.0433	1.0463
9.8	1.0000	1.0239	1.0360	1.0442	1.0473
10.0	1.0000	1.0244	1.0368	1.0450	1.0482
10.2	1.0000	1.0249	1.0375	1.0459	1.0492
10.4	1.0000	1.0254	1.0382	1.0468	1.0501
10.6	1.0000	1.0258	1.0389	1.0477	1.0511
10.8	1.0000	1.0263	1.0396	1.0486	1.0520
11.0	1.0000	1.0268	1.0404	1.0495	1.0530
11.2	1.0000	1.0273	1.0411	1.0503	1.0539
11.4	1.0000	1.0277	1.0418	1.0512	1.0549
11.6	1.0000	1.0282	1.0425	1.0521	1.0558
11.8	1.0000	1.0287	1.0432	1.0530	1.0568
12.0	1.0000	1.0292	1.0439	1.0539	1.0577
12.2	1.0000	1.0296	1.0447	1.0548	1.0587
12.4	1.0000	1.0301	1.0454	1.0556	1.0596
12.6	1.0000	1.0306	1.0461	1.0565	1.0605
12.8	1.0000	1.0310	1.0468	1.0574	1.0615
13.0	1.0000	1.0315	1.0475	1.0583	1.0624
13.2	1.0000	1.0320	1.0482	1.0591	1.0634
13.4	1.0000	1.0324	1.0489	1.0600	1.0643
13.6	1.0000	1.0329	1.0496	1.0609	1.0652
13.8	1.0000	1.0334	1.0504	1.0618	1.0662
14.0	1.0000	1.0339	1.0511	1.0626	1.0671
14.2	1.0000	1.0343	1.0518	1.0635	1.0681
14.4	1.0000	1.0348	1.0525	1.0644	1.0690
14.6	1.0000	1.0353	1.0532	1.0653	1.0699
14.8	1.0000	1.0357	1.0539	1.0661	1.0709
15.0	1.0000	1.0362	1.0546	1.0670	1.0718

TABLE B
TERM CERTAIN REMAINDER FACTORS
INTEREST RATE

YEARS	8.6%	8.8%	9.0%	9.2%	9.4%	9.6%	9.8%	10.0%	10.2%
1	.920810	.919118	.917431	.915751	.914077	.912409	.910747	.909091	.907441
2	.847892	.844777	.841680	.838600	.835536	.832490	.829460	.826446	.823449
3	.780747	.776450	.772183	.767948	.763744	.759571	.755428	.751315	.747232
4	.718920	.713649	.708425	.703250	.698121	.693039	.688003	.683013	.678069
5	.661989	.655927	.649931	.644001	.638136	.632335	.626597	.620921	.615307
6	.609566	.602874	.596267	.589745	.583305	.576948	.570671	.564474	.558355
7	.561295	.554112	.547034	.540059	.533186	.526412	.519737	.513158	.506674
8	.516846	.509294	.501866	.494560	.487373	.480303	.473349	.466507	.459777
9	.475917	.468101	.460428	.452894	.445496	.438233	.431101	.424098	.417221
10	.438230	.430240	.422411	.414738	.407218	.399848	.392624	.385543	.378603
11	.403526	.395441	.387533	.379797	.372228	.364824	.357581	.350494	.343560
12	.371571	.363457	.355535	.347799	.340245	.332869	.325666	.318631	.311760
13	.342147	.334060	.326179	.318497	.311010	.303713	.296599	.289664	.282904
14	.315052	.307040	.299246	.291664	.284287	.277110	.270127	.263331	.256719
15	.290103	.282206	.274538	.267092	.259860	.252838	.246017	.239392	.232957
16	.267130	.259381	.251870	.244589	.237532	.230691	.224059	.217629	.211395
17	.245976	.238401	.231073	.223983	.217123	.210485	.204061	.197845	.191828
18	.226497	.219119	.211994	.205113	.198467	.192048	.185848	.179859	.174073
19	.208561	.201396	.194490	.187832	.181414	.175226	.169260	.163508	.157961
20	.192045	.185107	.178431	.172007	.165826	.159878	.154153	.148644	.143340
21	.176837	.170135	.163698	.157516	.151578	.145874	.140395	.135131	.130073
22	.162834	.156374	.150182	.144245	.138554	.133097	.127864	.122846	.118033
23	.149939	.143726	.137781	.132093	.126649	.121439	.116452	.111678	.107108
24	.138065	.132101	.126405	.120964	.115767	.110802	.106058	.101526	.097195
25	.127132	.121416	.115968	.110773	.105820	.101097	.096592	.092296	.088198
26	.117064	.111596	.106393	.101441	.096727	.092241	.087971	.083905	.080035
27	.107794	.102570	.097608	.092894	.088416	.084162	.080119	.076278	.072627
28	.099258	.094274	.089548	.085068	.080819	.076790	.072968	.069343	.065905
29	.091398	.086649	.082155	.077901	.073875	.070064	.066456	.063039	.059804
30	.084160	.079640	.075371	.071338	.067527	.063927	.060524	.057309	.054269
31	.077495	.073199	.069148	.065328	.061725	.058327	.055122	.052099	.049246
32	.071358	.067278	.063438	.059824	.056422	.053218	.050202	.047362	.044688
33	.065708	.061837	.058200	.054784	.051574	.048557	.045722	.043057	.040552
34	.060504	.056835	.053395	.050168	.047142	.044304	.041641	.039143	.036798
35	.055713	.052238	.048986	.045942	.043092	.040423	.037924	.035584	.033392
36	.051301	.048013	.044941	.042071	.039389	.036882	.034539	.032349	.030301
37	.047239	.044130	.041231	.038527	.036005	.033652	.031457	.029408	.027497
38	.043498	.040560	.037826	.035281	.032911	.030704	.028649	.026735	.024952
39	.040053	.037280	.034703	.032309	.030083	.028015	.026092	.024304	.022642
40	.036881	.034264	.031838	.029587	.027498	.025561	.023763	.022095	.020546
41	.033961	.031493	.029209	.027094	.025136	.023322	.021642	.020086	.018645
42	.031271	.028946	.026797	.024811	.022976	.021279	.019711	.018260	.016919
43	.028795	.026605	.024584	.022721	.021002	.019415	.017951	.016600	.015353
44	.026515	.024453	.022555	.020807	.019197	.017715	.016349	.015091	.013932
45	.024415	.022475	.020692	.019054	.017548	.016163	.014890	.013719	.012642
46	.022482	.020657	.018984	.017449	.016040	.014747	.013561	.012472	.011472
47	.020701	.018986	.017416	.015978	.014662	.013456	.012351	.011338	.010410
48	.019062	.017451	.015978	.014632	.013402	.012277	.011248	.010307	.009447
49	.017552	.016039	.014659	.013400	.012250	.011202	.010244	.009370	.008572
50	.016163	.014742	.013449	.012271	.011198	.010221	.009330	.008519	.007779
51	.014883	.013550	.012338	.011237	.010236	.009325	.008497	.007744	.007059
52	.013704	.012454	.011319	.010290	.009356	.008508	.007739	.007040	.006406
53	.012619	.011446	.010385	.009423	.008552	.007763	.007048	.006400	.005813
54	.011620	.010521	.009527	.008629	.007817	.007083	.006419	.005818	.005275
55	.010699	.009670	.008741	.007902	.007146	.006463	.005846	.005289	.004786
56	.009852	.008888	.008019	.007237	.006532	.005897	.005324	.004809	.004343
57	.009072	.008169	.007357	.006627	.005971	.005380	.004849	.004371	.003941
58	.008354	.007508	.006749	.006069	.005458	.004909	.004416	.003974	.003577
59	.007692	.006901	.006192	.005557	.004989	.004479	.004022	.003613	.003246
60	.007083	.006343	.005681	.005089	.004560	.004087	.003663	.003284	.002945

TABLE B
TERM CERTAIN REMAINDER FACTORS
INTEREST RATE

YEARS	10.4%	10.6%	10.8%	11.0%	11.2%	11.4%	11.6%	11.8%	12.0%
1	.905797	.904159	.902527	.900901	.899281	.897666	.896057	.894454	.892857
2	.820468	.817504	.814555	.811622	.808706	.805804	.802919	.800049	.797194
3	.743178	.739153	.735158	.731191	.727253	.723343	.719461	.715607	.711780
4	.673168	.668312	.663500	.658731	.654005	.649321	.644679	.640078	.635518
5	.609754	.604261	.598827	.593451	.588134	.582873	.577669	.572520	.567427
6	.552313	.546348	.540457	.534641	.528897	.523225	.517625	.512093	.506631
7	.500284	.493985	.487777	.481658	.475627	.469682	.463821	.458044	.452349
8	.453156	.446641	.440232	.433926	.427722	.421617	.415610	.409700	.403883
9	.410467	.403835	.397322	.390925	.384642	.378472	.372411	.366458	.360610
10	.371800	.365131	.358593	.352184	.345901	.339741	.333701	.327780	.321973
11	.336775	.330137	.323640	.317283	.311062	.304974	.299016	.293184	.287476
12	.305050	.298496	.292094	.285841	.279732	.273765	.267935	.262240	.256675
13	.276313	.269888	.263623	.257514	.251558	.245749	.240085	.234561	.229174
14	.250284	.244022	.237927	.231995	.226221	.220601	.215130	.209804	.204620
15	.226706	.220634	.214735	.209004	.203436	.198026	.192769	.187661	.182696
16	.205350	.199489	.193804	.188292	.182946	.177761	.172732	.167854	.163122
17	.186005	.180369	.174914	.169633	.164520	.159570	.154778	.150138	.145644
18	.168483	.163083	.157864	.152822	.147950	.143241	.138690	.134291	.130040
19	.152612	.147453	.142477	.137678	.133048	.128582	.124274	.120117	.116107
20	.138235	.133321	.128589	.124034	.119648	.115424	.111357	.107439	.103667
21	.125213	.120543	.116055	.111742	.107597	.103612	.099782	.096100	.092560
22	.113418	.108990	.104743	.100669	.096760	.093009	.089410	.085957	.082643
23	.102733	.098544	.094533	.090693	.087014	.083491	.080117	.076884	.073788
24	.093056	.089100	.085319	.081705	.078250	.074947	.071789	.068770	.065882
25	.084289	.080560	.077003	.073608	.070369	.067278	.064327	.061511	.058823
26	.076349	.072839	.069497	.066314	.063281	.060393	.057641	.055019	.052521
27	.069157	.065858	.062723	.059742	.056908	.054213	.051650	.049212	.046894
28	.062642	.059547	.056609	.053822	.051176	.048665	.046281	.044018	.041869
29	.056741	.053840	.051091	.048488	.046022	.043685	.041470	.039372	.037383
30	.051396	.048680	.046111	.043683	.041386	.039214	.037160	.035216	.033378
31	.046554	.044014	.041617	.039354	.037218	.035201	.033297	.031500	.029802
32	.042169	.039796	.037560	.035454	.033469	.031599	.029836	.028175	.026609
33	.038196	.035982	.033899	.031940	.030098	.028365	.026735	.025201	.023758
34	.034598	.032533	.030595	.028775	.027067	.025463	.023956	.022541	.021212
35	.031339	.029415	.027613	.025924	.024341	.022857	.021466	.020162	.018940
36	.028387	.026596	.024921	.023355	.021889	.020518	.019235	.018034	.016910
37	.025712	.024047	.022492	.021040	.019684	.018418	.017236	.016131	.015098
38	.023290	.021742	.020300	.018955	.017702	.016533	.015444	.014428	.013481
39	.021096	.019658	.018321	.017077	.015919	.014841	.013839	.012905	.012036
40	.019109	.017774	.016535	.015384	.014316	.013323	.012400	.011543	.010747
41	.017309	.016071	.014923	.013860	.012874	.011959	.011111	.010325	.009595
42	.015678	.014531	.013469	.012486	.011577	.010735	.009956	.009235	.008567
43	.014201	.013138	.012156	.011249	.010411	.009637	.008922	.008260	.007649
44	.012864	.011879	.010971	.010134	.009362	.008651	.007994	.007389	.006830
45	.011652	.010740	.009902	.009130	.008419	.007765	.007163	.006609	.006098
46	.010554	.009711	.008937	.008225	.007571	.006971	.006419	.005911	.005445
47	.009560	.008780	.008065	.007410	.006809	.006257	.005752	.005287	.004861
48	.008659	.007939	.007279	.006676	.006123	.005617	.005154	.004729	.004340
49	.007844	.007178	.006570	.006014	.005506	.005042	.004618	.004230	.003875
50	.007105	.006490	.005929	.005418	.004952	.004526	.004138	.003784	.003460
51	.006435	.005868	.005351	.004881	.004453	.004063	.003708	.003384	.003089
52	.005829	.005306	.004830	.004397	.004005	.003647	.003322	.003027	.002758
53	.005280	.004797	.004359	.003962	.003601	.003274	.002977	.002708	.002463
54	.004783	.004337	.003934	.003569	.003238	.002939	.002668	.002422	.002199
55	.004332	.003922	.003551	.003215	.002912	.002638	.002390	.002166	.001963
56	.003924	.003546	.003205	.002897	.002619	.002368	.002142	.001938	.001753
57	.003554	.003206	.002892	.002610	.002355	.002126	.001919	.001733	.001565
58	.003220	.002899	.002610	.002351	.002118	.001908	.001720	.001550	.001398
59	.002916	.002621	.002356	.002118	.001905	.001713	.001541	.001387	.001248
60	.002642	.002370	.002126	.001908	.001713	.001538	.001381	.001240	.001114

TABLE U(1), BASED ON LIFE TABLE 80CNSMT
UNITRUST SINGLE LIFE REMAINDER FACTORS
ADJUSTED PAYOUT RATE

AGE	4.2%	4.4%	4.6%	4.8%	5.0%	5.2%	5.4%	5.6%	5.8%	6.0%
0	.06797	.06181	.05645	.05177	.04768	.04410	.04096	.03820	.03578	.03364
1	.05881	.05243	.04686	.04199	.03773	.03400	.03072	.02784	.02531	.02308
2	.06049	.05394	.04821	.04319	.03880	.03494	.03155	.02856	.02593	.02361
3	.06252	.05579	.04990	.04473	.04020	.03621	.03270	.02961	.02688	.02446
4	.06479	.05788	.05182	.04650	.04183	.03771	.03408	.03087	.02804	.02553
5	.06724	.06016	.05393	.04845	.04363	.03937	.03562	.03230	.02936	.02675
6	.06984	.06257	.05618	.05054	.04557	.04117	.03729	.03385	.03080	.02809
7	.07259	.06513	.05856	.05276	.04764	.04310	.03909	.03552	.03236	.02954
8	.07548	.06784	.06109	.05513	.04985	.04517	.04102	.03733	.03405	.03113
9	.07854	.07071	.06378	.05765	.05221	.04738	.04310	.03928	.03588	.03285
10	.08176	.07374	.06663	.06033	.05473	.04976	.04533	.04138	.03786	.03471
11	.08517	.07695	.06966	.06319	.05743	.05230	.04772	.04364	.04000	.03673
12	.08872	.08031	.07284	.06619	.06026	.05498	.05026	.04604	.04227	.03889
13	.09238	.08378	.07612	.06929	.06320	.05776	.05289	.04853	.04463	.04113
14	.09608	.08728	.07943	.07243	.06616	.06056	.05554	.05104	.04701	.04338
15	.09981	.09081	.08276	.07557	.06914	.06337	.05820	.05356	.04938	.04563
16	.10356	.09435	.08612	.07874	.07213	.06619	.06086	.05607	.05176	.04787
17	.10733	.09792	.08949	.08192	.07513	.06902	.06353	.05858	.05413	.05010
18	.11117	.10155	.09291	.08515	.07817	.07189	.06623	.06113	.05652	.05236
19	.11509	.10526	.09642	.08847	.08130	.07484	.06901	.06375	.05899	.05469
20	.11913	.10908	.10003	.09188	.08452	.07788	.07188	.06645	.06154	.05708
21	.12326	.11300	.10375	.09539	.08784	.08101	.07483	.06923	.06416	.05955
22	.12753	.11705	.10758	.09902	.09127	.08426	.07789	.07212	.06688	.06212
23	.13195	.12125	.11156	.10279	.09484	.08763	.08109	.07514	.06973	.06481
24	.13655	.12563	.11573	.10675	.09860	.09119	.08446	.07833	.07274	.06766
25	.14136	.13022	.12010	.11091	.10255	.09495	.08802	.08171	.07595	.07069
26	.14640	.13504	.12471	.11530	.10674	.09893	.09181	.08531	.07937	.07394
27	.15169	.14011	.12956	.11994	.11117	.10316	.09584	.08915	.08302	.07742
28	.15721	.14542	.13465	.12482	.11583	.10762	.10010	.09322	.08691	.08112
29	.16299	.15097	.13999	.12994	.12075	.11233	.10461	.09753	.09104	.08507
30	.16901	.15678	.14559	.13533	.12592	.11729	.10937	.10210	.09541	.08926
31	.17531	.16287	.15146	.14099	.13137	.12254	.11441	.10694	.10006	.09372
32	.18186	.16921	.15759	.14691	.13709	.12804	.11972	.11205	.10497	.09844
33	.18869	.17584	.16401	.15312	.14309	.13384	.12531	.11744	.11017	.10345
34	.19578	.18273	.17070	.15961	.14937	.13992	.13119	.12312	.11565	.10874
35	.20315	.18990	.17767	.16637	.15593	.14628	.13735	.12908	.12142	.11431
36	.21076	.19732	.18490	.17340	.16276	.15291	.14377	.13531	.12745	.12016
37	.21863	.20501	.19239	.18071	.16987	.15982	.15049	.14182	.13377	.12628
38	.22676	.21296	.20016	.18828	.17725	.16701	.15748	.14862	.14037	.13269
39	.23515	.22118	.20820	.19614	.18492	.17448	.16476	.15571	.14727	.13940
40	.24379	.22967	.21652	.20428	.19288	.18225	.17234	.16310	.15447	.14641
41	.25270	.23842	.22511	.21270	.20112	.19031	.18021	.17078	.16197	.15372
42	.26184	.24742	.23395	.22137	.20962	.19864	.18836	.17875	.16975	.16132
43	.27123	.25666	.24305	.23031	.21840	.20724	.19679	.18700	.17782	.16921
44	.28085	.26616	.25241	.23952	.22745	.21613	.20551	.19554	.18618	.17739
45	.29072	.27591	.26203	.24901	.23678	.22530	.21452	.20438	.19485	.18589
46	.30082	.28591	.27191	.25875	.24639	.23476	.22381	.21352	.20382	.19468
47	.31116	.29616	.28204	.26877	.25626	.24449	.23340	.22295	.21309	.20379
48	.32171	.30663	.29241	.27902	.26640	.25449	.24326	.23265	.22264	.21318
49	.33245	.31730	.30300	.28950	.27676	.26473	.25336	.24262	.23246	.22285
50	.34338	.32816	.31379	.30020	.28735	.27521	.26371	.25283	.24253	.23277
51	.35449	.33923	.32479	.31112	.29818	.28593	.27431	.26331	.25287	.24297
52	.36582	.35053	.33603	.32230	.30927	.29692	.28520	.27408	.26352	.25349
53	.37736	.36205	.34751	.33372	.32063	.30819	.29637	.28514	.27446	.26431
54	.38909	.37376	.35921	.34537	.33221	.31970	.30780	.29647	.28569	.27542
55	.40099	.38568	.37111	.35724	.34404	.33146	.31949	.30807	.29719	.28681
56	.41308	.39779	.38322	.36934	.35610	.34348	.33143	.31994	.30898	.29851

TABLE U(1), BASED ON LIFE TABLE 80CNSMT
UNITRUST SINGLE LIFE REMAINDER FACTORS
ADJUSTED PAYOUT RATE

AGE	4.2%	4.4%	4.6%	4.8%	5.0%	5.2%	5.4%	5.6%	5.8%	6.0%
57	.42536	.41011	.39555	.38167	.36841	.35575	.34366	.33210	.32106	.31051
58	.43781	.42262	.40810	.39422	.38096	.36828	.35615	.34454	.33344	.32281
59	.45043	.43530	.42083	.40698	.39373	.38104	.36888	.35724	.34609	.33540
60	.46318	.44813	.43372	.41992	.40668	.39400	.38183	.37017	.35898	.34824
61	.47602	.46107	.44674	.43299	.41979	.40713	.39497	.38329	.37207	.36129
62	.48893	.47410	.45986	.44617	.43303	.42039	.40825	.39657	.38534	.37454
63	.50190	.48720	.47306	.45946	.44638	.43379	.42168	.41001	.39878	.38796
64	.51494	.50038	.48636	.47286	.45986	.44733	.43526	.42362	.41240	.40158
65	.52808	.51368	.49980	.48641	.47350	.46104	.44903	.43743	.42624	.41544
66	.54134	.52711	.51338	.50013	.48733	.47496	.46302	.45148	.44033	.42956
67	.55471	.54068	.52712	.51401	.50134	.48908	.47723	.46577	.45467	.44394
68	.56820	.55437	.54100	.52805	.51552	.50339	.49165	.48027	.46925	.45858
69	.58172	.56812	.55495	.54219	.52982	.51783	.50620	.49494	.48401	.47341
70	.59526	.58190	.56894	.55637	.54417	.53234	.52086	.50971	.49889	.48838
71	.60874	.59564	.58291	.57055	.55854	.54687	.53554	.52453	.51382	.50342
72	.62218	.60934	.59685	.58471	.57291	.56143	.55026	.53939	.52882	.51854
73	.63557	.62301	.61078	.59887	.58728	.57600	.56501	.55431	.54389	.53373
74	.64896	.63669	.62472	.61307	.60171	.59064	.57985	.56932	.55906	.54906
75	.66237	.65040	.63872	.62733	.61622	.60538	.59480	.58447	.57439	.56455
76	.67581	.66416	.65279	.64168	.63083	.62023	.60988	.59977	.58989	.58023
77	.68925	.67793	.66688	.65606	.64550	.63516	.62506	.61517	.60551	.59605
78	.70263	.69166	.68093	.67044	.66016	.65010	.64026	.63062	.62119	.61195
79	.71585	.70525	.69486	.68468	.67471	.66495	.65538	.64600	.63681	.62780
80	.72885	.71860	.70856	.69872	.68906	.67959	.67031	.66120	.65227	.64350
81	.74150	.73162	.72193	.71242	.70308	.69392	.68492	.67609	.66742	.65890
82	.75376	.74425	.73490	.72572	.71671	.70785	.69915	.69059	.68219	.67393
83	.76559	.75643	.74744	.73859	.72989	.72134	.71293	.70466	.69652	.68852
84	.77700	.76821	.75955	.75104	.74266	.73441	.72629	.71831	.71044	.70270
85	.78805	.77961	.77130	.76311	.75505	.74711	.73929	.73158	.72399	.71652
86	.79866	.79056	.78258	.77472	.76697	.75933	.75180	.74438	.73707	.72985
87	.80870	.80094	.79329	.78574	.77829	.77095	.76370	.75656	.74951	.74255
88	.81825	.81081	.80348	.79623	.78908	.78202	.77506	.76818	.76139	.75469
89	.82746	.82035	.81332	.80638	.79952	.79275	.78606	.77945	.77292	.76647
90	.83643	.82963	.82291	.81627	.80971	.80322	.79681	.79047	.78420	.77801
91	.84503	.83854	.83212	.82578	.81950	.81330	.80716	.80109	.79509	.78915
92	.85308	.84689	.84076	.83470	.82870	.82276	.81689	.81107	.80532	.79963
93	.86052	.85460	.84875	.84295	.83721	.83152	.82590	.82033	.81481	.80935
94	.86729	.86163	.85602	.85046	.84496	.83951	.83412	.82877	.82348	.81823
95	.87338	.86795	.86257	.85723	.85195	.84672	.84153	.83639	.83129	.82624
96	.87877	.87354	.86836	.86323	.85814	.85309	.84809	.84313	.83822	.83334
97	.88365	.87861	.87362	.86867	.86375	.85888	.85405	.84926	.84450	.83979
98	.88805	.88318	.87835	.87356	.86880	.86409	.85941	.85477	.85016	.84559
99	.89210	.88739	.88271	.87807	.87347	.86890	.86436	.85986	.85539	.85095
100	.89588	.89131	.88678	.88227	.87780	.87337	.86896	.86459	.86024	.85593
101	.89949	.89506	.89066	.88629	.88195	.87764	.87336	.86911	.86488	.86069
102	.90325	.89897	.89471	.89047	.88627	.88209	.87794	.87381	.86971	.86564
103	.90724	.90311	.89900	.89491	.89085	.88681	.88279	.87880	.87484	.87089
104	.91167	.90770	.90376	.89983	.89593	.89205	.88819	.88435	.88053	.87673
105	.91708	.91333	.90959	.90587	.90217	.89848	.89481	.89116	.88752	.88391
106	.92470	.92126	.91782	.91440	.91100	.90760	.90422	.90085	.89749	.89414
107	.93545	.93246	.92948	.92650	.92353	.92057	.91762	.91467	.91173	.90880
108	.95239	.95016	.94792	.94569	.94346	.94123	.93900	.93678	.93456	.93234
109	.97900	.97800	.97700	.97600	.97500	.97400	.97300	.97200	.97100	.97000

TABLE F(10.2), WITH INTEREST AT 10.2 PERCENT, SHOWING FACTORS FOR COMPUTATION OF THE ADJUSTED PAYOUT RATE FOR CERTAIN VALUATIONS

1 NUMBER OF MONTHS BY WHICH THE VALUATION DATE PRECEDES THE FIRST PAYOUT		2 FACTORS FOR PAYOUT AT THE END OF EACH			
AT LEAST	BUT LESS THAN	ANNUAL PERIOD	SEMIANNUAL PERIOD	QUARTERLY PERIOD	MONTHLY PERIOD
..	1	1.000000	.976298	.964588	.956833
1	2	.991939	.968428	.956812	.949120
2	3	.983943	.960622	.949099	
3	4	.976011	.952878	.941448	
4	5	.968143	.945196		
5	6	.960338	.937577		
6	7	.952597	.930019		
7	8	.944918			
8	9	.937301			
9	10	.929745			
10	11	.922250			
11	12	.914816			
12	..	.907441			

TABLE F(10.4), WITH INTEREST AT 10.4 PERCENT, SHOWING FACTORS FOR COMPUTATION OF THE ADJUSTED PAYOUT RATE FOR CERTAIN VALUATIONS

1 NUMBER OF MONTHS BY WHICH THE VALUATION DATE PRECEDES THE FIRST PAYOUT		2 FACTORS FOR PAYOUT AT THE END OF EACH			
AT LEAST	BUT LESS THAN	ANNUAL PERIOD	SEMIANNUAL PERIOD	QUARTERLY PERIOD	MONTHLY PERIOD
..	1	1.000000	.975867	.963946	.956052
1	2	.991789	.967854	.956031	.948202
2	3	.983645	.959907	.948181	
3	4	.975568	.952025	.940395	
4	5	.967558	.944208		
5	6	.959613	.936455		
6	7	.951734	.928765		
7	8	.943919			
8	9	.936168			
9	10	.928481			
10	11	.920858			
11	12	.913296			
12	..	.905797			

TABLE F(10.6), WITH INTEREST AT 10.6 PERCENT, SHOWING FACTORS FOR COMPUTATION OF THE ADJUSTED PAYOUT RATE FOR CERTAIN VALUATIONS

1 NUMBER OF MONTHS BY WHICH THE VALUATION DATE PRECEDES THE FIRST PAYOUT		2 FACTORS FOR PAYOUT AT THE END OF EACH			
AT LEAST	BUT LESS THAN	ANNUAL PERIOD	SEMIANNUAL PERIOD	QUARTERLY PERIOD	MONTHLY PERIOD
..	1	1.000000	.975436	.963305	.955274
1	2	.991639	.967281	.955252	.947287
2	3	.983349	.959194	.947265	
3	4	.975127	.951174	.939345	
4	5	.966974	.943222		
5	6	.958890	.935336		
6	7	.950873	.927516		
7	8	.942923			
8	9	.935039			
9	10	.927222			
10	11	.919470			
11	12	.911782			
12	..	.904159			

TABLE F(10.8), WITH INTEREST AT 10.8 PERCENT, SHOWING FACTORS FOR COMPUTATION OF THE ADJUSTED PAYOUT RATE FOR CERTAIN VALUATIONS

1 NUMBER OF MONTHS BY WHICH THE VALUATION DATE PRECEDES THE FIRST PAYOUT		2 FACTORS FOR PAYOUT AT THE END OF EACH			
AT LEAST	BUT LESS THAN	ANNUAL PERIOD	SEMIANNUAL PERIOD	QUARTERLY PERIOD	MONTHLY PERIOD
..	1	1.000000	.975007	.962667	.954498
1	2	.991490	.966710	.954475	.946375
2	3	.983052	.958483	.946352	
3	4	.974687	.950327	.938299	
4	5	.966392	.942239		
5	6	.958168	.934221		
6	7	.950014	.926271		
7	8	.941930			
8	9	.933914			
9	10	.925966			
10	11	.918086			
11	12	.910273			
12	..	.902527			

TABLE F(11.0), WITH INTEREST AT 11.0 PERCENT, SHOWING FACTORS FOR COMPUTATION OF THE ADJUSTED PAYOUT RATE FOR CERTAIN VALUATIONS

1 NUMBER OF MONTHS BY WHICH THE VALUATION DATE PRECEDES THE FIRST PAYOUT		2 FACTORS FOR PAYOUT AT THE END OF EACH			
AT LEAST	BUT LESS THAN	ANNUAL PERIOD	SEMIANNUAL PERIOD	QUARTERLY PERIOD	MONTHLY PERIOD
..	1	1.000000	.974579	.962030	.953724
1	2	.991341	.966140	.953700	.945466
2	3	.982757	.957774	.945442	
3	4	.974247	.949481	.937255	
4	5	.965811	.941260		
5	6	.957449	.933109		
6	7	.949158	.925029		
7	8	.940939			
8	9	.932792			
9	10	.924715			
10	11	.916708			
11	12	.908770			
12	..	.900901			

TABLE F(11.2), WITH INTEREST AT 11.2 PERCENT, SHOWING FACTORS FOR COMPUTATION OF THE ADJUSTED PAYOUT RATE FOR CERTAIN VALUATIONS

1 NUMBER OF MONTHS BY WHICH THE VALUATION DATE PRECEDES THE FIRST PAYOUT		2 FACTORS FOR PAYOUT AT THE END OF EACH			
AT LEAST	BUT LESS THAN	ANNUAL PERIOD	SEMIANNUAL PERIOD	QUARTERLY PERIOD	MONTHLY PERIOD
..	1	1.000000	.974152	.961395	.952952
1	2	.991192	.965572	.952927	.944559
2	3	.982462	.957068	.944534	
3	4	.973809	.948638	.936215	
4	5	.965232	.940283		
5	6	.956731	.932001		
6	7	.948304	.923792		
7	8	.939952			
8	9	.931673			
9	10	.923467			
10	11	.915333			
11	12	.907272			
12	..	.899281			

TABLE F(11.4), WITH INTEREST AT 11.4 PERCENT, SHOWING FACTORS FOR COMPUTATION OF THE ADJUSTED PAYOUT RATE FOR CERTAIN VALUATIONS

1 NUMBER OF MONTHS BY WHICH THE VALUATION DATE PRECEDES THE FIRST PAYOUT		2 FACTORS FOR PAYOUT AT THE END OF EACH			
AT LEAST	BUT LESS THAN	ANNUAL PERIOD	SEMIANNUAL PERIOD	QUARTERLY PERIOD	MONTHLY PERIOD
..	1	1.000000	.973726	.960762	.952183
1	2	.991044	.965005	.952157	.943655
2	3	.982168	.956363	.943630	
3	4	.973372	.947798	.935178	
4	5	.964654	.939309		
5	6	.956015	.930896		
6	7	.947452	.922559		
7	8	.938967			
8	9	.930557			
9	10	.922223			
10	11	.913964			
11	12	.905778			
12	..	.897666			

TABLE F(11.6), WITH INTEREST AT 11.6 PERCENT, SHOWING FACTORS FOR COMPUTATION OF THE ADJUSTED PAYOUT RATE FOR CERTAIN VALUATIONS

1 NUMBER OF MONTHS BY WHICH THE VALUATION DATE PRECEDES THE FIRST PAYOUT		2 FACTORS FOR PAYOUT AT THE END OF EACH			
AT LEAST	BUT LESS THAN	ANNUAL PERIOD	SEMIANNUAL PERIOD	QUARTERLY PERIOD	MONTHLY PERIOD
..	1	1.000000	.973302	.960130	.951416
1	2	.990896	.964440	.951389	.942754
2	3	.981874	.955660	.942728	
3	4	.972935	.946959	.934145	
4	5	.964077	.938338		
5	6	.955300	.929795		
6	7	.946603	.921330		
7	8	.937985			
8	9	.929445			
9	10	.920984			
10	11	.912599			
11	12	.904290			
12	..	.896057			

TABLE F(11.8), WITH INTEREST AT 11.8 PERCENT, SHOWING FACTORS FOR COMPUTATION OF THE ADJUSTED PAYOUT RATE FOR CERTAIN VALUATIONS

1		2			
NUMBER OF MONTHS BY WHICH THE VALUATION DATE PRECEDES THE FIRST PAYOUT		FACTORS FOR PAYOUT AT THE END OF EACH			
AT LEAST	BUT LESS THAN	ANNUAL PERIOD	SEMIANNUAL PERIOD	QUARTERLY PERIOD	MONTHLY PERIOD
..	1	1.000000	.972878	.959501	.950651
1	2	.990748	.963877	.950624	.941855
2	3	.981582	.954959	.941828	
3	4	.972500	.946124	.933114	
4	5	.963502	.937370		
5	6	.954588	.928698		
6	7	.945756	.920105		
7	8	.937006			
8	9	.928337			
9	10	.919748			
10	11	.911238			
11	12	.902807			
12	..	.894454			

TABLE F(12.0), WITH INTEREST AT 12.0 PERCENT, SHOWING FACTORS FOR COMPUTATION OF THE ADJUSTED PAYOUT RATE FOR CERTAIN VALUATIONS

1		2			
NUMBER OF MONTHS BY WHICH THE VALUATION DATE PRECEDES THE FIRST PAYOUT		FACTORS FOR PAYOUT AT THE END OF EACH			
AT LEAST	BUT LESS THAN	ANNUAL PERIOD	SEMIANNUAL PERIOD	QUARTERLY PERIOD	MONTHLY PERIOD
..	1	1.000000	.972456	.958873	.949888
1	2	.990600	.963315	.949860	.940960
2	3	.981289	.954260	.940932	
3	4	.972065	.945290	.932087	
4	5	.962928	.936405		
5	6	.953877	.927603		
6	7	.944911	.918884		
7	8	.936029			
8	9	.927231			
9	10	.918515			
10	11	.909882			
11	12	.901329			
12	..	.892857			

Imported Substances; Rules for Filing a Petition

Notice 89-61

This Notice informs taxpayers of the procedures for filing a petition requesting that a substance be added to or removed from the list of taxable substances in section 4672(a)(3) (''List'') of the Internal Revenue Code (''Code''). These procedures will be adopted by the Internal Revenue Service in regulations implementing an amendment made by section 2001(b) of the Technical and Miscellaneous Revenue Act of 1988 (Pub. L. 100-647) (''1988 Act'') to the tax on certain imported substances under section 4672 of the Code. These procedures will be effective as of May 9, 1989.

I. BACKGROUND

Section 4671 of the Code imposes a tax on the sale or use, after December 31, 1988, by the importer of any taxable substance. The rate of tax for each taxable substance is based upon the rate of tax on the taxable chemicals from which the taxable substance is derived. The amount of tax imposed on a taxable substance is equal to the amount of tax that would have been imposed on the taxable chemicals used as materials in the manufacture of the taxable substance if such substance had been manufactured in the United States.

Section 4672 of the Code provides that a substance shall be added to the List if the Secretary determines, in consultation with the Administrator of the Environmental Protection Agency and the Commissioner of Customs, that taxable chemicals constitute more than 50 percent of the weight or more than 50 percent of the value of the materials used to produce such substance (determined on the basis of the predominant method of production). The Secretary may remove from the List only substances that meet neither the weight nor the value test. If an importer or exporter of any substance requests that the Secretary determine whether such substance should be added to the List or removed from the List, the Secretary shall make such determination within 180 days after the date the request was filed.

II. DEFINITIONS

A *taxable substance* is any substance listed in section 4672(a)(3) of the Code. A *taxable chemical* is any chemical listed in section 4661(b) that is not exempted from the chemical tax by section 4662(b). For purposes of determining whether a manufacturer or importer has ''used'' a taxable chemical or a taxable substance and thus is subject to the tax imposed on ''sale or use,'' taxable chemicals and taxable substances are *used* when they are consumed, when they function as a catalyst, or when they change their characteristics or chemical composition. However, loss or destruction through spillage, fire, or other casualty is not considered a use. For purposes of computing the rate of tax for a taxable substance, the term ''*conversion factor*'' meansthe number of tons of each taxable chemical consumed in the manufacture of one ton of the taxable substance, and the term ''*percentage*'' means the percentage in the taxable substance of metal that is listed as a taxable chemical.

The types of taxable substances enumerated in section 4672(a)(3) of the Code reflect the intent of Congress that only chemicals that are intended for further chemical conversion and certain metals should be subject to the imported substances tax. Thus, petitions to add substances to the List will be entertained only for similar types of chemical derivatives and metals. Accordingly, for *synthetic organic chemicals*, the term ''*substance*'' excludes textile fibers, yarns, and staple, and fabricated products that are molded, formed, woven, or otherwise finished into end-use products. For *inorganic chemicals*, the term ''*substance*'' excludes fabricated products that are molded, formed, or otherwise finished into end-use products. For *metals*, the term ''*substance*'' includes certain wrought metal and scrap.

For petitions based on value, the term ''*value*'' means the average market price during the preceding twelve months of each material in the chemical formula describing the production of the substance.

The *importer* is the person who enters a taxable substance into the United States for consumption, use, or warehousing. A taxable substance is *entered* into the United States for consumption, use, or warehousing when an entry summary (Customs Form 7501) is filed with the appropriate customs officer, in proper form, with estimated duties attached. The person *entering* the taxable substance is the person who files the entry summary. If the person filing the entry summary is filing as an agent for another person (for example, the person filing the entry summary is a Customs broker engaged by the owner), then the principal for whom the agent is acting is deemed to be the person filing the entry summary. The *exporter* is the person named as shipper or consignor in the export bill of lading. The *United States* includes the 50 States, the District of Columbia, the Commonwealth of Puerto Rico, any possession of the United States, the Commonwealth of the Northern Mariana Islands, the Trust Territory of the Pacific Islands, the continental shelf areas (applying the principles of section 638 of the Code), and foreign trade zones.

III. REQUESTS FOR MODIFICATIONS TO THE LIST

An importer or exporter of any substance that is not on the List or an importer or exporter of any taxable substance may request that the List be modified by either adding or removing such substance. Any person other than an importer or exporter may write suggesting modifications to the List, but such person may not petition. Suggestion letters do not require a response, and any action taken on such information is at the discretion of the Secretary.

The request is made by petition to the Commissioner of the Internal Revenue Service. Any substance for which it is claimed that taxable chemicals constitute more than 50 percent of the weight or more than 50 percent of the value of the materials used to produce such substance (determined on the basis of the predominant method of production) may be the subject of a petition. A separate petition must be filed for each substance for which a claim is being made. A separate petition is required for each molecular form of any substance that can include more than one molecular form.

IV. FILING OF PETITIONS

Petitions must be addressed to the Commissioner of the Internal Revenue Service, Attn: CC:CORP:T:R (Petition), Room 4429, Washington, D.C. 20224.

A petition must be sent by certified mail, return receipt requested. A petition is not considered ''filed'' until it has been accepted. A petition will be accepted only if it includes all the required information. Each petition will be acknowledged by letter mailed within thirty days of the petition's receipt (as stamped on the return receipt from the

Post Office). The acknowledgement letter will either accept the petition, or reject and return it because of insufficient information. If the petition is accepted, its filing date is the date the petition was received. If rejected, the petition may be resubmitted with the additional required information, and the filing date would be the date the resubmitted petition is accepted.

In order to be accepted, the petition must include the following:

(1) The name of the substance, including its physical state and form, that is the subject of the petition.

(2) The Harmonized Tariff System (HTS) item number as officially classified by the United States Customs Service, the Schedule B item number, and if applicable the Chemical Abstract Service (CAS) number, for the substance.

(3) The names, and HTS and Schedule B numbers, and CAS numbers if applicable, of all the taxable chemicals that constitute the materials used in the production of the substance.

(4) The name of the process that the petitioner is claiming is the predominant method of production for the substance.

(5) The data supporting the petitioner's position that the production process selected as the basis for the petition is the predominant one.

(6) An explanation of the process chosen as the predominant method of production of the substance, emphasizing the overall chemical reaction from the taxable chemicals to the substance.

(7) The stoichiometric material consumption formula, assuming a 100-percent yield, based on the predominant method of production, for the substance that shows that taxable chemicals constitute over 50 percent of the molecular weight or over 50 percent of the value of the raw materials used to produce the substance. Included in the formula must be all materials, taxable chemicals, nontaxable chemicals, solvents and catalysts not recovered or recycled, that are consumed in the process. If the request is to remove a taxable substance from the List, the petitioner must show that the taxable substance meets neither the weight nor the value test.

(8) The unit quantities (UQ) on a weight basis of all materials involved in the production of a unit of substance. Materials recycled in the process would have a UQ based on the amount consumed, lost, purged, or destroyed per unit of substance produced.

(9) In the case of a petition based upon value, the value of the materials multiplied by the unit quantity of each material.

(10) The name, address, taxpayer identification number, and principal place of business of the petitioner; the name and official capacity in such business of the person filling out the petition; any Form 637 registration numbers held by the business or the individuals involved; and the district in which Form 720 is filed, if any. The petition must include an explanation of the petitioner's eligibility (as an importer or exporter of the substance that is the subject of the petition) to file a petition, including the type of business and how long such business has been conducted.

(11) The statement, signed under penalties of perjury, that the petitioner has examined the petition and to the best of petitioner's knowledge and belief, it is true, correct, and complete.

V. EXAMPLES OF REQUIRED INFORMATION

A. *Predominant method of production.*

The following are examples, according to industry sources, of information satisfying items (4) and (5) of the petition, relating to the predominant method of production.

(1) Ethylene oxide is generally produced by the direct oxidation of ethylene. Direct oxidation has replaced the chlorohydrin process as the predominant method.

(2) Ethylbenzene is produced by the Friedel-Crafts alkylation between benzene and ethylene. Only 3 percent of the ethylbenzene produced is isolated by superfractionation.

B. *Stoichiometric material consumption formula.*

The following is an example of a stoichiometric formula.

	C_6H_6 benzene	+	$CH_2=CH_2$ ethylene	= =	$C_6H_5CH_2CH_3$ ethylbenzene
molecular weight	78.1		28		106.1
unit quantities	0.75 lb.		0.28 lb.		1 lb.

C. *Rate of tax based upon conversion factors.*

The following is an example of how to calculate the rate of tax for a substance.

The rate of tax for ethylbenzene, based upon the unit quantity of each chemical consumed in production, is calculated as follows:

The rate of tax for benzene ($4.87 per ton) is multiplied by the conversion factor for benzene derived from the above equation (0.75) which equals $3.65. The rate of tax for ethylene ($4.87 per ton) is multiplied by the conversion factor for ethylene derived from the above equation (0.28) which equals $1.36. Thus, the rate of tax that would have been imposed on benzene and ethylene used in the United States to produce one ton of ethylbenzene equals $3.65 plus $1.36 or $5.01 per ton. Therefore, the rate of tax for ethylbenzene, based on the predominant method of production, is $5.01 per ton.

D. *Unit quantities formula.*

The following is an example of how to show, by using unit quantities, that taxable chemicals constitute more than 50 percent of the weight of all the materials used in the production of a unit of substance.

Assume that A, B, C, and D represent the materials used to produce substance E, and that A and C are taxable chemicals.

A	+	B	+	C	+	D	−	waste	=	E
0.4 lb.		0.3 lb.		*0.7 lb.*		0.7 lb.		1.1 lbs.		1.0 lb.

Thus, 2.1 pounds of materials were consumed to produce 1.0 pound of substance (0.4 + 0.3 + 0.7 + 0.7 = 2.1). Of the 2.1 pounds of materials consumed, 1.1 pounds were taxable chemicals (0.4 + 0.7 = 1.1). The ratio of the amount of taxable chemicals consumed (1.1) to the total amount of materials consumed (2.1), converted to percent, is the percentage by weight of taxable chemicals in the substance.

$$1.1 / 2.1 \times 100 = 52\%$$

Therefore, 52 percent of the weight of substance E is comprised of taxable chemicals.

VI. PUBLIC NOTICE, COMMENTS, REQUESTS FOR A PUBLIC HEARING

After a petition has been filed, a "Notice of Filing" summarizing the petition and requesting comments will be published in the Federal Register and in the Internal Revenue Bulletin. The complete petition will be available in the Internal Revenue Service Freedom of Information Reading Room for copying by the public. The Notice of Filing will be based upon the information provided by the petitioner. The Notice of Filing of the petition will include—

(1) the name of the substance that is the subject of the petition;
(2) the HTS and Schedule B number, and CAS number if applicable;
(3) the filing date of the petition;
(4) a brief description of the basis for the petition;
(5) the claimed predominant method of production for the substance;
(6) the stoichiometric material consumption formula for the substance;
(7) the identity of the petitioner; and
(8) the rate of tax for the substance, based upon the conversion factors derived from the unit quantities formula, that would apply if the determination were made to add the substance to the List.

Before the determination is made, consideration will be given to any written comments that are submitted to the Internal Revenue Service within sixty days of the date that the Notice of Filing is published in the Federal Register. In addition to substantive comments on the petition, the Service requests comments that identify the primary importers or exporters, as appropriate, known to have an adverse interest to the petition, to make it more likely that the principal interested parties will learn of the filing of the petition. All comments will be made available for public inspection and copying. A public hearing will be held upon written request to the Internal Revenue Service by any person that also submits written comments. If a public hearing is scheduled, notice of the time and place will be published in the Federal Register.

VII. DETERMINATIONS

A determination on each petition filed will be made by the Secretary after public notice and an opportunity for comments, and after consultation with the Administrator of the Environmental Protection Agency and the Commissioner of Customs. A determination will be made within 180 days after the date the petition is filed. The determination period may be extended by agreement between the petitioner and the Commissioner.

When a decision is reached, a "Notice of Determination" will be published in the Federal Register and in the Internal Revenue Bulletin. This Notice will include—

(1) the determination of the Secretary;
(2) the identification of the substance, including HTS and Schedule B number, and CAS number if applicable;
(3) a synopsis of the reasons for the determination, including the technical data on which the determination is based;
(4) a synopsis of the material comments received for and against the petition;
(5) the date of the determination;
(6) the effective date for any modification to the List; and, in the case of substances added to the List,
(7) the identification of the predominant method of production of the substance; and
(8) the rate of tax prescribed by the Secretary for the substance based upon the predominant method of production.

VIII. EFFECTIVE DATE FOR MODIFICATIONS TO THE LIST

The date of the determination by the Secretary is not the date that a substance is added to or removed from the List. The effective date of any modification to the List will be as follows:

Determinations made between	*Listed as of*
July 1 and September 30	January 1
October 1 and December 31	April 1
January 1 and March 31	July 1
April 1 and June 30	October 1

As set forth in the above table, determinations made during a quarter will be reflected in the list of taxable substances as of the first day of the second quarter following the quarter in which the determination is made. The listing dates would thus provide at least 90 days' notice to persons that would be liable for tax upon their use or sale of the newly listed substance, and to persons that would no longer be eligible to claim a credit or refund of the tax paid on taxable chemicals used in the manufacture, for export, of substances removed from the List. The dates are chosen to correspond to the calendar quarters on Form 720, *Quarterly Federal Excise Tax Return*, which is the return filed by excise taxpayers.

IX. ADMINISTRATIVE PRONOUNCEMENT AND DRAFTING INFORMATION

This document serves as an "administrative pronouncement" as that term is described in section 1.6661-3(b)(2) of the Income Tax Regulations and may be relied upon to the same extent as a revenue ruling or revenue procedure.

The collection of information contained in this Notice has been reviewed and approved by the Office of Management and Budget in accordance with the requirements of the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545-1117. The estimated average burden associated with the collection of information in this Notice is one hour per respondent.

These estimates are an approximation of the average time expected to be necessary for a collection of information. They are based on such information as is available to the Internal Revenue Service. Individual respondents/recordkeepers may require greater or less time, depending on their particular circumstances.

Comments concerning the accuracy of this burden estimate and suggestions for reducing this burden should be directed to the Internal Revenue Service, Washington, D.C. 20224, Attention: IRS Reports Clearance Officer TR:FP; or to the Office of Management and Budget, Paperwork Reduction Project (1545-1117), Washington, D.C. 20503.

List of Countries Requiring Cooperation With an International Boycott

Notice 89-62[1]

In order to comply with the mandate of section 999(a)(3) of the Internal Revenue Code of 1954, the Department of the Treasury is publishing a current list of countries which may require participation in, or cooperation with, an international boycott [within the meaning of section 999(b)(3) of the Internal Revenue Code of 1954]. The list is the same as the prior quarterly list published in the **Federal Register.**

On the basis of the best information currently available to the Department of the Treasury, the following countries may require participation in, or cooperation with, an international boycott (within the meaning of section 999(b)(3) of the Internal Revenue Code of 1954).

Bahrain
Iraq
Jordan
Kuwait
Lebanon
Libya
Oman
Qatar
Saudi Arabia
Syria
United Arab Emirates
Yemen, Arab Republic
Yemen, Peoples Democratic Republic of

Date: September 29, 1988.

O. Donaldson Chapoton,
Assistant Secretary for Tax Policy.

(Filed by the Office of the Federal Register on October 5, 1988, 8:45 a.m., and published in the issue of the Federal Register for October 6, 1988, 53 F.R. 39398).

Normalization of accelerated depreciation and cost recovery: inconsistent ratemaking procedures and adjustments

Notice 89-63

Regulations project PS-107-88 was opened in December 1988 under section 168(i)(9) of the Internal Revenue Code. The purpose of this project is to provide guidance as to the proper application of the normalization requirements for public utilities filing consolidated income tax returns. The regulations will address the use by public utilities of "effective tax rates" and "consolidated tax adjustments." These procedures are used in calculating the utility's income tax expense for ratemaking purposes by taking into consideration the tax deductions and credits of nonregulated affiliates with which the utility files a consolidated return. The general effect of these procedures is to decrease a utility's ratemaking tax expense.

The Internal Revenue Service is developing regulations that will prescribe the extent, if any, to which adjustments and procedures that reduce a utility's ratemaking tax expense to reflect the tax losses of nonregulated affiliated companies will be treated as inconsistent with the normalization rules. These regulations may provide that the normalization requirements are violated by reductions to total ratemaking tax expense achieved through use of an "effective tax rate," by application of a "consolidated tax adjustment," or by other adjustments to utility cost of service leading to similar results.

To the extent the regulations treat such ratemaking adjustments as inconsistent with the normalization requirements, they will apply to public utility rate orders that become "final determinations" (within the meaning of section 1.46-6(f)(8)(iii) of the regulations) on or after the effective date of the regulations. The effective date of the regulations will be no earlier than June 29, 1989, thirty days after publication of this notice in the Internal Revenue Bulletin. Any rate order that becomes a final determination before the effective date and contains such an adjustment will not be considered to violate the normalization requirements merely because it contains such an adjustment, provided that deferred tax expense is computed using the statutory rate.

Nonrecognition Exchange of U.S. Real Property Interests and Article XIII(9) of the United States-Canada Income Tax Convention

Notice 89-64

This notice provides guidance relating to nonrecognition distributions and exchanges by Canadian residents of U.S. real property interests (USRPIs) that qualify for reduced taxation under Article XIII(9) of the United States-Canada Income Tax Convention (the Treaty), 1986-2 C.B. 258, 264. The rules contained in this notice will be incorporated in final regulations to be issued under section 897(d) and (e) of the Internal Revenue Code, and will be effective for any period in which a USRPI may be disposed of with reduced taxation under Article XIII(9) of the Treaty.

A foreign person that disposes of a USRPI is generally subject to U.S. income taxation under section 897(a) of the Code. Article XIII(9) of the Treaty provides for a reduction in the amount of gain subject to U.S. taxation when a resident of Canada alienates certain USRPIs, to the extent the gain is attributable to the period before January 1, 1985. In order to qualify for the reduced U.S. income taxation under the Treaty, the Canadian resident had to own the USRPI on September 26, 1980, and be a resident of Canada on that date, or the USRPI had to be acquired by the Canadian resident in an alienation of property that qualified as a nonrecognition transaction for purposes of taxation in the United States.

Section 337 of the Code generally provides for nonrecognition treatment on the distribution of property in a distribution pursuant to section 332. The nonrecognition treatment provided under section 337 may be overridden by section 897(d)(1), which specifies that a foreign corporation shall recognize gain on the distribution of a USRPI except to the extent provided in regulations or in section 897(d)(2). Under the regulations implementing section 897(d), a Canadian corporation that distributes a USRPI, the gain inherent in which would qualify for reduced taxation under the Treaty, must recognize gain on the distribution unless the following requirements of section 1.897-5T(c)(2)(i) of the Temporary Income Tax Regulations are met: (1) the distributee must be subject to U.S. income taxation on a subsequent disposition of the USRPI; (2) the distributee's basis in the USRPI must be no greater than the Canadian corporation's basis in the USRPI before the distribution, increased by the amount of gain (if any) recognized by the Canadian corporation on the distribution and added to the adjusted basis under the otherwise applicable provision, and (3) the Canadian corporation must comply with the filing requirements of paragraph (d)(1)(iii) of section 1.897-5T.

corporation must comply with the filing requirements of paragraph (d)(1)(iii) of section 1.897-5T.

The Code also provides for nonrecognition treatment on the exchange of property in certain instances, including an exchange pursuant to section 351(a) of the Code. The nonrecognition treatment provided in those instances may be overridden by section 897(e). If a Canadian resident transfers a USRPI, the gain inherent in which would qualify for reduced taxation under the Treaty, and such transfer would, but for section 897(e), qualify for nonrecognition under the Code, the transferee must recognize gain realized on the transfer unless the transfer complies with the following requirements of section 897(e)(1) of the Code and section 1.897-6T(a)(1) of the temporary regulations: (1) the Canadian resident must receive a USRPI in the exchange that, immediately following the exchange, would be subject to U.S. taxation upon its disposition; and (2) the Canadian resident must comply with the filing requirements of paragraph (d)(1)(iii) of section 1.897-5T.

Section 1.897-5T(d)(1)(ii)(B) of the temporary regulations provides that, if a distributee of a USRPI in a distribution or a transferor in an exchange who receives a USRPI would be entitled to reduced U.S. taxation under a treaty upon the disposition of the USRPI, then only a portion of the USRPI received is treated as subject to U.S. taxation upon its disposition, and only that portion is entitled to nonrecognition treatment on the original distribution or transfer. The temporary regulation states that this provision is applicable to certain transfers of USRPIs qualifying for reduced taxation under Article XIII(9) of the Treaty. Thus, if a Canadian corporation distributes to a Canadian distributee a USRPI, the gain inherent in which would qualify for reduced taxation under Article XIII(9), and such distribution would otherwise qualify for nonrecognition under section 1.897-5T(c)(2)(i), the Canadian corporation is required to recognize gain on the distribution if the Canadian distributee would be entitled to reduced U.S. taxation under the Treaty on the subsequent disposition of the USRPI. Similarly, if a Canadian person transfers a USRPI, the gain inherent in which would qualify for reduced taxation under Article XIII(9), in an exchange that otherwise qualifies for nonrecognition under section 1.897-6T(a)(1), the transferor is required to recognize gain if it is a Canadian individual or corporation that would be entitled to reduced U.S. taxation under the Treaty on a subsequent disposition of the USRPI received in the exchange.

The final regulations under section 897(d) and (e) of the Code will be revised to provide generally that if a Canadian corporation distributes a USRPI, the gain inherent in which would qualify for reduced taxation under Article XIII(9) of the Treaty, in a liquidation under section 332(a), the Canadian corporation will not recognize gain solely because the distributee is a Canadian resident corporation qualifying for reduced taxation under Article XIII(9) in regard to the USRPI distributed. Thus, the distributee Canadian corporation will not be required to waive its U.S. treaty benefits under Article XIII(9) pursuant to section 1.897-5T(d)(1)(ii)(C) of the temporary regulations and any such waiver if filed shall be disregarded. All of the other provisions and requirements of the regulations under section 897 will apply to the liquidation under section 332(a).

The final regulations under section 897(d) and (e) of the Code will also be revised to provide generally that if a Canadian person transfers a USRPI, the gain inherent in which would qualify for reduced taxation under Article XIII(9) of the Treaty, to a U.S. corporation (or to a corporation that has made an election under section 897(i)) in exchange under section 351(a) for stock in such corporation that is a USRPI and also qualifies for reduced taxation under Article XIII(9), the transferor will not recognize gain on such exchange solely because the later transfer of the USRPI received in the exchange will qualify for reduced taxation under Article XIII(9). This exception will apply only where the Canadian person transfers solely USRPIs, the gain inherent in which would qualify in whole or in part for reduced taxation under Article XIII(9) of the Treaty (and such cash as is reasonably appropriate working capital), in actual (and not deemed) exchange for stock in such corporation that is equivalent in value to the USRPIs and the cash (if any) transferred. Thus, the Canadian transferor will not be required, in such case, to waive its U.S. treaty benefits under Article XIII(9) pursuant to section 1.897-5T(d)(1)(ii)(C) of the temporary regulations, and any such waiver if filed shall be disregarded.

These provisions of the final regulations under section 897(d) and (e) of the Code will apply to transfers, exchanges, distributions, and other dispositions occurring after June 18, 1980. Except as otherwise provided, all of the other provisions and requirements of the regulations under section 897 will apply to the transfer.

The final regulations to be issued under section 897(d) and (e) of the Code may provide other exceptions to section 1.897-5T(d)(1)(ii)(B) of the temporary regulations for gains from transfers of USRPIs which qualify for reduced taxation under the Treaty. Additionally, exceptions may also be provided for transfers or distributions that do not consist solely of USRPIs (and reasonable working capital) which qualify for reduced taxation under the Treaty.

Section 1.897-3(c)(4)(i) of the regulations provides that a foreign corporation must submit both a signed consent to the making of an election under section 897(i) of the Code and a waiver of U.S. treaty benefits with respect to any gain or loss from the disposition of an interest in the corporation from each person who holds an interest in the corporation on the date the election is made. Section 1.897-3(c)(4)(i) will be revised to provide that an interest-holder will not be required to waive benefits under Article XIII(9) upon the making of an election under section 897(i) by a Canadian corporation. This provision will apply to all elections under section 897(i) by Canadian corporations occurring after June 18, 1980.

ADMINISTRATIVE PRONOUNCEMENT

This document serves as an "administrative pronouncement" as that term is described in section 1.6661-3(b)(2) of the Income Tax Regulations and may be relied on to the same extent as a revenue ruling or revenue procedure.

Section 89 Transitional Rules

Notice 89-65

PURPOSE

The purpose of this notice is to provide employers additional transitional relief to October 1, 1989, for testing relief to October 1, 1989, for testing their plans for compliance with the nondiscrimination rules of section 89(a) and the reasonable notice requirement of section 89(k). With respect to the testing requirements, the notice permits employers to use a partial testing year beginning on October 1, 1989, eliminates certain restrictions on the availability of this delayed partial testing year for health plans, and expands the availability of the October 1, 1989, partial testing year from health plans to all statutory employee benefit plans covered by section 89(a). This relief is provided to reduce taxpayer compliance burdens under current section 89.

REVISIONS TO TRANSITIONAL RULES

Section 89(a) nondiscrimination rules

Commencement of partial testing year.

Under section 89 and the proposed regulations, an employer generally applies the section 89 nondiscrimination rules to its statutory employee benefit plans based on applicable facts as of any testing day that occurs during a testing year selected by the employer. However, adjustments to the facts in existence on the testing day must be made for certain changes in plan terms and certain election changes by highly compensated employees occurring during the testing year both before and after the testing day.

Paragraph (b)(5) of Q&A-5 of the proposed regulations provides a special transition rule for 1989 that may be used by employers in testing their health plans under section 89 of the Code. Under the transition rule, for any testing year beginning before July 1, 1989, an employer may apply the nondiscrimination rules of section 89 with respect to its health plans based on a partial testing year. The facts with respect to all employees of the employer as of the testing day for the testing year are to be treated as in existence for the partial testing year. The partial testing year begins on the earliest of July 1, 1989, the testing day for such testing year, or the first day of the calendar month beginning three months before the end of the testing year. The last day of the partial testing year is the last day of such testing year.

Under the provisions of paragraph (b)(5) of Q&A-5, the employer-provided benefit (received or made available) of an employee determined as of the testing day is to be adjusted for elections and plan design changes occurring during the partial testing year as if the partial testing year were the entire testing year. The employer-provided benefit of an employee for the partial testing year, determined after application of the other rules in paragraph (b)(5) of Q&A-5, is then annualized for the entire testing year. Thus, an employer may limit most of the data collection and testing efforts to the partial testing year period and disregard changes in plan terms or election changes by highly compensated employees that occurred prior to the commencement of the partial testing year.

The final regulations under section 89 will amend Q&A-5 of section 1.89(a)-1 of the proposed regulations published March 7, 1989 (54 FR 9460) to substitute "October 1, 1989" for "July 1, 1989" in the first sentence of paragraph (b)(5)(i) and the second sentence of paragraph (b)(5)(ii). Therefore, an employer may apply the nondiscrimination rules of section 89 based on a partial testing year starting as late as October 1, 1989 and may disregard facts in existence prior to that date.

Waiver of restrictions on availability of partial testing year.

Under paragraph (b)(5)(v) of Q&A-5, the use of the partial testing year rule is not available in the following circumstances: (1) if a health plan provides an employer-provided benefit that for the partial testing year is less, by more than a de minimis amount, than the plan's employer-provided benefit for the portion of the testing year that precedes the partial testing year; (2) if a health plan that is first established, or coverage under a health plan that is first provided, on or after January 1, 1989, terminates or ceases to be provided before the end of the partial testing year; or (3) if less than 25 percent of the employees eligible for a health plan are nonhighly compensated employees and the plan does not satisfy the alternative eligibility percentage test of section 89(d)(2) of the Code and paragraph (d)(3)(iii) of Q&A-1 of the proposed regulations.

The final regulations under section 89 will amend Q&A-5 to delete paragraph (b)(5)(v) in its entirety, thereby eliminating these restrictions on the availability of the delayed partial testing year.

Availability of partial testing year extended to statutory benefit plans other than health plans.

The availability of the partial testing year provision in Q&A-5 of the proposed regulations is limited to health plans. The final regulations will amend Q&A-5 to substitute the term "statutory employee benefit plans" for "health plans" in paragraph (b)(5)(i). Thus, for example, employers may also apply the nondiscrimination rules of section 89(a) to group-term life insurance plans on the basis of a partial testing year beginning October 1, 1989.

Section 89(k) notice requirement.

Under section 89 and the proposed regulations, employees must be provided with reasonable notification of benefits available under plans subject to the requirements of section 89(k). Under section 1151 of the Tax Reform Act of 1986, this requirement became effective for years beginning after December 31, 1988. However, the proposed regulations, in paragraph (g)(4) of Q&A-5 of Treas. Reg. §1.89(k)-1, delayed the compliance date for the notice requirement to no earlier than July 1, 1989.

The final regulations under section 89 will amend paragraph (g)(4) of Q&A-5 to substitute "October 1, 1989" for "July 1, 1989". Therefore, a plan will not be required to comply with the notice requirement of section 89(k)(1)(C) until October 1, 1989.

ADDITIONAL REVISIONS FOR CONSISTENCY

To the extent other provisions, including examples, provided in Treas. Reg. §§1.89(a)-1 and 1.89(k)-1 are inconsistent with these changes, they will be modified in the final regulations.

RELIANCE

This document serves as an "administrative pronouncement" as that term is described in section 1.6661-3(b)(2) of the Income Tax Regulations and may be relied upon to the same extent as a revenue ruling or revenue procedure. Taxpayers may rely on this notice until the final regulations are published. No inference should be drawn, however, regarding any issue not specifically addressed in this notice.

List of Countries Requiring Cooperation With an International Boycott

Notice 89-66

In order to comply with the mandate of section 999(a)(3) of the Internal Revenue Code of 1954, the Department of the Treasury is publishing a current list of countries which may require participation in, or cooperation with, an international boycott [within the meaning of section 999(b)(3) of the Internal Revenue Code of 1954]. The list is the same as the prior quarterly list published in the **Federal Register.**

On the basis of the best information currently available to the Department of the Treasury, the following countries may require participation in, or cooperation with, an international boycott (within the meaning of section 999(b)(3) of the Internal Revenue Code of 1954).

Bahrain
Iraq
Jordan
Kuwait
Lebanon
Libya
Oman
Qatar
Saudi Arabia
Syria
United Arab Emirates
Yemen, Arab Republic
Yemen, Peoples Democratic Republic of

Date: December 15, 1988.

O. Donaldson Chapoton,
Assistant Secretary for Tax Policy.

(Filed by the Office of the Federal Register on December 21, 1988, 8:45 a.m., and published in the issue of the Federal Register for December 22, 1988, 53 F.R. 51622).

Issues Relating to the Uniform Capitalization Rules under Section 263A

Notice 89-67

The purpose of this notice is to provide guidance regarding forthcoming regulations interpreting the uniform capitalization rules under section 263A of the Internal Revenue Code. Included in this notice is a discussion of the amendments to section 263A made by the Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647 (the "1988 Act"). Finally, this notice, 89-67, provides clarification relating to certain issues raised in other guidance previously published under section 263A of the Code.

I. BACKGROUND

Section 263A of the Code, enacted by the Tax Reform Act of 1986, Pub. L. No. 99-514 (the "1986 Act") provides uniform capitalization rules that apply to the production of property and the acquisition of property for resale.

Proposed and temporary regulations interpreting section 263A of the Code were published in the Federal Register on March 31, 1987, and August 7, 1987 (T.D. 8131, 1987-1 C.B. 98; T.D. 8148, 1987-2 C.B. 70). A public hearing on the regulations was held on December 7, 1987. Notice 88-24, 1988-1 C.B. 491, contains guidance relating to the application of section 263A to property produced in the trade or business of farming. Notice 88-62, 1988-1 C.B. 548, provides an elective simplified method for deducting the business expenses of authors, photographers, artists, and other similarly situated persons who incur expenses in producing creative properties. Notice 88-78, 1988-2 C.B. 394, provides guidance to taxpayers that fail to change their method of accounting in order to conform to the uniform capitalization provisions of section 263A. Notice 88-86, 1988-2 C.B. 401, contains additional guidance on a number of issues that will be addressed in the final regulations under section 263A. Notice 88-99, 1988-2 C.B. 422, relates to the interest capitalization requirements of section 263A. Notice 88-104, 1988-2 C.B. 443, contains guidance relating to the application of section 263A to foreign persons.

II. AMENDMENTS TO SECTION 263A UNDER THE 1988 ACT.

(A) *Simplified Resale Method.*

Section 1008(b)(8) of the 1988 Act provides that, for purposes of the simplified resale method provided in the regulations under section 263A of the Code, the allocation formula used for apportioning storage costs and related handling costs may be determined by dividing the amount of such costs by the beginning inventory balances and the purchases made during the year and by multiplying the resulting allocation ratio by the amount of purchases that, under the taxpayer's method of accounting for inventories, are treated as remaining in ending inventory. The method provided in section 1.263A-1T(d)(4) of the Temporary Treasury Regulations includes in the denominator of the allocation ratio only the current year's purchases. Beginning inventory balances are excluded from the calculation of the allocation ratio in the simplified resale method contained in the temporary regulations. As discussed in the preamble to the temporary regulations (52 Fed. Reg. 10055 (1987)), because under the simplified resale method the allocation ratio is not applied to purchases in ending inventory that are not treated as acquired during the current year (*i.e.*, beginning inventory balances), beginning inventory balances are similarly excluded from the ratio to provide consistency in the treatment of such balances for purposes of the simplified resale method.

An alternative simplified resale method was provided in Notice 88-86. Under the alternative simplified resale method, beginning inventory balances are included in the denominator of the allocation ratio, and the allocation ratio is applied to the taxpayer's total ending inventory, including amounts that were included in beginning inventory for the current year.

The temporary regulations will be amended to provide that, effective for taxable years beginning after December 31, 1986, taxpayers may elect the "modified resale" method permitted by section 1008(b)(8) of the 1988 Act. For purposes of section 263A of the Code, the election to use the modified resale method is a method of accounting and, except as provided in this notice, a change to or from the modified resale method is a change in method of accounting that requires the consent of the Commissioner. Other than the calculation of the allocation ratio, as provided herein, the application of the modified resale method shall be made in accordance with all of the provisions of section 1.263A-1T of the regulations.

In calculating the allocation ratio, for purposes of both the alternative simplified method and the modified resale method, beginning inventory amounts included in the denominator by a taxpayer using the last-in, first-out (LIFO) method of accounting for inventories are to be stated using the LIFO carrying value of such inventory and shall not be stated in current year dollars. Once the allocation ratio is determined, section 1.263A-1T(d)(4)(v) of the regulations provides that, if the taxpayer determines that there has been an inventory increment for the current year, then the taxpayer shall state the amount of the increment in current year dollars and multiply the resulting amount by the allocation ratio.

Example.

Year	*Base-year Cost*	*LIFO Index*	*LIFO Value*	*Inflator Index*	*Current Cost*
1984	$20,000	0.50	$10,000	4.00	$40,000
1985	6,667	0.75	5,000	2.67	13,333
1986	3,000	1.00	3,000	2.00	6,000
1987	2,667	1.50	4,000	1.33	5,333
1988	1,000	2.00	2,000	1.00	0,000
	$33,334		$24,000		$66,666

Current (1989) Storage and Handling Costs $ 5,000

Current (1989) Total Purchases $25,000

Allocation Ratio (using the modified resale method):

$\frac{\$5{,}000}{\$49{,}000} = 10.2\%$ (LIFO value of beginning inventory: $24,000 + current year's purchases: $25,000)

The simplified resale method, the alternative simplified resale method, and the modified resale method are available to taxpayers for the first taxable year beginning after December 31, 1986. Taxpayers wishing to elect the modified resale method may do so for either (i) the taxpayer's first taxable year ending after December 5, 1989, or (ii) the taxpayer's first taxable year beginning after December 31, 1986.

A taxpayer electing the modified resale method for its first taxable year ending after December 5, 1989 shall effect such election by applying the modified resale method in calculating the amount of additional section 263A costs required to be capitalized beginning with the year of change on a cut-off basis; *i.e.*, without restating beginning balances for the year of change, and without any corresponding adjustment under section 481(a) for any year, if and only if the previous method used by the taxpayer for prior taxable years for which 263A was effective was a correct method of accounting under section 263A and the regulations thereunder.

A taxpayer electing the modified resale method for its first taxable year beginning after December 31, 1986, shall effect such election by filing returns amended to reflect the election of the modified resale method, for the taxpayer's first taxable year beginning after December 31, 1986, and any subsequent year for which a Federal income tax return has already been filed. (Section III(A) of this Notice 89-67 contains the deadline for filing an amended return for any such year.) In filing amended returns for the purpose of electing the modified resale method, taxpayers shall recompute the adjustment under section 481(a) of the Code determined by revaluing inventory on hand at the beginning of the year of change pursuant to the provisions of section 1.263A-1T(e) of the regulations as if the modified resale method had been applied during all relevant prior periods.

The provisions of this section apply only to any taxpayer eligible to elect the simplified resale method or the alternative simplified resale method under section 1.263A-1T of the regulations, regardless of whether the taxpayer has elected either method for any taxable year.

(B) *Free-lance Authors, Photographers, and Artists.*

The uniform capitalization rules of section 263A of the Code apply to the production of all tangible personal property and to the acquisition of property for resale. ''Tangible personal property'' includes a film, sound recording, video tape, book, or similar property. Thus, for example, publishers and authors must capitalize the cost of researching, preparing, and writing literary works.

In Notice 88-62, the Internal Revenue Service provided an elective safe harbor method of accounting for ''qualified costs'' incurred by certain authors, photographers, artists, and other similarly situated individuals who incur expenses in producing creative properties. Under this method, eligible taxpayers may aggregate and capitalize all qualified creative costs incurred during each taxable year and may deduct 50 percent of such aggregate costs in the year they are incurred and 25 percent of such costs in each of the two succeeding years.

Section 6026(a) of the 1988 Act provides an exemption from the capitalization provisions of section 263A of the Code for ''qualified creative expenses'' incurred by free-lance authors, photographers, and artists, in the trade or business of being a writer, author, photographer or artist. ''Qualified creative expenses'' are any expenses which are otherwise deductible and which are paid or incurred by an individual engaged in the business of being an author, photographer, or artist. The exemption applies to an individual whose personal efforts create (or may reasonably be expected to create) a literary manuscript, musical composition, dance score, photograph, photographic negative or transparency, picture, painting, sculpture, statue, etching, drawing, cartoon, graphic design, or original print edition. The originality and uniqueness of the item created (or to be created) and the predominance of aesthetic value over utilitarian value of the item created (or to be created) will be considered in determining whether a qualified creative expense is paid or incurred by an artist. Thus, for example, any expense that is paid or incurred in producing jewelry, silverware, pottery, furniture, and other similar household items generally will not be considered as being paid or incurred in the business of an individual being an artist.

The exemption for qualified creative expenses does not apply to any expenses incurred by an individual in his or her capacity as an employee. However, expenses paid or incurred by a personal service corporation that directly relate to the activities of a qualified employee-owner qualify for the exception to the uniform capitalization rules to the extent that expenses would qualify if paid or incurred directly by the employee-owner. The exemption under section 6026(a) of the 1988 Act does not apply to any expense that is related to printing, photographic plates, motion picture films, sound recordings, video tapes, or similar items.

The exemption provided for qualified creative expenses in section 6026(a) of the 1988 Act is retroactive and effective as if included in the Tax Reform Act of 1986. Eligible taxpayers (including taxpayers who elected the safe harbor method provided in Notice 88-62 for any taxable year) may change from the method of accounting required under section 263A of the Code to any other method of accounting permitted under the Code for the costs incurred in the trade or business of such taxpayers by either (1) applying the provisions of section 6026(a) of the 1988 Act beginning with the first taxable year for which section 263A applied to the taxpayer (Section III(A) of this Notice 89-67 contains the deadline for filing an amended return for any such year), or (2) applying the provisions of section 6026(a) of the 1988 Act for its first Federal income tax return filed after the date September 5, 1989, or, if the taxpayer wishes, with a return filed before such date]. Costs capitalized by a taxpayer described in clause (2) in any return filed before the return described in the preceding sentence shall continue to be treated as capitalized costs and shall be recovered using the taxpayer's method of accounting for the recovery of such capitalized costs, *e.g.*, the income forecast method or, if elected, the safe harbor method provided in Notice 88-62.

(C) *Certain Producers of Animals in a Farming Business.*

The uniform capitalization provisions of section 263A of the Code apply to the production, growing, or raising of property in the trade or business of farming. As enacted by the 1986 Act, the uniform capitalization rules apply to plants and animals produced by a taxpayer in a farming business if (1) the plants or animal has a preproductive period of more than two years, or (2) the taxpayer engaged in the farming business is a corporation, partnership, or tax shelter that is required to use an accrual method of accounting.

Section 6026(b) of the 1988 Act exempts from the application of the uniform capitalization rules expenses incurred by a taxpayer in connection with the production of animals in an eligible farming business. An eligible farming business is a farming business which is not a corporation, partnership, or tax shelter that is required to use an accrual method of accounting under sections 447 or 448(a)(3). This exemption is prospective and applies only to costs incurred after December 31, 1988, in taxable years ending after such date. The exemption does not apply to costs incurred with respect to plants.

In Notice 88-24, the Internal Revenue Service provided an elective simplified method for capitalizing the costs of raising female cattle that are to be used principally for purposes of breeding (''beef cattle'') or for purposes of producing milk to be sold for consumption (''dairy cattle''). Under this method, available only to taxpayers other than those required to use an accrual method of accounting, a total of $340 for each beef cow, or $540 for each dairy cow, is to be capitalized over a period of three years beginning with the year in which the cow is born.

A taxpayer that elected, under section 263A(d)(3), not to apply the uniform capitalization rules to its farming business for a taxable year beginning before January 1, 1989, may, without the consent of the Commissioner, revoke such election for the taxpayer's first taxable year beginning after December 31, 1988. A taxpayer that initially elected not to apply the uniform capitalization rules for any taxable years beginning before January 1, 1989, must continue to apply the alternative depreciation method provided in section 168(g)(2) to property placed in service during such years. With respect to property placed in service in taxable years ending after December 31, 1988, an eligible taxpayer is not required to apply the alternative depreciation method, and may use any other depreciation method permissible with respect to such property, without obtaining the consent of the Commissioner. For costs incurred after December 31, 1988, the determination of whether costs are deductible shall be made under all other applicable provisions of the Code. A taxpayer that elected the safe harbor values provided in Notice 88-24 shall continue to amortize the costs capitalized in taxable years beginning before January 1, 1989, using the taxpayer's depreciation method applicable to such costs.

In the case of a taxpayer that elected the safe harbor method provided in Notice 88-24 and whose taxable year begins before December 31, 1988, and ends after January 1, 1989, the taxpayer may account for the costs incurred in such taxable year in one of two ways:

(1) The taxpayer may account for costs incurred using the safe harbor values for the entire taxable year, without regard to whether costs were incurred on, before or after January 1, 1989, or

(2) the taxpayer may account for costs incurred using the safe harbor values for the portion of its taxable year that includes only the number of months before January 1, 1989, and account for costs incurred on or after January 1, 1989, using the taxpayer's method of accounting for costs available under the applicable provisions of the Code other than section 263A. Thus, for example, a dairy farmer having a fiscal year ending on June 30, 1989, would account for costs using the safe harbor values for the first six months of its taxable year: $6/12 \times$ $135 for each cow born during the taxpayer's current taxable year, $6/12 \times$ $270 for each cow born in the taxpayer's taxable year ending June 30, 1988, and $6/12$ $\times$ $135 for each cow born in the taxpayer's taxable year ending, June 30, 1987. Section 263A (or the safe-harbor values) would not apply to costs incurred after December 31, 1988.

III. CLARIFICATION OF ISSUES.

(A) *Extension of Filing Dates for Amended Returns under Notice 88-78, Notice 88-86, Notice 88-99, and Notice 89-67.*

In order to minimize the administrative complexities that may be involved in complying with the additional guidance issued under section 263A of the Code, the dates by which an amended return filed for the purpose of changing a method of accounting in accordance with the provisions of Notice 88-78, Notice 88-86, Notice 88-99, or this notice, Notice 89-67 shall be extended, and the same date shall apply with respect to all notices. The date by which amended Federal income tax returns, for purposes of Notice 88-78, Notice 88-86, Notice 88-99, or this notice, Notice 89-67 must be filed is the later of (i) the due date (determined with regard to extensions) of the taxpayer's income tax return for the second taxable year that begins (or is deemed to begin) after December 31, 1986, or (ii) October 16, 1989. All terms and conditions (other than the date by which an amended return must be filed) contained in each of the above notices remain in effect with respect to each particular change in method of accounting provided in the applicable notice. Except as specifically provided to the contrary, any change in method of accounting with respect to a taxpayer's inventory for the year of change (generally, its first taxable year beginning after December 31, 1986), made in accordance with the provisions of the temporary regulations or notices issued under section 263A, is to be included in the taxpayer's calculation of the adjustment under section 481(a) pursuant to the automatic change in method of accounting to comply with section 263A provided in section 1.263A-1T(e) of the temporary regulations. Any amount that is required or permitted, for purposes of section 263A, to be included in the taxpayer's calculation of the adjustment under section 481(a) shall be taken into account in accordance with the provisions of section 1.263A-1T(e). However, if the taxpayer is under examination and receives written notification from the examiner that the method to be changed is an issue under consideration, and such notice is given prior to the taxpayer's timely filing of the Federal income tax return (including an amended return) for the year of change, the provisions of section 1.263A-1T(e) may not apply. Other administrative provisions such as Rev. Proc. 84-74, 1984-2 C.B. 736, or Notice 88-78 may instead be applicable.

(B) *Taxpayers subject to the Coordinated Examination Program.*

A taxpayer that is subject to the Coordinated Examination Program (CEP), for its first taxable year for which section 263A applies, and that has filed a Federal income tax return for such year will not be required to file an amended return, which, but for this paragraph (B), would be required in order to effect a change in method of accounting for purposes of Notice 88-78, Notice 88-86, Notice 88-99, Notice 88-104, or this notice, Notice 89-67, if the following conditions are met:

(i) The first taxable year for which section 263A applies shall be treated as the year of change for all purposes. Thus, in the case of inventory property, the adjustment under section 481(a) shall be redetermined as if the method of accounting adopted pursuant to one of the designated notices has been used by the taxpayer for all prior periods.

(ii) The taxpayer types or legibly prints on its timely filed (including extensions) Federal income tax return for the first taxable year after the year of change, a statement indicating that the taxpayer applied the procedures of Rev. Proc. 85-26, 1985-1 C.B. 580, (or any successor rulings or procedures), to effectuate the change in method of accounting for the preceding year (the year of change).

(iii) In its timely filed (including extensions) Federal income tax return for the first taxable year after the year of change (and any subsequent year for which the method is in effect), the taxpayer reports all items in accordance with the method of accounting adopted pursuant to one of the designated notices as if the method had been used by the taxpayer for the year of change and any subsequent year, including a redetermination of the portion of the adjustment under section 481(a) (where applicable) to be taken into account for each subsequent taxable year.

(iv) The taxpayer satisfies all requirements of Rev. Proc. 85-26 and any other administrative rules applicable to a taxpayer subject to the CEP.

(C) *Capitalization of period costs.*

Under section IV(E) of Notice 88-86, taxpayers are permitted to capitalize costs that otherwise would be treated as period costs, if such practice does not result in a material distortion of income; such costs are included in computing beginning inventory, ending inventory, and cost of goods sold; and the taxpayer consistently capitalizes such costs, treating the practice as a method of accounting under the Code. A cost may not be capitalized under section 263A with respect to production or resale property if no portion of such cost relates to the taxpayer's production or resale activity, or if the capitalization (or deduction) of such cost is prohibited by any other section of the Code. For example, because selling expenses, losses, or other items are not ordinarily used in computing the cost of goods sold, such costs may not be included in inventoriable costs for purposes of section 1.61-3(a) of the regulations, and, accordingly, such costs may not be capitalized with respect to property for purposes of section 263A of the Code. (For an exception to this rule, see Notice 88-99, relating to the capitalization of certain costs for purposes of the substitute cost method.)

A taxpayer may capitalize certain period costs if such capitalization does not result in a material distortion. For this purpose, a period cost may not be capitalized under section 263A of the Code if such capitalization results in a material distortion of a computation under any provision of the Code, including material distortions relating to the source, character, amount, or timing of the cost capitalized. Thus, for example, a taxpayer may not capitalize a period cost under section 263A of the Code if the capitalization would result in a material change in the computation of the foreign tax credit limitation under section 904 of the Code. In addition, the capitalization of interest that is not allocable to production activities under the avoided cost method of section 263A(f) generally results in a material distortion of income.

(D) *Expedited Procedures under Section VI of Notice 88-86.*

A number of comments have been received by the Service with respect to the availability of the expedited procedures contained in section VI (Expedited Changes in Methods of Accounting), of Notice 88-86. In Notice 88-86, the expedited procedures for effecting a change in method of accounting are available only with respect to certain provisions specified in the notice. (It should be noted that Notice 88-86 does not apply to any change for which the taxpayer applies, or is required to apply, the provisions of Notice 88-78.) Paragraph (1) of Section VI of Notice 88-86 contains details regarding expedited procedures applicable to a change in method of accounting beginning with the first taxable year in which section 263A is effective and requires an adjustment to the amount calculated under section 481(a) for such year. Expedited changes made according to paragraph (2) are available for the taxable year following the year of change, on a cut-off basis, without restating beginning balances for such year and without any corresponding section 481(a) adjustment. It has been suggested that these expedited procedures be made available to additional provisions contained in Notice 88-86. In response to these comments, Notice 88-86 is modified as follows—

(i) Only paragraph (1) of section VI of Notice 88-86 (and not paragraph (2)) is available with respect to the changes to the methods of accounting described in the following sections of Notice 88-86:

III(D) *Services Versus Property Acquired for Resale*, but only to the extent that the rules discussed in the third and fourth paragraphs of Section III(D) would require the capitalization of costs with respect to the types of property described therein.

III(E) *Capitalization of Handling Costs*, but only to the extent of any change in method required as a result of the application of the rule relating to costs required to be capitalized at any facility, as discussed in the third paragraph of Section III(E).

III(F) *Distribution Costs.*

III(G) *$10 Million Gross Receipts Exception for Certain Taxpayers*, but only to the extent of any change in method required as a result of a determination that, due to the application of the rules discussed in Section III(G), the taxpayer is not entitled to the exception from the general rules of section 263A provided in section 263A(b)(2)(B).

IV(A) *Deferred Intercompany Transactions.*

IV(C) *Intangible and Tangible Property*, but only to the extent that the taxpayer failed to apply the rules of section 263A with respect to intangible personal property acquired for resale.

IV(H) *Depletion.*

IV(I) *Prepublication Expenditures*, but only to the extent that the taxpayer failed to capitalize payments made to authors other than payments that relate to sales of books that have already taken place.

IV(J) *Dual Function Facilities.*

IV(K) *Materials and Supplies.*

IV(M) *Storage Costs.*

IV(N) *Lower of Cost or Market.*

(ii) In addition to the provisions for which the expedited procedures were initially available, both paragraphs (1) and (2) of section VI of Notice 88-86 shall be available with respect to the changes to the methods of accounting described in the following sections of Notice 88-86:

II(C) *Manufacturers and On-Site Storage.*

III(B) *Property Produced Under Contract for Subsequent Resale.*

III(C) *De Minimis Production Activities.*

III(D) *Services Versus Property Acquired for Resale*, but only to the extent of any change in method permitted as a result of the de minimis rule provided in the second paragraph of Section III(D).

III(E) *Capitalization of Handling Costs*, but only to the extent of any change in method permitted as a result of the application of the rules relating to certain on-site labor costs described in the second paragraph of Section III(E).

III(G) *$10 Million Gross Receipts Exception for Certain Taxpayers*, but only to the extent of any change in method of accounting resulting from a determination that, due to the application of the rules described in section III(G), the taxpayer is entitled to the exception from the general rules of section 263A provided in section 263A(b)(2)(B).

IV(C) *Intangible and Tangible Properties*, but only to the extent that a taxpayer applied the rules of section 263A to the production of personal property that pursuant to section IV(C) is not tangible personal property for purposes of section 263A.

IV(D) *Service Departments — Accounts Receivable.*

IV(G) *Warranty Costs and Products Liability Insurance.*

IV(I) *Prepublication Expenditures*, but only to the extent that, for purposes of section 263A, the taxpayer capitalized payments made to authors that relate to sales of books that have already taken place.

IV(L) *Allocation Methods and De Minimis Rule.*

V(A) *Farmers and Constructive Ownership Rules.*

(E) *Application of section 263A to Foreign Persons.*

A simplified method of accounting for the additional costs required to be capitalized by foreign persons for purposes of the uniform capitalization rules of section 263A of the Code (the "U.S. ratio method") was provided in Notice 88-104. Under the U.S. ratio method, the additional costs (other than interest) required to be capitalized by the foreign person under section 263A are to be allocated to property produced or property acquired for resale by a foreign person by applying the "U.S ratio" of the "applicable U.S. trade or business" to the cost (as determined by the foreign person before the application of the rules of section 263A) of the property produced or property acquired for resale. Under the U.S. ratio method, no adjustment to the U.S. ratio of the applicable U.S. trade or business or to the costs (as determined before the application of the rules of section 263A) of property produced or property acquired for resale by the foreign person, is permitted.

Notice 88-104 limited the election of the U.S. ratio method to taxable years beginning before January 1, 1988. The provisions of Notice 88-104 are extended to taxable years beginning after December 31, 1987, and will remain in effect until further guidance under section 263A is issued. A taxpayer that did not elect the U.S. ratio method for its first taxable year for which section 263A is effective may elect to apply the U.S. ratio method: (i) on its Federal income tax return adopting the use of the U.S. ratio method (including any necessary revisions of adjustments under section 481(a)) for its first taxable year for which section 263A is effective, including a Federal income tax return amended for the purpose of electing the U.S. ratio method, or (ii) on its Federal income tax return for its second taxable year for which section 263A is effective, if and only if the previous method used by the taxpayer for the prior taxable year was a correct method of accounting under section 263A and the regulations thereunder.

It is anticipated that forthcoming regulations will permit a taxpayer to elect the U.S. ratio method as provided therein regardless of whether the U.S. ratio method was elected for previous taxable years. In addition, it is anticipated that a taxpayer that elected the U.S. ratio method prior to the publication of the regulations will be permitted to elect to discontinue use of the U.S. ratio method under rules provided in the regulations.

PROCEDURAL INFORMATION

This notice serves as an "administrative pronouncement" as that term is described in section 1.6661-3(b)(2) of the regulations and may be relied upon to the same extent as a revenue ruling or a revenue procedure.

Notice to Terminate and Amend Model Cash or Deferred Arrangements

Notice 89-68

Purpose

The purpose of this Notice is to provide a cut-off date of October 31, 1989, for adoption by sponsoring organizations of the model cash or deferred arrangement (CODA) set forth in Notice 87-34, 1987-1 C.B. 490, and to provide additional options to sponsoring organizations who have already adopted, or will adopt, such model amendment.

Background

Revenue Procedure 87-18, 1987-1 C.B. 709, sets forth procedures to enable a sponsoring organization to obtain an opinion letter for a master or prototype profit-sharing plan which includes a cash or deferred arrangement as described in section 401(k) of the Code. The Revenue Procedure includes a special expedited procedure for sponsoring organizations which adopt the model CODA amendment set forth in Notice 87-34.

Notice 87-34 provides a model CODA to be attached as an amendment to an existing master or prototype profit-sharing plan. Notice 87-51, 1987-2 C.B. 359, amended Notice 87-34 to allow sponsoring organizations more flexibility in the options they can offer adopting employers. Both Notices provide model language that could only be used on a word-for-word basis.

Model Amendments I and II provided by Notice 87-51 address hardship distributions. Model Amendment I is designed to be used when distributions on account of financial hardship are a desired feature of the plan, but the hardship provisions in the underlying plan do not meet the requirements of the regulations under section 401(k) of the Code. Model Amendment II is designed to permit hardship distributions when the underlying plan has no hardship provisions. Model Amendment III of Notice 87-51 permits adopters to satisfy the actual deferral percentage (ADP) nondiscrimination test of section 401(k)(3) of the Code by using qualified matching contributions.

Revenue Procedure 89-9, page 780, this Bulletin, provides for the opening of the master and prototype program with respect to the changes made by the Tax Reform Act of 1986 (TRA 86) and other provisions of law effective at the same time as the TRA 86 changes. In order to have continued reliance for its adopting employers, a sponsoring organization with a favorable TEFRA opinion letter (as defined in section 3 of such Revenue Procedure) must submit its replacement plan no later than October 31, 1989.

Adoption of Model

The model CODA was intended to provide sponsoring organizations with a simple and expeditious means of offering CODAs to their adopting employers. However, in light of the issuance of regulations under sections 401(k) and (m) of the Code and because sponsoring organizations must revise their underlying plans to reflect the changes made by TRA 86, the Service has decided to discontinue the model CODA program.

Accordingly, plans submitted pursuant to Rev. Proc. 89-9 will no longer be given any special priority or reliance because the plan includes language identical to the model CODA. Sponsoring organizations may, however, continue to use the language of the model as the basis for plan language. However, sponsors should be aware that the model language is not up-to-date with respect to all the requirements of the regulations that are effective beginning in 1989.

Sponsoring organizations may continue to apply for opinion letters with respect to the model CODA until they receive an opinion letter on a replacement plan submitted pursuant to Rev. Proc. 89-9; however in no case will any application for an opinion letter on the model CODA be accepted after October 31, 1989. Sponsoring organizations with opinion letters on the model CODA may continue to market such CODA until the Service acts on an opinion-letter request for a replacement plan, provided such replacement plan is submitted prior to November 1, 1989.

Further Model CODA Amendments

The model CODA amendments of Notices 87-34 and 87-51 were issued prior to the final and proposed regulations under sections 401(k) and (m) of the Code. Consequently, they allowed limited flexibility to adopting employers in certain cases. For the limited time the model is still available, some sponsoring organizations have indicated a desire to include additional options permitted by the regulations. The remainder of this Notice provides such options. In addition, the model CODA did not adequately deal with "gap period" income or loss on distributions of excess amounts. Part D of this Notice includes language to accomplish this. However, employers should note that even if Part D is not adopted by a sponsoring organization or an employer, gap period income or loss must be included when excess amounts are distributed.

The amendments provided by this Notice are divided into four parts: Part A provides language for hardship distributions pursuant to Code Section 401(k)(2); Part B provides language to permit recharacterization; Part C provides language permitting the use of elective deferrals in the ACP test; and Part D provides language for calculating income or loss on excess amounts.

Sponsoring organizations which have already adopted the model CODA may add any or all parts of this Notice, together with Model Amendment III of Notice 87-51, if desired, on a word-for-word basis and may continue to rely on an opinion letter obtained for the model CODA without further application to the Service. Similarly, sponsoring organizations wishing to adopt the model CODA for the first time may, if desired, include any or all parts of this Notice. Sponsoring organizations wishing to provide for hardship distributions may adopt the deeming rules for hardship specified in the regulations. Language to accomplish this is provided in Part A. The adoption of Part A of this Notice by a sponsoring organization which has previously adopted Model Amendment I or II of Notice 87-51 (and the elimination of the availability of such "facts-and-circumstances" hardship distribution by an adopting employer) will not violate section 411(d)(6) of the Code if the change is made effective as of the date the adopting employer first begins operating in accordance with Part A.

Employers wishing to take advantage of any of these amendments offered by the sponsoring organization must properly execute an addendum (to the previously-adopted model CODA) which incorporates by reference the plan as amended. Alternatively, the amendment to the plan may be consolidated in the model CODA and its adoption agreement and adopted by the employer in conformity with state law. Except for certain adopters of Part A, as described above, the amendment is effective for the plan year in which adopted by the employer but no earlier than the effective date of such employer's model CODA. Notice of the amendment must be provided by the employer to interested parties in accordance with sections 7 and 8 of Rev. Proc. 80-30, 1980-1 C.B. 685 (whether the plan is standardized or non-standardized), but the employer need not apply to the appropriate key district office on account of amendments contained in this Notice or in Notices 87-34 and 87-51 in order to maintain reliance on an otherwise-valid determination or opinion letter. However, a summary of material modifications may have to be filed with the Department of Labor and distributed to participants and beneficiaries pursuant to section 102 of the Employee Retirement Income Security Act of 1974 (ERISA), Pub. L. 93-406.

Part A

The provisions contained in this part are designed to permit an adopting employer to allow distributions to participants on account of financial hardship. Sponsoring organizations which previously adopted Model Amendment I or II of Notice 87-51 may delete adoption agreement section 7.2 from their existing model CODA and substitute or add, as appropriate, section 5.2 and adoption agreement section 7.1.e as contained in this part.

[Note: This section, by addition or substitution, becomes section 5.2 of the model CODA]

5.2. Distribution on Account of Financial Hardship

5.2(a). If elected by the Employer in section 7.1.e of the CODA adoption agreement, distributions of Elective Deferrals (plus earnings, if any, credited thereon as of December 31, 1988) may be made on account of financial hardship if the distribution is necessary in light of the immediate and heavy financial need of the Participant as described in (b), below. Such distribution shall not exceed the amount required to meet the immediate financial need created by the hardship and may not be made to the extent that distributions (other than hardship distributions) and non-taxable loans are still available under this and all other plans maintained by the Employer. Hardship distributions in plan years beginning before January 1, 1989 may include, in addition to Elective Deferrals, earnings, if any, on Elective Deferrals and Qualified Non-elective Contributions and earnings, if any, thereon.

5.2(b). A distribution is made on account of an immediate and heavy financial need of a Participant if and only if it is made on account of: medical expenses of the Participant or the Participant's spouse or dependents; the purchase (excluding mortgage payments) of a principal residence for the Participant; payment of tuition for the next term of post-secondary education for the Participant or the Participant's spouse, children or dependents; or the need to prevent the Participant's eviction from, or foreclosure on the mortgage of, the Participant's principal residence.

5.2(c). In addition, the Participant may not make any Elective Deferrals or Employee Contributions for twelve (12) months following receipt of the hardship distribution and may not make Elective Deferrals for the Participant's taxable year immediately following the taxable year of the distribution in excess of the applicable limit under section 402(g) of the Code for such year less the amount of Elective Deferrals made in the year of the distribution.

5.2(d). Unless circumstances indicate that it is unreasonable to do so, the Employer may rely on an employee's written certification of the existence of a need described in (b), above, and of the amount necessary to alleviate such need. Processing of applications and distributions of amounts under this section, on account of a bona fide financial hardship, must be made as soon as administratively feasible.

[Note: This section replaces section 7.1.e of the model CODA adoption agreement]

[ ] e. Upon the hardship of the Participant, to the extent provided for in section 5.2 of the CODA.

Part B

This part amends the model CODA by adding section 3.12 to permit adopting employers the option of having Excess Contributions recharacterized as after-tax Employee Contributions. This part can be adopted only if the underlying plan permits Employee Contributions by Participants.

[Note: This section adds section 3.12 to the model CODA]

3.12. For purposes of section 3.6 of the CODA amendment, the Employer may treat Excess Contributions as amounts distributed to Participants and recontributed to the plan as Employee Contributions. Amounts so recharacterized remain fully-vested and subject to the same restrictions on distribution as Elective Deferrals. In addition, such amounts are to be treated as Employee Contributions for purposes of section III of the CODA amendment and sections 72 and 6047 of the Code, but for all other purposes under the Code, they shall continue to be treated as Elective Deferrals.

Amounts may not be recharacterized to the extent such amounts would cause the plan's stated limit, if any, on Employee Contributions to be exceeded for any Highly Compensated Employee. Recharacterization must occur no later than two and one-half months after the end of the Plan Year with respect to which such Excess Contributions were made and is deemed to occur on the date the last Highly Compensated Employee is informed in writing of the amount recharacterized and the consequences thereof.

Recharacterized amounts will be taxable to the Participant for such Participant's taxable year containing the earliest dates in the Plan Year on which the Participant would have received these amounts had he or she originally elected to receive them in cash.

Part C

This part amends section 7.2 of the model CODA to allow a plan to use Elective Deferrals in the ACP test. Sponsors wishing to use this Part should add the following language as section 7.2(b)(1), or, if Model Amendment III was previously adopted, as section 7.2(b)(2).

[Note: This section adds section 7.2(b)(1) or (2), as appropriate, to the model CODA]

7.2(b)(1)[or(2)]. The Employer may treat all or part of the Elective Deferrals for the Plan Year as Matching Contributions for purposes of calculating the Contribution Percentage, provided the Average Actual Deferral Percentage test of section 3.6 is satisfied both including and excluding Elective Deferrals that are treated as Matching Contributions for purposes of the Average Contribution Percentage test of section 7.1.

Part D

This part provides replacement language for sections 3.5(a)(2), 3.8(b) (originally published as "3.8(a)" due to a typographical error) and 7.4(b) of the model CODA, relating to the determination of the income or loss which must accompany excess amounts distributed from the plan.

[Note: This section replaces 3.5(a)(2) of the model CODA]

3.5(a)(2). Determination of Income or Loss. Excess Elective Deferrals shall be adjusted for any income or loss up to the date of distribution. The income or loss allocable to Excess Elective Deferrals is the sum of:

(i) income or loss allocable to the Participant's Elective Deferral account for the Participant's taxable year for which the Excess Elective Deferrals occurred multiplied by a fraction, the numerator of which is the Participant's Excess Elective Deferrals for such taxable year and the denominator of which is the Participant's account balance attributable to Elective Deferrals as of the end of the taxable year without regard to any income or loss occurring during such taxable year; and

(ii) income or loss allocable to the Participant's Elective Deferral account for the period between the end of such taxable year and the date of distribution multiplied by the fraction determined under (i), above; or, at the option of the employer, ten (10) percent of the amount determined under (i) multiplied by the number of whole calendar months between the end of such taxable year and the date of distribution, counting the month of distribution if distribution occurs after the 15th of such month.

The amount of Excess Elective Deferrals that may be distributed with respect to a Participant shall be reduced by any Excess Contributions previously distributed or recharacterized with respect to such Participant for the Plan Year beginning with or within such taxable year. In no event may the amount distributed exceed the Participant's total Elective Deferrals for such taxable year.

[Note: This section replaces 3.8(b) [(a)] of the model CODA]

3.8(b). Determination of Income or Loss. Excess Contributions shall be adjusted for income or loss up to the date of distribution. The income or loss allocable to Excess Contributions is the sum of:

(1) income or loss allocable to the Participant's Elective Deferral account and Qualified Non-elective Contributions account for the Plan Year for which the Excess Contributions occurred multiplied by a fraction, the numerator of which is the Participant's Excess Contributions for such Plan Year and the denominator of which is the Participant's account balances attributable to Elective Deferrals and Qualified Non-elective Contributions as of the end of the Plan Year without regard to any income or loss occurring during such Plan Year; and

(2) income or loss allocable to the Participant's Elective Deferral account and Qualified Non-elective Contributions account for the period between the end of such Plan Year and the date of distribution multiplied by the fraction determined under (1), above; or, at the option of the employer, ten (10) percent of the amount determined under (1) multiplied by the number of whole calendar months between the end of such Plan Year and the date of distribution, counting the month of distribution if distribution occurs after the 15th of such month.

[Note: This section replaces 7.4(b) of the model CODA]

7.4(b). Determination of Income or Loss. Excess Aggregate Contributions shall be adjusted for income or loss up to the date of distribution. The income or loss allocable to Excess Aggregate Contributions is the sum of:

(1) income or loss allocable to the Participant's Employee Contribution account and Matching Contribution account for the Plan Year for which the Excess Aggregate Contributions occurred multiplied by a fraction, the numerator of which is the Participant's Excess Aggregate Contributions for such Plan Year and the denominator of which is the Participant's account balances attributable to Employee Contributions and Matching Contributions as of the end of the Plan Year without regard to any income or loss occurring during such Plan Year; and

(2) income or loss allocable to the Participant's Employee Contribution account and Matching Contribution account for the period between the end of such Plan Year and the date of distribution multiplied by the fraction determined under (1), above; or, at the option of the employer, ten (10) percent of the amount determined under (1) multiplied by the number of whole calendar months between the end of such Plan Year and the date of distribution, counting the month of distribution if distribution occurs after the 15th of such month.

Effect on Other Documents

Notices 87-34 and 87-51 are modified to the extent described above and Rev. Proc. 87-18 is modified to the extent it prohibits recharacterization in a standardized plan. Further, Notices 87-34 and 87-51 are obsoleted with respect to applications for opinion letters submitted after October 31, 1989.

Administrative Pronouncement

This Notice is an ''administrative pronouncement'' as that term is used in section 1.6661-3(b)(2) of the Income Tax Regulations and may be relied on to the same extent as a revenue ruling or revenue procedure.

List of Countries Requiring Cooperation With an International Boycott

Notice 89-69

In order to comply with the mandate of section 999(a)(3) of the Internal Revenue Code of 1954, the Department of the Treasury is publishing a current list of countries which may require participation in, or cooperation with, an international boycott [within the meaning of section 999(b)(3) of the Internal Revenue Code of 1954]. The list is the same as the prior quarterly list published in the Federal Register.

On the basis of the best information currently available to the Department of the Treasury, the following countries may require participation in, or cooperation with, an international boycott [within the meaning of section 999(b)(3) of the Internal Revenue Code of 1954]:

Bahrain
Iraq
Jordan
Kuwait
Lebanon
Libya
Oman
Qatar
Saudi Arabia
Syria
United Arab Emirates
Yeman, Arab Republic
Yeman, Peoples Democratic Republic of

Date: March 20, 1989.

Dennis E. Ross,
Acting Assistant Secretary for Tax Policy.

(Filed by the Office of the Federal Register on March 23, 1989; 8:45 a.m., and published in the issue of the Federal Register for March 24, 1989, 54 F.R. 12308)

Additional Integration Rules

Notice 89-70

The Tax Reform Act of 1986 (TRA '86) amended section 401(l) of the Internal Revenue Code to provide rules dealing with permitted disparity in contributions or benefits under qualified plans. Proposed regulations were issued under section 401(l) in the Federal Register on November 15, 1988 (53 Fed. Reg. 45917). This notice supplements the proposed regulations by providing additional guidance concerning certain aspects of permitted disparity under section 401(l) of the Code. Specifically, this notice provides (1) a modification of the definition of covered compensation stated in the proposed regulations, (2) additional alternatives for the choice of integration levels in both defined contribution excess plans and defined benefit excess plans, (3) additional alternatives for the choice of an offset in a defined benefit offset plan, (4) guidance concerning reliance on determination letters issued with respect to defined benefit plans that use an integration level other than covered compensation, an offset based on an amount other than covered compensation, or a uniform factor in determining the portion of a participant's benefits attributable to employee contributions, (5) additional methods by which certain types of career average plans may meet the permitted disparity requirements, and (6) additional guidance on adjustments for the payment of retirement benefits before social security retirement age.

I. *Definition of Covered Compensation*

Covered compensation is defined in section 1.401(l)-1(b)(9) of the regulations as the average (without indexing) of the taxable wage bases for the 35 calendar years ending with the year prior to the calendar year an individual attains social security retirement age (as defined in section 415(b)(8) of the Code). The final regulations will modify the definition of covered compensation to be the average of the taxable wage bases for the 35 calendar years ending with the year an individual attains 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 individual's covered compensation for any particular plan year, it is assumed that the taxable wage base in effect at the beginning of the plan year will remain the same for all future years. Presented in Attachment I is the covered compensation table for plan years beginning in 1989 (the 1989 Covered Compensation Table).

In lieu of using the definition of covered compensation specified above, plans may use the definition of covered compensation as stated in the proposed regulations for plan years beginning prior to 1995. Thus, for plan years beginning in 1989 through 1994 plans may use the covered compensation table for each such year based upon the definition of covered compensation in the proposed regulations. Alternatively, pursuant to Alternative 2 of section III.B. below, the covered compensation table for 1989 based upon the definition of covered compensation in the proposed regulations may be used for plan years beginning in 1989 through 1994. Attachment II is the covered compensation table for plan years beginning in 1989 based upon the definition of covered compensation in the proposed regulations.

II. *Integration Level — Defined Contribution Excess Plans*

A. The permitted disparity requirements applicable to defined contribution plans are specified in section 1.401(l)-2 of the regulations. One of the requirements of such section is that, for any participant, the excess contribution percentage may not exceed the base contribution percentage by more than the maximum excess allowance. The maximum excess allowance is defined as the lesser of:

(i) the base contribution percentage, or

(ii) the greater of

(A) 5.7%, or

(B) the percentage rate of tax under section 3111(a) of the Code (in effect as of the beginning of the plan year) which is attributable to the old age insurance portion of the Old Age, Survivors and Disability Insurance provisions of the Social Security Act.

The base contribution percentage with respect to a defined contribution excess plan is defined in the regulations as the percentage of compensation at which employer contributions (and forfeitures) are allocated to the accounts of participants with respect to compensation of participants at or below the integration level specified in the plan. The excess contribution percentage with respect to a defined contribution excess plan is the percentage of compensation at which employer contributions (and forfeitures) are allocated to accounts of participants with respect to compensation of participants above the integration level specified in the plan. Section 1.401(l)-2(b)(4) of the regulations specifies that, in order to meet the permitted disparity requirements for defined contribution plans, the integration level of a plan must equal the taxable wage base in effect as of the beginning of the plan year. (See section 1.401(l)-1(b)(5) for the definitions of integration level and taxable wage base).

B. Pursuant to this notice, the following two alternative approaches for determining integration levels may be used in lieu of the taxable wage base:

(1) Provided all other permitted disparity requirements are met, an acceptable integration level is a uniform dollar amount for all participants no greater than the greater of $10,000 or 1/5 of the taxable wage base in effect as of the beginning of the plan year.

(2) Provided all other permitted disparity requirements are met, any uniform dollar amount greater than the amount in (1), above, that is less than the taxable wage base (TWB) in effect as of the beginning of the plan year is an acceptable integration level provided the limitation on the maximum excess allowance stated in section 1.401(l)-2(b)(5)(ii)(A) of the regulations (and II.A.(ii)(A) of this notice) of 5.7% is reduced in accordance with the table set forth below. A proportionate reduction is made in the limitation of section 1.401(l)-(b)(5)(ii)-(B) (and II.A.(ii)(B) of this notice) relating to the old age portion of the OASDI tax.

If the integration level		the 5.7 percent factor in the maximum excess allowance is reduced to
Is more than	But not more than	
X*	80% of TWB***	4.3%
80% " "	Y**	5.4%

* X = the greater of $10,000 or 20% of the TWB.

** Y = any amount more than 80% of the TWB but less than 100% of the TWB.

*** The 1989 taxable wage base is $48,000

Example. Employer X maintains a profit-sharing plan that has a plan year beginning July 1 of each year. For the plan year beginning July 1, 1989, the plan uses an integration level for all participants of $30,000, which is 62.5% of the taxable wage base of $48,000 for the 1989 calender year. Consequently, in applying the permitted disparity requirements, the 5.7% factor must be replaced by 4.3%.

III. *Integration Level — Defined Benefit Excess Plans*

A. The permitted disparity requirements applicable to defined benefit excess plans are stated in section 1.401(l)-3(b) of the regulations. One of the requirements of such section is that the excess benefit percentage may not exceed the base benefit percentage by more than the maximum excess allowance. The maximum excess allowance is defined as:

(A) With respect to employer-derived benefits provided under the plan for any year of credited service, the lesser of 3/4 of 1%, or the base benefit percentage for the plan year, and

(B) With respect to total employer-derived benefits provided under the plan for all years of credited service, the lesser of the 3/4 of 1% limitation determined under (A) multiplied by the participant's total years of credited service (not in excess of 35) or the base benefit percentage with respect to the total employer-derived benefit.

The base benefit percentage with respect to a defined benefit excess plan is the percentage of compensation at which employer-derived benefits are accrued with respect to compensation of participants at or below the integration level specified in the plan for the plan year. The excess benefit percentage with respect to a defined benefit excess plan is the percentage of compensation at which employer-derived benefits are accrued with respect to compensation of participants above the integration level specified in the plan.

The 3/4 of 1% limitation applies to benefits commencing at a participant's social security retirement age (as defined in section 415(b)(8) of the Code). If benefits commence prior to social security retirement age, the ¾ of 1% factor is reduced depending on the age at which benefits commence and the participant's social security retirement age. The appropriate reductions are specified in section 1.401(l)-3(e) of the regulations, relating to early benefit commencement.

In addition, the ¾ of 1% factor is applicable if the integration level for each participant is such participant's covered compensation.

Certain alternative integration levels are permitted under section 1.401(l)-3(b)(4) of the regulations. In order to use some of the alternative integration levels, it is necessary that the plan satisfy the demographic tests stated in sections 1.401(l)-3(b)(4)(iii)(B) and (C) of the regulations. However, the use of an integration level for any participant other than such participant's covered compensation may result in an adjustment to the ¾ of 1% factor. Rules for determining the adjustment are stated in section 1.401(l)-3(d)(1) of the regulations. Adjustments required under paragraphs (d)(1) and (e) of section 1.401(l)-3 are cumulative. (The safe harbor integration level for a plan year of a uniform dollar amount not exceeding the greater of $10,000 or one-half of the covered compensation of an individual attaining social security retirement age in the plan year does not require the use of the demographic tests and is not affected by this notice.)

B. Pursuant to this notice, the following additional alternatives for determining an integration level are acceptable provided all other permitted disparity requirements are met:

Alternative 1

Any uniform dollar amount that is greater than the safe harbor integration level of the greater of $10,000 or one-half of the covered compensation of an individual attaining social security retirement age in the plan year and that does not exceed the taxable wage base in effect as of the beginning of the plan year is an acceptable integration level, provided the limitation on the maximum excess allowance of ¾ of 1% is reduced to the lesser of (a) the adjusted amount determined in accordance with section 1.401(l)-3(d)(1) of the regulations, or (b) 80% of the otherwise applicable limitation determined without regard to section 1.401(l)-3(d)(1). The reduced limitation so determined is used in place of the ¾ of 1% limitation for all purposes in determining whether the permitted disparity rules for defined benefit excess plans are met. (Of course, any reduction to the ¾ of 1% factor required under section 1.401(l)-3(e) must also be made.)

Example. Employer X maintains a noncontributory defined benefit excess plan. The plan has a normal retirement age of 65. The plan uses the calendar year as its plan year. For the 1989 plan year, the plan uses an integration level of $20,000, which is 117.87% of the 1989 covered compensation of $16,968 for an individual reaching social security retirement age in 1989 (see Attachment I). Pursuant to this notice, such an integration level is acceptable without meeting the demographic tests specified in the regulations, provided the adjustment required under this alternative to the ¾ of 1% factor is made. Because the integration level exceeds the covered compensation of an individual reaching social security retirement age in the plan year but is not more than 125% of such covered compensation, the ¾ of 1% factor is replaced by .69% pursuant to section 1.401(l)-3(d)(1) of the regulations, relating to adjustments to the ¾ of 1% factor when the integration level is something other than the covered compensation of each participant. The .69% factor is 92% of the ¾ of 1% factor. Because the lesser of 80% and 92% is 80%, the ¾ of 1% factor is reduced to .6 of 1% (80% of ¾ of 1%) under this alternative. Such factor applies to benefits commencing at age 65 for a participant with a social security retirement age of 65. In determining projected benefits for participants with social security retirement ages of 66 or 67, the applicable factors for benefits commencing at age 65 are, respectively, .56 of 1% (80% of .7 of 1%) and .52 of 1% (80% of .65 of 1%).

Of course, an integration level of a uniform dollar amount may be used without the reduction in the ¾ of 1% factor required under this alternative provided the demographic tests of both sections 1.401(l)-3(b)(4)(iii)(B) and (C) are met.

Alternative 2 (Frozen Covered Compensation Table)

An amount for a participant equal to a participant's covered compensation for a plan year prior to the current plan year is an acceptable integration level for the participant, provided the plan year used is the same for all participants and is not earlier than the later of (1) the plan year 5 years prior to the current plan year, and (2) the plan year beginning in 1989. This alternative may be used without satisfying the demographic tests of section 1.401(l)-3(b)(4)(iii)(B) and (C) of the regulations. In addition, no adjustment to the ¾ of 1% factor is required under either section 1.401(l)-3(d)(1) of the regulations or this notice. However, pursuant to section 1.401(l)-1(c) of the regulations, any change in the integration level is subject to sections 411(d)(6) and 411(b)(1)(G) of the Code regarding impermissible reductions in accrued benefits. (Plans must include language that would prevent violations of sections 411(d)(6) or 411(b)(1)(G) resulting from changes in integration levels.)

Example. Employer X maintains a noncontributory defined benefit excess plan. The plan has a calendar plan year. For the 1989 plan year, the plan provides that the integration level for any participant is the covered compensation of the participant determined using the 1989 covered compensation table. The plan may continue to use the 1989 covered compensation table (provided the terms of the plan so specify) for each subsequent plan year through the 1994 plan year, without any adjustment to the ¾ of 1% factor for the use of an integration level other than current covered compensation and without meeting the demographic tests of the regulations. (Of course, the adjustments of section 1.401(l)-3(e) relating to benefits commencing prior to the social security retirement age must continue to be made.) To meet the requirements of section 401(l) of the Code (and this Alternative) the integration level would have to be changed for the 1995 plan year. Such a change in the integration level in the 1995 plan year is subject to sections 411(d)(6) and 411(b)(1)(G) of the Code regarding reductions in accrued benefits pursuant to 1.401-(l)-1(c) of the regulations.

IV. *Defined Benefit Offset Plans*

A. The permitted disparity requirements applicable to defined benefit offset plans are stated in section 1.401(l)-3(c) of the regulations. A defined benefit offset plan is a defined benefit plan that is not an excess plan and that provides that each participant's employer-derived benefit is reduced or offset by an amount specified (either directly or by formula) in the plan or by a specified percentage of the participant's final average compensation. A participant's final average compensation, as of a plan year, is the average of the participant's annual compensation from the employer for the 3-consecutive-year period ending with or within the plan year. For this purpose, compensation in excess of the taxable wage base for any year may not be considered.

The permitted disparity requirements applicable to defined benefit offset plans are stated in section 1.401(l)-3(c) of the regulations. One of the requirements of such section is that no participant's benefit is reduced by an offset that exceeds the maximum offset allowance.

The maximum offset allowance for any plan year is equal to:

(A) With respect to employer-derived benefits provided under the plan for any year of credited service, the lesser of

(1) ¾ of 1% multiplied by the participant's final average compensation (up to covered compensation), or

(2) one-half of the employer-derived benefit that would be provided,

prior to the application of the offset, with respect to the participant's average annual compensation not in excess of the participant's final average compensation (up to covered compensation), and

(B) With respect to total employer-derived benefits provided under the plan for all years of credited service, the offset determined under (A)(1), above, multiplied by the participant's total years of credited service (not in excess of 35).

The ¾ of 1% factor is applicable to benefits commencing at a participant's social security retirement age (as defined in section 415(b)(8) of the Code). If benefits commence prior to social security retirement age, the ¾ of 1% factor is reduced depending on the age at which benefits commence and the participant's social security retirement age. The appropriate reductions are specified in section 1.401(l)-3(e) of the regulations.

In addition, the ¾ of 1% factor is applicable if the offset for each participant is based on such participant's final average compensation up to covered compensation. Certain alternatives to the use of a participant's covered compensation in determining the offset applicable to a participant are permitted under section 1.401(l)-3(c)(4) of the regulations. In order to use some of the alternatives, it is necessary that the plan satisfy the demographic tests stated in sections 1.401(l)-3(c)(4)(iii)(B) and (C) of the regulations. (The safe harbor offset in the regulations based on final average compensation up to a uniform dollar amount not exceeding the greater of (1) $10,000 or (2) one-half of the covered compensation of an individual attaining social security retirement age in the plan year does not require the use of the demographic tests and is not affected by this notice). However, if the offset to a participant's benefit is based on final average compensation up to an amount other than the participant's covered compensation, an adjustment to the ¾ of 1% factor may need to be made. Rules for determining the adjustment are stated in section 1.401(l)-3(d)(2) of the regulations. Adjustments required under paragraphs (d)(2) and (e) of section 1.401-(l)-3 are cumulative.

B. Pursuant to this notice, provided all other permitted disparity requirements are met, the offset to a participant's benefit may be determined based on a participant's final average compensation up to the amount specified in the following alternatives:

Alternative 1

Any uniform dollar amount that is greater than the safe harbor amount of the greater of $10,000 or one-half of the covered compensation of an individual attaining social security retirement age in the plan year and that does not exceed the taxable wage base in effect as of the beginning of the plan year, provided the ¾ of 1% factor is reduced to the lesser of (a) the adjusted factor determined in accordance with section 1.401(l)-3(d)(2) of the regulations, or (b) 80% of the otherwise applicable limitation determined without regard to section 1.401(l)-3(d)-(2). The reduced limitation is used in place of the ¾ of 1% limitation for all purposes in determining whether the permitted disparity rules are satisfied. In addition, any reduction to the ¾ of 1% factor required under paragraph 1.401-(l)-3(e) must also be made.

Of course, an offset based on final average compensation up to a uniform dollar amount may be used without the reduction of the ¾ of 1% factor required under this alternative provided the tests of both paragraphs 1.401(l)-3(c)(4)(iii)-(B) and (C) are met.

Alternative 2 (Frozen Covered Compensation Table)

An amount for a participant equal to the participant's covered compensation for a plan year prior to the current plan year, provided the plan year used is the same for all participants and is not earlier than the later of (1) the plan year 5 years prior to the current plan year, or (2) the plan year beginning in 1989. This alternative may be used without satisfying the demographic tests of sections 1.401(l)-3(c)(4)(iii)(B) and (C) of the regulations. In addition, no adjustment to the ¾ of 1% factor is required under either section 1.401(l)-3(d)(2) of the regulations or this notice. However, pursuant to section 1.401(l)-1(c) of the regulations, any change in the offset is subject to sections 411(d)(6) and 411(b)(1)(G) of the Code regarding impermissible reductions in accrued benefits. (Plans must include language that would prevent violations of section 411(d)(6) or 411(b)(1)(G) resulting from changes in offsets.)

V. *Reliance Without Annual Demographic Tests*

A. Section 1.401(l)-3(b)(4) of the regulations provides alternatives for specifying an integration level in a defined benefit excess plan. Section 1.401(l)-3(c)(4) provides alternatives for specifying an offset in a defined benefit offset plan. Some of the alternatives require that the plan satisfy certain demographic tests stated in sections 1.401(l)-3(b)(4)-(iii)(B) and (C) of the regulations for excess plans and sections 1.401(l)-3(c)-(4)(iii)(B) and (C) for offset plans.

Section 1.401(l)-3(g) of the regulations states that benefits attributable to employee contributions in a defined benefit excess plan or a defined benefit offset plan are not taken into account in applying the permitted disparity requireapplying the permitted disparity requirements. Two methods were provided for determining the portion of a participant's benefit deemed attributable to employee contributions. The method in section 1.401(l)-3(g)(2) involved the use of a uniform factor. The proper uniform factor for a plan and the ability to use a uniform factor depended on the satisfaction of certain demographic standards.

B. An individually designed plan that (l) uses an integration level in an excess plan or an offset in an offset plan requiring the satisfaction of the demographic tests of the regulations, or (2) uses a uniform factor pursuant to the demographic standards of section 1.401(l)-3(g) of the regulations for determining the portion of a participant's benefits deemed attributable to employee contributions, and (3) receives a favorable determination letter based on employee census data for a particular plan year may rely on the favorable letter for subsequent plan years unless, effective for such year, there is a plan amendment or change in law affecting the application of the permitted disparity requirements to the plan. However, the reliance provided in this notice is not applicable if there is a significant change in material fact, such as a significant change in the workforce, in subsequent years. In addition, the reliance provided in this notice with respect to the use of a uniform factor for determining the portion of a participant's benefits deemed attributable to employee contributions does not apply to plan years ending after the sixth anniversary of the last day of the plan year for which the favorable determination letter was obtained.

VI. *Career Average Plans*

The final regulations will also provide that certain types of career average defined benefit plans that are not covered by the proposed regulations can satisfy the requirements of section 401(l). The types of career average plans are those that determine the retirement benefit of a participant based on each year of service separately and sum the benefit for each year to determine the total retirement benefit. If such plans are excess plans, the integration level for such plans may either be (1) the covered compensation of each participant for the particular year, (2) a uniform dollar amount for all participants that does not exceed the greater of $10,000 or one-half of the covered compensation of an individual who attains social security retirement age in the plan year, (3) a stated dollar amount uniformly applicable to all participants that does not exceed the taxable wage base for each year, provided the demographic tests specified in sections 1.401(l)-3(b)(4)(iii)(B) and (C) of the regulations are met, or (4) a uniform percentage (greater than 100 percent) of each participant's covered compensation (but not in excess of the taxable wage base in effect as of the beginning of the plan year).

If the integration level applicable to a participant for a plan year is not the participant's covered compensation, the adjustments found in the regulations will have to be made. Thus, for example, if the integration level is the taxable wage base, the adjustments in section 1.401-(l)-3(d)(1) of the regulations will have to be made to the ¾ of 1 percent factor.

In addition to the integration levels specified above, a career average plan may determine an integration level using Alternatives I or II of section III.B. of this notice, provided that the adjustments to the ¾ of 1% factor described in the alternatives are made.

Example. Plan A provides that the retirement benefit a participant earns for each year of service is 1 percent of the participant's compensation for that year not in excess of the taxable wage base for such year, plus 1 ¾ percent of the participant's compensation in excess of the taxable wage base for such year. Assume all participants have a social security retirement age of 65. In order to satisfy the requirements of the regulations, the ¾ of 1 percent difference will have to be reduced as provided in regulations for an integration level in excess of covered compensation.

Similar rules apply to the types of career average plans described above that are offset plans.

VII. *Early Retirement Adjustments*

Section 1.401(l)-3(e) of the proposed regulations provides adjustments to the ¾ of 1 percent factor for benefits payable under a defined benefit excess or a defined benefit offset plan prior to social security retirement age. Section 1.401-(l)-3(e)(3) of the proposed regulations provided tables showing the reductions in the ¾ of 1 percent factor applicable to benefits commencing on or after age 55 for a participant who has a social security age of 65, 66, or 67. The tables in the final regulations will be revised to use a reduction of 1/15 for each of the first five years that the benefits are payable before social security retirement age and a reduction of 1/30 for each of the next five years that the benefits are payable before social security retirement age, with an actuarial reduction used for any additional years. As revised the tables are as follows:

Social Security retirement age 67

Age at which benefits commence	Annual factor in maximum excess allowance and maximum offset allowance (percent)
66	0.70
65	0.65
64	0.60
63	0.55
62	0.50
61	0.475
60	0.45
59	0.425
58	0.40
57	0.375
56	0.344
55	0.316

Social Security retirement age 66

Age at which benefits commence	Annual factor in maximum excess allowance and maximum offset allowance (percent)
65	0.70
64	0.65
63	0.60
62	0.55
61	0.50
60	0.475
59	0.45
58	0.425
57	0.40
56	0.375
55	0.344

Social Security retirement age 65

Age at which benefits commence	Annual factor in maximum excess allowance and maximum offset allowance (percent)
64	0.70
63	0.65
62	0.60
61	0.55
60	0.50
59	0.475
58	0.45
57	0.425
56	0.40
55	0.375

VIII. *Early Retirement — Excess Plans*

Section 1.401(l)-3(b)(5) of the proposed regulations provides that in a defined benefit excess plan any optional form of benefit, ancillary benefit, actuarial factor or other right, benefit or feature provided under the plan with respect to employer-derived benefits attributable to compensation above the integration level is also provided under the plan on the same basis with respect to employer-derived benefits attributable to compensation at or below the integration level. This notice clarifies that such rights, benefits, or features provided with respect to employer-derived benefits attributable to compensation at or below the integration level may be provided either on the same basis or at least as favorable a basis as that provided with respect to employer derived benefits attributable to compensation above the integration level.

Example. Employer X maintains a noncontributory defined benefit excess plan with a normal retirement age of 65. The formula for determining benefits under the plan for participants with a social security retirement age of 65 provides a normal retirement benefit (for each year of credited service up to 35 years) of 1.25% of the participant's average annual compensation up to covered compensation plus 2.0% of the participant's average annual compensation in excess of the participant's covered compensation. (Such benefit may also be described as 1.25% of average annual compensation plus .75% of average annual compensation in excess of covered compensation.) The plan also provides an early retirement benefit at age 55 of 1.25% of average annual compensation plus .375% of average annual compensation in excess of covered compensation for each year of credited service up to 35 years. Such early retirement benefit meets the requirements of section 1.401(l)-3(b)(5) of the regulations because the early retirement factor applied to the benefit attributable to compensation below the integration level is at least as favorable as the factor applied to the benefit attributable to compensation above the integration level.

IX. *Early Retirement — Offset Plans*

Section 1.401(l)-3(e) of the regulations provides that in the case of a benefit payable to a participant commencing at an age before the participant's social security retirement age, the ¾ of 1 percent factor in the maximum offset allowance is reduced to at least a specified amount. Pursuant to this notice, in the case of a benefit commencing before social security retirement age, an offset plan satisfies the required reduction under paragraph 1.401(l)-3(e)(2) of the regulations if the benefit provided under the formula prior to the application of the offset is reduced by an amount (expressed as a percentage of average annual compensation) that is not less than the amount by which the offset must be reduced (expressed as a percentage of compensation used for determining the offset).

Example 1. Employer Y maintains a noncontributory defined benefit offset plan with a normal retirement age of 65. Pursuant to the formula for determining benefits under the plan for participants with a social security retirement age of 65, a participant accrues a normal retirement benefit (for each year of credited service up to 35 years) of 2% of the participant's average annual compensation offset by .75% of the participant's final average compensation (up to covered compensation). The plan also provides that the offset will not exceed 50% of the benefit the participant would have accrued under the plan for any plan year with respect to the participant's average annual compensation (up to covered compensation). The plan provides an early retirement benefit at age 55 for each year of credited service up to 35 years of 2% of average annual compensation offset by .375% of final average compensation (up to covered compensation). Thus, the offset portion of the formula is reduced for early retirement in accordance with the regulations (as modified by this notice), but the formula as stated prior to the application of the offset is not reduced for early retirement. Such early retirement benefit is in violation of the requirements of section IX of this notice. In addition, such early retirement benefit is larger than the normal retirement benefit not reduced for early retirement. Because the larger early retirement benefit is not taken into account in determining accruals prior to early retirement age, the plan's formula violates the accrual requirements of section 411 of the Code.

Example 2. Assume the same facts as in Example 1 except that the early retirement benefit at age 55 for each year of credited service up to 35 years is 1.625% of average annual compensation offset by .375% of final average compensation (up to covered compensation).

Because the benefit (prior to the application of the offset) is reduced by .375% (from 2.0% to 1.625%) of average annual compensation and this reduction is the same (determined as .75% to .375%) as that made in the offset expressed as a percentage of compensation used in determining the offset (final average compensation up to covered compensation), the early retirement benefit meets the requirements of section IX of this notice.

ADMINISTRATION PRONOUNCEMENT

This document serves as an "administrative pronouncement" as that term is described in section 1.6661-3(b)(2) of the Income Tax Regulations and may be relied upon to the same extent as a revenue ruling or revenue procedure.

ATTACHMENT I

1989 COVERED COMPENSATION TABLE

CALENDAR YEAR OF BIRTH	CALENDAR YEAR OF SOCIAL SECURITY RETIREMENT AGE	1989 COVERED COMPENSATION	
		TABLE II	TABLE I
1907	1972	4488	4200
1908	1973	4704	4800
1909	1974	5004	4800
1910	1975	5316	5400
1911	1976	5664	5400
1912	1977	6060	6000
1913	1978	6480	6600
1914	1979	7044	7200
1915	1980	7692	7800
1916	1981	8460	8400
1917	1982	9300	9600
1918	1983	10236	10200
1919	1984	11232	11400
1920	1985	12276	12000
1921	1986	13368	13200
1922	1987	14520	14400
1923	1988	15708	15600
1924	1989	16968	16800
1925	1990	18228	18000
1926	1991	19476	19200
1927	1992	20724	21000
1928	1993	21972	22200
1929	1994	23208	23400
1930	1995	24444	24600
1931	1996	25680	25800
1932	1997	26916	27000
1933	1998	28152	28200
1934	1999	29388	29400
1935	2000	30612	30600
1936	2001	31800	31800
1937	2002	32988	33000
1938	2004	35280	35400
1939	2005	36432	36600
1940	2006	37572	37800
1941	2007	38688	38400
1942	2008	39756	39600
1943	2009	40752	40800
1944	2010	41712	42000
1945	2011	42648	42600
1946	2012	43548	43800
1947	2013	44412	44400
1948	2014	45132	45000
1949	2015	45768	45600
1950	2016	46284	46200
1951	2017	46740	46800
1952	2018	47088	46800
1953	2019	47376	47400
1954	2020	47616	47400
1955	2022	47904	48000
1956 OR LATER	2023 OR LATER	48000	48000

ATTACHMENT II

1989 TRANSITIONAL COVERED COMPENSATION TABLE

CALENDAR YEAR OF BIRTH	CALENDAR YEAR OF SOCIAL SECURITY RETIREMENT AGE	1989 COVERED COMPENSATION TABLE II	1989 COVERED COMPENSATION TABLE I
1908	1973	4488	4200
1909	1974	4704	4800
1910	1975	5004	4800
1911	1976	5316	5400
1912	1977	5664	5400
1913	1978	6060	6000
1914	1979	6480	6600
1915	1980	7044	7200
1916	1981	7692	7800
1917	1982	8460	8400
1918	1983	9300	9600
1919	1984	10236	10200
1920	1985	11232	11400
1921	1986	12276	12000
1922	1987	13368	13200
1923	1988	14520	14400
1924	1989	15708	15600
1925	1990	16968	16800
1926	1991	18228	18000
1927	1992	19476	19200
1928	1993	20724	21000
1929	1994	21972	22200
1930	1995	23208	23400
1931	1996	24444	24600
1932	1997	25680	25800
1933	1998	26916	27000
1934	1999	28152	28200
1935	2000	29388	29400
1936	2001	30612	30600
1937	2002	31800	31800
1938	2004	34128	34200
1939	2005	35280	35400
1940	2006	36432	36600
1941	2007	37572	37800
1942	2008	38688	38400
1943	2009	39756	39600
1944	2010	40752	40800
1945	2011	41712	42000
1946	2012	42648	42600
1947	2013	43548	43800
1948	2014	44412	44400
1949	2015	45132	45000
1950	2016	45768	45600
1951	2017	46284	46200
1952	2018	46740	46800
1953	2019	47088	46800
1954	2020	47376	47400
1955	2022	47784	48000
1956	2023	47904	48000
1957 OR LATER	2024 OR LATER	48000	48000

Furnishing Identification of Dependent Care Providers

Notice 89-71

This notice provides guidance on the new reporting requirements for taxpayers claiming the dependent care credit under section 21 of the Internal Revenue Code or taking the dependent care exclusion under section 129 of the Code.

Section 703(c) of the Family Support Act of 1988 (the Act), Pub. L. No. 100-485, amended sections 21 and 129 of the Code to require taxpayers claiming the credit for dependent care expenses under section 21, or taking the exclusion pursuant to a dependent care assistance program under section 129, to furnish the Internal Revenue Service (Service) with the name, address, and taxpayer identification number (TIN) of the care provider. (For individuals, their TIN is their social security number. For other entities, generally, their TIN is their employer identification number.) In the case of a care provider that is an organization described in section 501(c)(3) and exempt from tax under section 501(a), the taxpayer claiming such a credit or taking such an exclusion is required to furnish only the name and address of the care provider.

Act section 703(c) also amended section 6109(a)(2) of the Code to require care providers to furnish their TINs to taxpayers who need the TINs in order to claim the credit under section 21 or to take the exclusion under section 129. A care provider who fails to comply with this requirement is subject to a penalty under section 6676 of $50 for each such failure, unless the failure is due to reasonable cause and not to willful neglect. Care providers that are organizations described in section 501(c)(3) and exempt from tax under section 501(a) do not have to furnish TINs to taxpayers.

Taxpayers claiming the credit under section 21 of the Code or taking the exclusion under section 129 must furnish the required information on the federal income tax return on which the credit is claimed or to which the exclusion relates. Form 2441, Credit for Child and Dependent Care Expenses (filed with Form 1040), and Part I of Schedule 1, Credit for Child and Dependent Care Expenses, (filed with Form 1040A), will be retitled and revised to provide space and instructions for taxpayers claiming the credit or taking the exclusion to furnish the required information. In the case of a care provider that is an organization described in section 501(c)(3) and exempt from tax under section 501(a), taxpayers must write "tax-exempt" in the space in which the TIN of the care provider generally would be reported.

These new requirements are effective for taxable years beginning after December 31, 1988. Thus, taxpayers claiming the credit or taking the exclusion generally must furnish the required information on their federal income tax returns for 1989 and subsequent years (that is, beginning with returns due by April 16, 1990).

Taxpayers who do not furnish correct or complete information will not be allowed the dependent care credit or exclusion unless, upon the Service's request, they show that they exercised due diligence in attempting to furnish the required information. Any one of the following documents may be used to show that a taxpayer exercised due diligence in attempting to furnish the required information, unless the taxpayer knows or has reason to know that the information on the document is incorrect:

1. A completed Form W-10, Dependent Care Provider's Identification and Certification;
2. A copy of the care provider's social security card or driver's license (in a state where the license includes the social security number);
3. A recently printed letterhead or printed invoice of the care provider that contains the required information;
4. If the care provider is the taxpayer's household employee and has given the taxpayer a completed Form W-4, Employee's Withholding Allowance Certificate, a copy of that W-4; and
5. If the employer is the care provider in the case of a section 129 program, a copy of the statement furnished to the employee under section 129(d)(6) of the Code that contains the required information.

Taxpayers should request the required information from the care provider. In cases where the care provider does not comply with such a request, taxpayers should furnish whatever information they have (that is, a name, an address, and, if known and required, a TIN of the care provider) on the Form 2441 or Schedule F (whichever is applicable) Taxpayers should then include a statement on the Form 2441 or Schedule 1 (whichever is applicable) that they requested the required information from the care provider, and that the care provider did not comply with the request. This statement will show that the taxpayer exercised due diligence in attempting to furnish the required information, unless the taxpayer knows or has reason to know that the statement is incorrect.

This document serves as an "administrative pronouncement" as that term is described in section 1.6661-3(b)(2) of the Income Tax Regulations, and may be relied upon to the same extent as a revenue ruling or revenue procedure.

New Information Reporting Requirements for Real Estate Mortgage Investment Conduits (REMICs) and Other Issuers of Collateralized Debt Obligations

Notice 89-72

The Service will soon issue temporary regulations that will establish new rules for information reporting by real estate mortgage investment conduits (REMICs) and other issuers of collateralized debt obligations (obligations described in section 1272(a)(6)(C)(ii) of the Internal Revenue Code). These new rules will replace those currently set out in temporary regulations that were published in the Federal Register on March 9, 1988 (53 F.R. 7504). The new rules will ensure that both the Service and investors will receive timely and accurate tax information.

In general, the existing temporary regulations require a chain of reporting if an investor holds a REMIC regular interest through a nominee, such as a broker or other middleman. A REMIC must annually report tax information to the Service and to each interest holder of record. If the interest holder of record is a nominee of another, then the nominee must report that information to the Service and to the person for whom it holds the REMIC regular interest. Often, several middlemen are interposed between the REMIC and the ultimate owner of the REMIC regular interest. Because each middleman in the chain is allowed 30 days from the time it receives the tax information until the time it must report that information, many REMIC regular interest holders may not receive the tax information until after the date their tax returns are due.

The new temporary regulations will differ from the existing temporary regulations in two important ways. First, the new regulations will contain information reporting rules not only for REMIC regular interests, but also for other collateralized debt obligations. Second, the new regulations will generally eliminate the chain of reporting by requiring only the nominee who holds an interest for the actual owner (the last middleman in the chain) to report tax information to the investor and to the Service.

The new regulations will require a REMIC or other issuer of collateralized debt obligations to file new Form 8811, Information Return for Real Estate Mortgage Investment Conduits (REMICs) and Issuers of Collateralized Debt Obligations, with the Service. On that form, the REMIC or other issuer must list its name, employer identification number, and the Committee on Uniform Security Identification Procedure (CUSIP) number assigned to each class of REMIC regular interest or collateralized debt obligation. In addition, the REMIC or other issuer must provide the name, address, and telephone number of a person who can be contacted by a broker or other middleman to obtain the tax information needed to fulfill its reporting obligation to the actual owner and to the Service.

The Service will compile the information submitted by REMICs and other issuers and publish it in January of each year in publication 938, *Real Estate Mortgage Investment Conduits (REMICs) Reporting Information (Including Other Issuers of Collateralized Debt Obligations)*. Brokers and other middlemen who will have a reporting obligation under the new regulations can refer to Publication 938 to find the appropriate contact person who will be required to provide tax information to them.

Generally, a REMIC must file Form 8811 within 30 days of its startup day, and other issuers of collateralized debt obligations must file Form 8811 within 30 days of the issuance of those obligations. The temporary regulations will require, however, that REMICs that are in existence on July 1, 1989, and other issuers that have issued collateralized debt obligations on or before July 1, 1989, must file Form 8811 with the Service by July 31, 1989. Because the new information reporting rules will be effective for information returns to be prepared for the 1989 taxable year, REMICs and other issuers must file Form 8811 by the July 31, 1989, deadline so that the Service can issue Publication 938 in January of 1990.

Form 8811 should be mailed to:

REMIC Publication Project
Internal Revenue Service
1111 Constitution Ave. N.W.
Room 5607
Washington, D.C. 20224

Copies of Form 8811 can be obtained from I.R.S. Forms Distribution Centers, or by calling 1-800-424-3676.

This notice will not apply to REMICs all of whose regular interests are owned by another REMIC.

ADMINISTRATIVE PRONOUNCEMENT

This notice serves as an "administrative pronouncement" as that term is described in section 1.6661-3(b)(2) of the Income Tax Regulations and may be relied on to the same extent as a revenue ruling or revenue procedure.

Branch Profits Tax: Rate under the French Income Tax Treaty

Notice 89-73

Section 1.884-1T(h)(4)(i)(B) of the Temporary Income Tax Regulations lists the rates of tax imposed under section 884 of the Internal Revenue Code of 1986 (the branch profits tax) on foreign corporations that (1) are residents of certain countries that have an income tax treaty with the United States and (2) qualify for treaty benefits with respect to the branch profits tax. The regulation reserved with respect to the rate of tax imposed on corporations resident in France. The regulation will be amended to specify a rate of 5 percent for corporations that are residents of France and are entitled to treaty benefits with respect to the branch profits tax.

Administrative Pronouncement

This document serves as an "administrative pronouncement" as that term is described in section 1.6661-3(b)(2) of the Income Tax Regulations and may be relied upon to the same extent as a revenue ruling or revenue procedure.

Effective Date

This amendment will be effective for taxable years beginning after December 31, 1986.

Translation of the Income of a Foreign Branch

Notice 89-74

This notice provides guidance relating to the amendments made to the foreign currency rules by the Tax Reform Act of 1986, 1986-3 (Vol. 1) C.B. 1 (the Act), as amended by the Technical and Miscellaneous Revenue Act of 1988, P. L. 100-647, 100 Stat. 3342. Specifically, this notice provides rules for translating the income of a foreign branch of a United States taxpayer (a qualified business unit (QBU)) that has a functional currency other than the U.S. dollar when the taxpayer credits, rather than deducts, foreign taxes.

Section 1261(a) of the Act added sections 985 through 989 of the Internal Revenue Code of 1986 to provide rules for the treatment of foreign currency transactions. Section 985(a) provides that, unless otherwise provided in regulations, all determinations under subtitle A of the Code shall be made in the taxpayer's functional currency (as defined in section 985(b)). Under section 987, a taxpayer with one or more QBUs with a functional currency other than the dollar must compute the taxable income or loss of each QBU separately in the functional currency of the QBU before translating such income into dollars at the appropriate exchange rate. Under section 989(b)(4), the appropriate exchange rate for translating branch income is, except as provided in regulations, the weighted average exchange rate for the taxable year.

A taxpayer may elect either to credit or to deduct foreign taxes paid or accrued. In order to prevent a double benefit, section 275(a)(4) of the Code and section 1.901-1(c) of the Income Tax Regulations provide that a taxpayer is not allowed to deduct foreign income taxes if the taxpayer chooses to credit such taxes. Therefore, if a taxpayer credits foreign taxes, taxable income (or loss) attributable to a branch consists of two elements: a functional currency amount equal to the foreign taxes paid on branch income for which no deduction is allowed (the "tax equivalent amount") and a functional currency amount of "earnings" (or "deficit"). For this purposes the "earnings" (or "deficit") equal taxable income (or loss) minus taxes paid or accrued.

The regulations will provide that when a United States taxpayer with a foreign branch that has a functional currency other than the dollar credits rather than deducts the branch's foreign taxes, the taxpayer must translate the tax equivalent amount into dollars using the exchange rate at the time of payment of such taxes to a foreign country or possession of the United States. The regulations will also provide that the taxpayer will translate the branch's "earnings" (or "deficit") into dollars using the weighted average exchange rate.

In addition, to the extent there is a foreign tax redetermination, as defined in section 1.905-3T(c) of the Temporary Income Tax Regulations, the taxpayer will be required to recompute the taxable income, the "tax equivalent amount," and "earnings" attributable to the branch using the translation rules of this notice.

The following examples illustrate the rules of this notice. Assume in each example that all of *X*'s income is income generated by *M* that is foreign source general limitation income (income described in section 904(d)(1)(I) of the Code).

Example (1). M is a foreign branch of a calendar year domestic corporation *X*, that for 1988 credits its foreign taxes paid. *M* operates in foreign country *R* and is a QBU. *R*'s currency is the u and *M*'s functional currency is the u. In 1988, *M* has 100u of taxable income. *M* pays 20u of tax on that income to country *R* on December 31, 1988. For 1988, the weighted average exchange rate is 1u/$1. On December 31, 1988, the exchange rate is 1u/$1.2. The 20u of foreign tax is a creditable tax under section 901 of the Code and the regulations thereunder.

In 1988, *X*'s 100u of income attributable to *M* consists of 80u of earnings and 20u of a tax equivalent amount. The 80u of earnings is translated at the weighted average exchange rate for 1988 (1u/$1) to $80 and 20u is translated at the exchange rate when the taxes are paid (1u/$1.2) to $24. For 1988, *X*, therefore, has taxable income of $104 ($80 + $24) attributable to its branch *M* and has paid $24 of foreign taxes with respect to that income.

Example (2). The facts are the same as in *Example* 1, except that in 1989, there is a foreign tax redetermination with respect to *M*'s 1988 income that results in a 10u refund. Therefore, under section 1.905-3T(d) of the temporary regulations, *X* must redetermine its tax liability for 1988. The redetermination results in a change in the dollar amount of the taxable income of *X* attributable to *M*. *X* has 100u of taxable income attributable to *M* which, after the redetermination, consists of 90u of earnings and 10u of a tax equivalent amount. The 90u of earnings is translated at the weighted average exchange rate (1u/$1) to $90 and 10u is translated at the exchange rate on December 31, 1988, the time of the original payment of the foreign tax (1u/$1.2) to $12. Section 986(a)(1)(B)(ii) of the Code. *X*, therefore, has taxable income of $102 ($90 + $12) attributable to its branch *M* and has paid $12 of foreign taxes with respect to that income.

Example (3). The facts are the same as in *Example* 1, except that in 1988 *X* accrues, rather than pays, the 20u of foreign taxes. The December 31, 1988 rate (1u/$1.2) is the rate used to translate the accrued taxes in 1988. Section 1.905-3T(b)(1) of the temporary regulations. In 1989, when *X* pays the 20u of foreign taxes attributable to 1988, the exchange rate is 1u/$1.4. The difference in the dollar value of foreign taxes accrued and foreign taxes paid is a foreign tax redetermination. Section 1.905-3T(c)(3) of the temporary regulations. The redetermination results in a change in the dollar amount of *X*'s taxable income attributable to *M*. *X* has 100u of taxable income attributable to *M*, which after the redetermination consists of 80u of earnings translated at the 1u/$1 rate to $80 and 20u of a tax equivalent amount equal to foreign taxes paid translated at the 1u/$1.4 rate to $28. *X*, therefore, has taxable income of $108 ($80 + $28) attributable to *M* and has paid $28 of foreign taxes with respect to that income.

Example (4). The facts are the same as in *Example* 1, except that in 1989 there is a foreign tax redetermination within the meaning of section 1.905-3T(c) of the temporary regulations that results from an additional tax payment of 5u on *M*'s 1988 income. In 1989 *X* pays the additional 5u in foreign tax when the exchange rate is 1u/$1.4. The foreign tax redetermination results in a change in the dollar amount of *X*'s taxable income attributable to *M*. After the redetermination, *M* has 75u of earnings and 25u a tax equivalent amount. The 75u of earnings is translated at the 1u/$1 rate to $75, 20u is translated at the 1u/$1.2 rate to $24, and 5u is translated at the 1u/$1.4 rate to $7. Section 986(a)(1)(B)(i) of the Code. *X*, therefore, has taxable income of $106 ($75 + $24 + $7) attributable to *M* in 1988 and has paid $31 ($24 + $7) of foreign taxes with respect to that income.

Example (5) The facts are the same as in *Example* 1, except that *M* has 10u of taxable income and country *R* imposes 30u of tax on that income. *X*, therefore, has 10u of taxable income that consists of 30u of a tax equivalent amount and a deficit of 20u (taxable income minus foreign taxes). *X* translates 30u at the exchange rate as of the date of the payment of the taxes (1u/$1.2) to $36 and translates the 20u deficit at the weighted average rate (1u/$1) to <$20>. *X* has $16 ($36 + <20>) of taxable income attributable to branch *M* and has paid $36 of foreign taxes with respect to that income.

PROCEDURAL INFORMATION

The rules contained in this notice will be incorporated in regulations to be issued under the Act. This document serves as an "administrative pronouncement" as that term is described in section 1.6661-3(b)(2) of the regulations and may be relied on to the same extent as a revenue ruling or revenue procedure.

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26 CFR 601.201: Rulings and determination letters.

Rev. Proc. 89-1

CONTENTS

SECTION 1. PURPOSE

The purpose of this revenue procedure is to update Rev. Proc. 88-1, 1988-1 C.B. 557, as amplified, modified, and supplemented, which provides procedures for issuing rulings, determination letters and information letters, and for entering into closing agreements on specific issues involving the interpretation or application of the federal tax laws. It also tells taxpayers and their representatives where to send requests for rulings, determination letters and information letters. It gives the steps to follow so that requests may be handled more efficiently. Changes to this revenue procedure will be incorporated annually in a new revenue procedure published as the first revenue procedure of the year.

SEC. 2. SCOPE

.01 The Chief Counsel through the Associate Chief Counsel (Technical) provides basic principles and rules for the uniform interpretation and application of the federal tax laws under the jurisdiction of the Associate Chief Counsel (Technical).

.02 This revenue procedure applies only to ruling requests, information letters, and closing agreements under the jurisdiction of the Associate Chief Counsel (Technical) and to requests for determination letters under the jurisdiction of field offices that relate to Code sections under the jurisdiction of the Associate Chief Counsel (Technical).

.03 The procedures for obtaining rulings, closing agreements, and information letters on specific tax issues involving the interpretation or application of the federal tax laws and income tax treaties relating to international transactions are contained in Rev. Proc. 87-4, 1987-1 C.B. 529, as modified by 88-4, 1988-1 C.B. 586.

.04 The procedures for obtaining rulings, etc., that apply specifically to federal firearms, alcohol and tobacco taxes under subtitle E of the Internal Revenue Code are under the jurisdiction of the Bureau of Alcohol, Tobacco and Firearms. The procedures for obtaining rulings, determination letters, etc., on employee plans and exempt organizations are under the jurisdiction of the Assistant Commissioner (Employee Plans and Exempt Organizations). See Rev. Proc. 83-36, 1983-1 C.B. 763, as modified by Rev. Proc. 87-40, 1987-2 C.B. 514. However, the jurisdiction of the Associate Chief Counsel (Technical) includes section 521 of the Code, on exemption of farmer's cooperatives from tax; section 526, on shipowners' protection and indemnity associations; and section 528 on certain homeowners association.

SEC. 3. CHANGES

.01 References throughout the revenue procedure to the Associate Chief Counsel (Technical and International) are changed to the Associate Chief Counsel (Technical) to reflect that separate Associate Chief Counsel positions have been established for the Technical and International organizations.

.02 Section 5.02 is amended to provide that the National Office will consider prospective estate tax rulings on all issues, with certain limited exceptions, during a test period ending December 31, 1989. See Rev. Proc. 88-50, 1988-2 C.B. 711, which modified Rev. Proc. 88-1.

.03 Section 5.07 is amended to reflect the modifications made to that section by Rev. Proc. 88-18, 1988-1 C.B. 694.

.04 Section 8.03 is amended by redesignating such section 8.04 and by inserting a new section 8.03 that describes user fees and provides a schedule of fees.

.05 Section 8.06 is amended by the addition of language from Rev. Proc. 88-6, 1988-1 C.B. 589 (guidelines concerning requests involving public utilities), which amplified Rev. Proc. 88-1.

.06 Section 8.06 is amended to provide that an extension of the 21-day period for post-conference submissions must be approved by the Branch Chief, Senior Technician Reviewer, or Assistant to the Branch Chief of the Branch to which the case is assigned.

.07 Sections 8.16 through 8.18 are amended and sections 8.19 and 8.20 are redesignated as section 8.22 and 8.23. New sections 8.17 through 8.21 describe the primary responsibilities of the new Assistant Chief Counsels in the Technical organization.

.08 Section 10.08 has been added to describe pre-submission conferences.

SEC. 4. GENERAL PRACTICE AND DEFINITIONS

.01 The Service answers inquiries of individuals and organizations, when appropriate in the interest of sound tax administration, about their status for tax purposes and the tax effects of their acts or transactions. The National Office issues rulings in such matters.

.02 District Directors of the Internal Revenue Service apply the statutes and tax treaties, regulations, revenue rulings, and other precedents published in the Internal Revenue Bulletin in determining tax liability, collecting taxes, and issuing information letters and determination letters in answer to taxpayers' inquiries or requests. For purposes of this revenue procedure, any reference to District Director or District Office includes their respective offices or, when appropriate, the Director of an Internal Revenue Service Center.

.03 The word "taxpayer" includes all persons subject to any provision of the Internal Revenue Code and, when appropriate, their representatives and issuers of section 103 obligations. Any reference to National Office means only the Office of the Associate Chief Counsel (Technical).

.04 A "ruling" is a written statement issued to a taxpayer by the National Office that interprets and applies the tax laws to that taxpayer's specific set of facts. Rulings are issued only by the National Office, under the general supervision of the Associate Chief Counsel (Technical). Issuing rulings has been largely delegated to the Assistant Chief Counsel (Corporate), the Assistant Chief Counsel (Employee Benefits and Exempt Organizations), the Assistant Chief Counsel (Financial Institutions and Products), the Assistant Chief Counsel (Income Tax and Accounting), and the Assistant Chief Counsel (Passthroughs and Special Industries).

.05 A "determination letter" is a written statement issued by a District Director in response to a written inquiry by a taxpayer that applies the principles and precedents previously announced by the National Office to a specific set of facts. A determination letter is issued only when a determination can be made on the basis of clearly established rules in the statute or regulations, or by a position in a ruling, opinion, or court decision published in the Internal Revenue Bulletin that specifically answers the question presented. A determination letter will not be issued if a determination cannot be made, for example, when the question presents a novel issue, or if the matter is excluded from the jurisdiction of a District Director under section 6 of this revenue procedure.

.06 An "information letter" is a statement issued either by the national Office or by a District Director that calls attention to a well-established interpretation or principle of tax law, without applying it to a specific set of facts. It may be issued if the request indicates that the taxpayer is seeking general information. If the request does not meet the requirements of section 8 of this revenue procedure, but the Service thinks that the general information may help the individual or organization, it may issue an information letter.

.07 A "revenue ruling" is an interpretation by the Service that has been published in the Internal Revenue Bulletin. It is the conclusion of the Service on how the law is applied to an entire set of facts. Revenue rulings are issued only by the National Office and are published for the information and guidance of taxpayers. Internal Revenue Service officials, and other interested parties.

Since each revenue ruling represents the conclusion of the Service as to the application of the law to the entire statement of facts involved, taxpayers, Service personnel, and others concerned are cautioned against reaching the same conclusion in other cases unless the facts and circumstances are substantially the same. They should consider the effect of subsequent legislation, regulations, court decisions, and revenue rulings. See Rev. Proc. 86-15, 1986-1 C.B. 544.

.08 A "closing agreement" is an agreement between the Commissioner of Internal Revenue or the Commissioner's delegate and a taxpayer on a specific issue or issues or liability that is entered into under the authority in section 7121 of the Code. A closing agreement prepared in an office under the responsibility of the Associate Chief Counsel (Technical) is based on a ruling that has been signed by the Commissioner or the Associate Chief Counsel (Technical) that says that a closing agreement will be entered into on the basis of the holding of the ruling letter. Closing agreements are final, unless fraud, malfeasance, or misrepresentation of a material fact can be shown. Closing agreements may be entered into when it is advantageous to have the matter permanently and conclusively closed, or when a taxpayer can show good and sufficient reasons for an agreement and the government will sustain no disadvantage by its consummation. In appropriate cases, taxpayers may be asked to enter into a closing agreement as a condition to the issuing of a ruling. If, in a single case, closing agreements are requested for each of a number of taxpayers, such agreements are entered into only if the number of taxpayers is 25 or less. However, if the issue and holding are identical for all taxpayers and they number more than 25, a "mass closing agreement" will be entered into with the taxpayer who is authorized by the others to represent the entire group.

SEC. 5. RULINGS ISSUED BY THE NATIONAL OFFICE

.01 *In income and gift tax matters*, the National Office issues rulings on prospective transactions and on completed transactions that occurred before the return is filed for the year in which such transactions are consummated. However, see Rev. Proc. 79-63, 1979-2 C.B. 578, which concerns applications for extensions of the time for making an election or application for relief under section 1.9100-1 of the regulations. If a request for an extension of time under section 1.9100‹ is submitted after the return is filed but before the return is examined, the procedures under Rev. Proc. 89-1 are applicable. If an examination of the return has begun, or is being considered by an Appeals Office, the procedures of Rev. Proc. 89-2, page 753, this Bulletin, are applicable. The National Office issues rulings on the exempt status of organizations under section 521. See Rev. Proc. 84-46, 1984-1 C.B. 541. Specific instructions and guidelines relating to corporate distributions and the determination of the earnings and profits of corporate taxpayers are contained in Rev. Proc. 75-17, 1975-1 C.B. 677. In such matters only the provisions of sections 8.02, 8.10, 8.11, 8.14, 8.17, and 10 of this revenue procedure (Rev. Proc. 89-1) are applicable. Specific instructions and guidelines relating to a change in method of accounting for federal income tax purposes are contained in Rev. Proc. 84-74, 1984-2 C.B. 736. In such matters only the provisions of sections 7.02, 8.02, 803, 8.06, 8.09, 8.11, 8.12, 8.16, 8.18, 8.20, 8.21 8.24, 10, 14, 15 and 16 of this revenue procedure (Rev. Proc. 89-1) are applicable. In matters relating to accounting period changes only the provisions of sections 7.02, 8.02, 8.03, 8.06, 8.09, 8.11, 8.12, 8.16, 8.18, 8.20, 8.24, 10, 14, 15, and 16 of this revenue procedure (Rev. Proc. 89-1) are applicable. The National Office ordinarily does not issue rulings if, at the time the ruling is requested, the identical issue is involved in the taxpayer's return for an earlier period, and (1) that issue is being examined by a District Director or is being considered by an Appeals Office, or (2) that issue has been examined by a District Director or considered by an Appeals Office and the statutory period of limitation on either assessment or for filing a claim for refund or credit of Tax has not expired, or a closing agreement covering the issue of liability has not been entered into by a District Director or by an Appeals Office. If a return dealing with an issue for a particular year is filed while a request for ruling on that issue is pending, the National Office will issue the ruling unless it is notified by the taxpayer that an examination of that issue or the identical issue on an earlier year's return has been started by a District Director. See section 8.07. However, even if an examination has begun, the National Office ordinarily will issue the ruling if the District Director agrees, by memorandum, to permit the ruling to be issued. The National Office does not issue rulings on the replacement of involuntarily converted property, whether or not replacement has been made, if the taxpayer has already filed a return for the tax year in which the property was converted. See section 6.03 for the District Director's authority to issue determination letters in this connection. In addition, the National Office generally does not issue rulings on the classification of an organization if a return has been filed for the organization for an earlier period. However, the National Office will consider ruling requests concerning the classification of an existing organization as a partnership. See Rev. Proc. 86-12, 1986-1 C.B. 534.

.02 *In estate tax matters,* the National Office issues rulings with respect to transactions affecting the estate tax of a living person and a decedent before the estate tax return is filed. With respect to ruling requests involving a decedent's estate tax, if the estate tax return is due to be filed before the ruling is issued, the taxpayer should secure an extension of time for filing the return for the maximum period of six months, and notify the National Office Branch considering the request for ruling that an extension has been secured. If the return is filed before the ruling is issued, the taxpayer must disclose on the return that a ruling has been requested, attach a copy of the pending ruling request to the return, and notify the National Office that the return has been filed. The National Office will make every effort to issue the ruling within three months of the day on which the return was filed. If the ruling cannot be issued within that three month period, the National Office will notify the District Director having jurisdiction of the return who may, by memorandum to the National Office, grant an additional period for the issuance of the ruling. In addition, pursuant to Rev. Proc. 88-50 The National Office requests for prospective estate tax rulings on a test basis until December 31, 1989. However, requests for prospective estate tax rulings involving computations of tax, actuarial factors and factual matters will not be considered.

1. *In matters involving additional tax under section 2032A(c)* the National Office issues rulings on prospective transactions and on completed transactions that occurred before the return is filed for the year in which such transactions are consummated.

.03 *In generation-skipping transfer tax matters,* the National Office issues rulings on transactions that affect the generation-skipping transfer tax before the return is filed. In the case of a generation-skipping trust, or trust equivalent, rulings are not issued until after the trust or trust equivalent has been established. Rulings may be issued on a generation-skipping transfer tax matter before a "direct skip" transfer takes place. Notwithstanding the foregoing, the National Office will issue rulings regarding the application of the generation-skipping transfer tax effective date rules (section 1433 of the Tax Reform Act of 1986, 1986-3 C.B. (Vol. 1) to wills, trusts and trust equivalents in existence on October 22, 1986, and to generation-skipping transfers taking place on or before October 22, 1986.

.04 *In employment and excise tax matters,* the National Office issues rulings on prospective transactions and on completed transactions either before or after the return is filed for those transactions. In employment tax matters, generally the taxpayer is the employer. However, if the worker asks for the ruling, both the worker and the employer are considered to be the taxpayer and both are entitled to the ruling. The National Office usually will not issue rulings if, at the time the ruling is requested, the identical issue is involved in the taxpayer's return for an earlier period and (1) that issue is under examination by a District Director or under consideration by an Appeals Office, or (2) that issue has been examined by a District Director or considered by an Appeals Office and the statutory period of limitation on either assessment or for filing a claim for refund or credit of tax has not expired, or a closing agreement covering the issue or liability has not been entered into by a District Director or by an Appeals Office. However, if a District Director began an examination of the issue involved in the ruling request, the National Office usually will issue the ruling if the District Director agrees, by memorandum, to permit the ruling to be issued.

.05 *In administrative provisions matters,* the National Office issues rulings on issues arising under the Internal Revenue Code, and related statutes, and the regulations thereunder, that relate primarily to the time, place, manner, and procedures, for reporting and paying taxes; assessing and collecting taxes (including interest and penalties); abating, crediting, or refunding over assessments or overpayments of tax; and filing information returns. Rulings ordinarily are not issued, if, at the time the ruling is requested, the identical issue is involved in the taxpayer's return for an earlier period and (1) that issue is being considered by a District Director or an Appeals Office, or (2) that issue has been examined by a District Director or considered by an Appeals Office and the statutory period of limitation on either assessment or for filing a claim for refund, or credit of tax has not expired, or a closing agreement covering the issue or liability has not been entered into by a District Director or Appeals Office. If a return involving an issue for a particular year is filed while a request for a ruling on that issue is pending, the National Office will issue the ruling unless an examination of that issue or an examination of the identical issue on an earlier year's return has been started by a District Director. But, even if consideration has begun, the National Office ordinarily will issue the ruling if the District Director agrees, by memorandum, to permit the ruling to be issued.

.06 The National Office does not issue rulings to business, trade, or industrial associations or to similar groups concerning the application of the tax laws to members of the group. It may, however, issue rulings to these groups or associations on their own tax status or liability if the request meets the requirements of this section. Furthermore, such groups or associations may submit suggestions of generic issues that would be appropriately addressed in revenue rulings.

.07 Pending the adoption of regulations (either temporary or final) that interpret the provisions of any act, the issuing of rulings will be considered under the following conditions.

1. If the ruling request presents an issue on which the answer seems clear by applying the statute to the facts, a ruling will be issued under the usual procedures.

2. If the ruling request presents an issue on which the answer seems reasonably certain but not entirely free from doubt, a ruling will be issued.

3. Section 2.02 of Rev. Proc. 88-18, 1988-1 C.B. 694, which modified Rev. Proc. 88-1, provides that for Code sections enacted or amended by the Tax Reform Act of 1986 or the Revenue Act of 1987 the appropriate Branch will entertain all ruling requests and do its best to issue a ruling even if the answer does not seem reasonably certain.

However, if the ruling request presents an issue that cannot be readily resolved before regulations are issued, a ruling will not be issued. However, section 2.03 of Rev. Proc. 88-18 provides that where the Service has closed a regulations project or does not intend to open a regulations project, the appropriate Branch will entertain all ruling requests unless the issue is covered by section 7 of Rev. Proc. 89-1 or by Rev. Proc. 89-3, page 761, this Bulletin.

SEC. 6. DETERMINATION LETTERS ISSUED BY DISTRICT DIRECTOR

.01 District Directors issue determination letters only if the question presented is specifically answered by statute or regulation, or by a position stated in a ruling, opinion, or court decision published in the Internal Revenue Bulletin.

1. *In income and gift tax matters.* District Directors issue determination letters in response to taxpayers' written requests on completed transactions that affect returns over which they have examination jurisdiction. A determination letter usually is not issued for a question concerning a return to be filed by the taxpayer if the same question is involved in a return already filed. District Directors do not issue determination letters on the tax consequences of prospective or proposed transactions, except as provided in section 6.03.

2. *In estate tax matters.* District Directors issue determination letters in response to written requests affecting the estate tax returns over which they have examination jurisdiction. District Directors do not issue determination letters on matters concerning the application of the estate tax to property or the estate of a living person.

3. *In generation-skipping transfer tax matters,* District Directors issue determination letters in response to written requests affecting the generation-skipping transfer tax returns over which they have examination jurisdiction. District Directors do not issue determination letters on matters concerning the application of the generation-skipping transfer

tax before the distribution or termination takes place.

4. *In employment and excise tax matters,* District Directors issue determination letters on completed transactions in response to written requests from taxpayers over which they have examination jurisdiction.

.02 Notwithstanding the provisions of section 6.01, even though a request presents a question specifically answered by statute or regulation, or by a position stated in a ruling, opinion or court decision published in the Internal Revenue Bulletin, a District Director will not issue a determination letter in response to the request (1) if appears that the taxpayer has directed a similar inquiry to the National Office, (2) the same issue involving the same taxpayer is pending in a case before an Appeals Office, (3) the determination letter is requested by an industry, trade association, or similar group, or (4) the request involves an industry-wide problem. Under no circumstances will a District Director issue a determination letter unless it is clearly shown that the request concerns a return which has been filed or is required to be filed and over which the District Director has or will have examination jurisdiction. Notwithstanding the provisions of section 6.01, a District director will not issue a determination letter on an employment tax question if the specific question for the same taxpayer has been or is being considered by the Central office of the Social Security Administration or the Railroad Retirement Board. Nor will District Directors issue determination letters for determination of a constructive sales price under section 4216(b) or 4218(c) of the Code. The National Office, however, will issue rulings in this area. See section 7.04.

.03 District Directors issue determination letters on the replacement of involuntarily converted property under section 1033 even though the replacement has not been made, if the taxpayer has filed an income tax return for the year in which the property was involuntarily converted.

.04 A request received by a District Director on a question concerning an income, estate, or gift tax return already filed will be, in general, considered in connection with the examination of the return. If a response is made to such a request before the return is examined, it will be considered a tentative finding in any later examination of that return.

SEC. 7. DISCRETIONARY AUTHORITY TO ISSUE RULINGS AND DETERMINATION LETTERS

.01 The Service ordinarily will not issue rulings or determination letters in certain areas because of the factual nature of the problem involved, or for other reasons. Rev. Proc. 89-3, page 00, this Bulletin, provides a list of these areas. This list is not all inclusive, since the Service may decline to issue a ruling or a determination letter on other grounds, whenever warranted by the facts or circumstances of a particular case. The National Office and District Directors may, when it is considered appropriate and in the best interest of the Service, issue information letters calling attention to well-establishing principles of tax law.

.02 A ruling or a determination letter is not issued on alternative plans of proposed transactions or on hypothetical situations.

.03 The National Office ordinarily will not issue rulings on only part of an integrated transaction.

.04 The National Office will issue rulings in all cases on the determination of a constructive sales price under section 4216(b) or 4218(c) of the Code and in all other cases on prospective or future transactions if the law or regulations require a determination of the effect of a proposed transaction for tax purposes.

SEC. 8. INSTRUCTIONS TO TAXPAYER

.01 The taxpayer should submit a request for a ruling or a determination letter in duplicate if (1) more than one issue is presented in the request, or (2) a closing agreement is requested on the issue presented. It is not necessary to submit requests in duplicate under other circumstances except as set forth in section 8.10.

.02 A request for a ruling or determination letter and any factual information or change in the ruling request submitted at a later time must be accompanied by a declaration in the following form: "Under penalties of perjury, I declare that I have examined this request, including accompanying documents, and to the best of my knowledge and belief, the facts presented in support of the requested ruling or determination letter are true, correct, and complete." The declaration may not be made by the taxpayer's representative. It must be signed by the person or persons on whose behalf the request is made. The person who signs for a corporate taxpayer must be an officer of the corporate taxpayer who has personal knowledge of the facts. The officer must be one whose duties are not limited to obtaining a ruling or determination letter from the Service. Furthermore, if the corporate taxpayer is a member of an affiliated group filing consolidated returns, a penalties-of-perjury statement must also be submitted by the common parent of the group. The person signing for a trust or partnership must be a trustee or general partner who has personal knowledge of the facts. If multiple submissions of additional factual information are made, one declaration that refers specifically to each of the additional submissions may be provided.

.03 Section 10511 of the Revenue Act of 1987, Pub. L. 100-203, enacted December 22, 1987, requires the payment of user fees for requests for rulings, opinion letters, determination letter, and similar requests. Rev. Proc. 88-8, 1988-1 C.B. 628, which modified Rev. Proc. 88-1 and which was modified by Rev. Proc. 88-13, 1988-1 C.B. 639, and Rev. Proc. 88-27, 1988-1 C.B. 804, contains the schedule of fees and provides guidance for administering the user fee requirements. The amount of user fee payable with respect to each category of submission under the jurisdiction of the Associate Chief Counsel (Technical) is as follows:

Applications with respect to accounting periods (Forms 1128 and 2553)	$150
Change in accounting method (Form 3115)	$200
All other rulings (which includes accounting period, accounting method, and earnings and profits requests other than those submitted on Forms 1128, 2553, 3115, and 5452)	$300

.04 If more than one issue is presented in a request for a ruling, the Service generally will issue a single ruling letter. However, the taxpayer may request a separate ruling letter on any of the issues. Unless the Service determines that it is not feasible or not in the best interest of the Service to comply with such a request, it will issue separate ruling letters.

.05 When multiple issues are involved in a single factual situation and separate letters requesting rulings are submitted, a statement to this effect must be included in each ruling letter request. The Service in issuing each ruling will state that separate rulings have been issued or requests for rulings are pending.

.06 Each request for a ruling or a determination letter must contain a complete statement of all of the facts relating to the transaction. Such facts include: names, addresses, telephone numbers, and taxpayer identification numbers of all interested parties; the location of the District Office that has or will have examination jurisdiction over the return, not the Service Center where the return is filed and a full and precise statement of the business reasons for the transaction and a carefully detailed description of the transaction. (The term "all interested parties" does not mean that a list is required of all shareholders of a widely held corporation requesting a ruling relating to a reorganization, or a list of employees where a larger number may be involved.) If the request deals with only one step of a larger integrated transaction, the facts, circumstances, etc. relating to the entire transaction must be submitted. However, see section 7.03 of this revenue procedure (Rev. Proc. 89-1). In addition, true copies of all contracts, wills, deeds, agreements, instruments, and other documents in the transaction must be submitted with the request. Original documents, such as contracts wills, etc., should not be submitted because they become part of the Service's file and will not be returned. All material facts in documents must be included in the taxpayer's letter requesting a ruling or in supplemental letters, and not merely incorporated by reference, and must be accompanied by an analysis of their bearing on the issue or issues, specifying the provisions that apply. If the request concerns a corporate distribution, reorganization, or similar transaction, the corporate balance sheet and profit and loss statement should be submitted. If the request relates to a prospective transaction, the most recent balance sheet and profit and loss statement should be submitted.

Material facts furnished to the Service by telephone or orally at a conference must be promptly confirmed by letter to the Service with a declaration in the form described in section 8.02. This confirmation must be furnished within 21 calendar days to be considered part of the request. An extension of the 21-day period will be granted only if justified in writing by the taxpayer and approved by the Branch Chief, Senior Technician Reviewer, or Assistant to the Branch Chief of the Branch to which the case is assigned. A request for extension should be submitted before the end of the 21-day period. If unusual circumstances close to the end of the 21-day period make a written request impractical, within the 21-day period the National Office should be told of the problem and that the written request for extension will be coming soon. Such a request must be sent promptly. The taxpayer or taxpayer's representative will be told promptly and later in writing of the approval or denial of the requested extension. There is no right of appeal to a denial of an extension request. Because the purpose of these procedures is to speed up the ruling process, the taxpayer is encouraged to submit the required relevant material promptly. Therefore, requests for extension should be justified by compelling facts and circumstances. If the Service is not made aware, as provided above, of problems in meeting the 21-day period, or if the request is not sent promptly after the National Office is notified of problems in meeting the 21-day period, the Service will process the case on the assumption that no further submission will be received.

Specific guidelines for requesting rulings under certain Code sections follows: Rev. Proc. 88-32, 1988-1 C.B. 833, and Rev. Proc. 88-33, 1988-1 C.B. 835, supplementing Rev. Proc. 88-1 (guidelines for submitting request for rulings under sections 103 and 7478); Rev. Proc. 68-11, 1968-1 C.B. 761 (guidelines for a ruling request under section 117); Rev. Proc. 87-28, 1987-1 C.B. 770 (guidelines for a request for a ruling under section 162(k)); Rev. Proc. 86-18, 1986-1 C.B. 551 (guidelines concerning a request for a ruling under section 302 or 311); Rev. Proc. 81-68, 1981-2 C.B. 723 (guidelines concerning a request for a ruling under section 332, 334(b)(1) or 334(b)(2)); Rev. Proc. 86-16, 1986-1 C.B. 546 (guidelines concerning a request for a ruling under sections 331 and 337); Rev. Proc. 81-42, 1981-2 C.B. 611 (guidelines concerning a request for a ruling under section 302(b)(4)); Rev. Proc. 83-59, 1983-2 C.B. 575 (guidelines concerning a request for a ruling under section 351); Rev. Proc. 86-41, 1986-2 C.B. 716 (guidelines concerning a request for a ruling under section 355); Rev. Proc. 81-70, 1981-2 C.B. 729 (guidelines for estimating the basis of stock acquired in a section 368(a)(1)(B) reorganization); Rev. Proc. 81-60, 1981-2 C.B. 680 (guidelines concerning a request for a ruling under section 368(a)(1)(E)). See, however, section 3.0123 of Rev. Proc. 89-1, which describes circumstances under which the Service will not issue advance rulings or determination letters as to whether a transaction constitutes a corporate recapitalization within the meaning of section 368(a)(1)(E)(or a transaction that also qualifies under section 1036). Rev. Proc. 87-22, 1987-1 C.B. 718, and Rev. Proc. 77-37, 1977-2 C.B. 568, as superseded in part by Rev. Proc. 79-14, 1979-1 C.B. 469, and as amplified by Rev. Proc. 77-41, 1977-2 C.B. 574, Rev. Proc. 83-81, 1983-2 C.B. 598, Rev. Proc. 84-42, 1984-1 C.B. 521 and Rev. Proc. 86-42, 1986-2 C.B. 722 (certain other guidelines concerning requests for rulings handled by the office of the Assistant Chief Counsel (Corporate); Rev. Proc. 71-19, 1971-1 C.B. 698 (guidelines concerning requests for rulings on unfunded deferred compensation); Rev. Proc. 87-32, 1987-2 C.B. 396 (guidelines for requesting to adopt, retain or change an accounting period for partnerships, S corporations, and personal service corporations); Rev. Proc. 72-13, 1972-1 C.B. 735, Rev. Proc. 74-17, 1974-1 C.B. 438, and Rev. Proc. 75-16, 1975-1 C.B. 676 (guidelines on classification of limited partnerships); Rev. Proc. 82-58, 1982-2 C.B. 847 (guidelines on classification of organizations as liquidating trusts); Rev. Proc. 82-36, 1982-1 C.B. 490 (guidelines concerning requests for consent to elect not to defer gain or loss on deferred intercompany transactions); Rev. Proc. 79-63, 1979-2 C.B. 578 (factors considered and information needed for granting extensions under section 1.9100-1 of the Income Tax Regulation; Rev. Proc. 87-35, 1987-2 C.B. 456 (concerning requests for rulings under section 704(b); and Rev. Proc. 88-50, 1988-2 C.B. 711 (guidelines for requesting prospective estate tax rulings).

A ruling request that involves a question of whether a rate order, proposed or issued by a regulatory agency, will meet the normalization requirements of sections 46(f), 167(1), and 168(f)(2) (pre-Tax Reform Act of 1986, section 163(e)(3)) of the Code, ordinarily will not be considered unless the taxpayer states in the request for ruling whether:

(1) the regulatory authority responsible for establishing or approving the taxpayer's rates has reviewed the request and believes that the request is adequate and complete, and

(2) the taxpayer will permit the regulatory authority to participate in any National Office conference concerning the request. If the taxpayer or the regulatory authority informs a consumer advocate of the request for rulings and the advocate wishes to communicate with the Service regarding the request, any such communication should be sent to

Internal Revenue Service, Associate Chief Counsel (Technical), Attention CC:P&SI:6, Room 5112, 1111 Constitution Avenue N.W., Washington, D.C. 20224. These communications will be treated as third party contacts for purposes of section 6110 of the Code.

.07 The request must contain a statement of whether, to the best of the knowledge of the taxpayer and the taxpayer's representative(s), if any, the identical issue is in a prior return of the taxpayer (or in a return for any year of a related taxpayer within the meaning of section 267 of the Code, or of a member of an affiliated group of which the taxpayer is also a member within the meaning of section 1504). If so, the statement must specify whether the issue (1) is being examined by a District Director, (2) has been examined and the statutory period of limitation on either assessment or for filing a claim for refund or credit of tax has not expired, or a closing agreement covering the issue or liability has not been entered into by a District Director, (3) is being considered by an Appeals Office in connection with the taxpayer's return for an earlier period, or has been considered by an Appeals Office and the statutory period of limitation on either assessment or for filing a claim for refund or credit of tax has not expired, or a closing agreement covering the issue or liability has not been entered into by an Appeals Office, or (4) is pending in litigation in a case involving the taxpayer or a related taxpayer. The request must also contain a statement whether, to the best of the knowledge of the taxpayer and the taxpayer's representative(s), if any, (i) the identical or similar issue has been submitted to the Service, by the taxpayer or its predecessor, but withdrawn before a ruling was issued, or (ii) ruled on by the Service to the taxpayer or to the taxpayer's predecessor. If so, the statement must specify the date of submission, withdrawal, or ruling and other details of the Service's consideration of the issue. If, after the request is filed but before a ruling is issued, the taxpayer knows that an examination of the issue by a District Director has been started, the taxpayer must notify the National Office of such action. If a return is filed before a ruling is received from the National Office concerning the issue, a copy of the request must be attached to the return. This alerts the District Office and avoids premature District action on the issue.

.08 As an alternative procedure (known as the "two-part" ruling request procedure) for the issuance of rulings on prospective transactions, the taxpayer may submit a summary of the facts considered to be controlling the issue, in addition to the complete statement required for ruling requests by section 8.06. If the National Office agrees with the summary, the National Office will use it as the basis for the ruling. To use this procedure, the taxpayer should submit the following with the request for a ruling:

1. A complete statement of facts about the transaction, together with related documents, as required by section 8.06, and

2. A summary statement of the facts believed to be controlling in reaching the requested conclusion. When the taxpayer's statement of controlling facts is accepted, the Service will base its ruling on these facts and only this statement will ordinarily be incorporated in the ruling letter. It is emphasized, however, that:

(a) The taxpayer may elect this procedure for a "two-part" ruling request. It is not to be considered a required substitute for the regular procedures provided by this revenue procedure.

(b) The taxpayer's rights and responsibilities are the same under the "two-part" ruling request procedure as those provided in this revenue procedure.

(c) The Service reserves the right to rule on the basis of a more complete statement of facts it considers controlling and to seek more information in developing facts and restating them; and

(d) The "two-part" ruling request procedure will not apply, if it is inconsistent with other procedures, such as those dealing with request for permission to change accounting methods or periods; applications for recognition of exempt status under section 521 of the Code; or rulings on employment tax status.

.09 If the taxpayer advocates a particular conclusion, an explanation of the grounds for the assertion must be furnished, together with a statement of relevant authorities in support of the taxpayer's views. Even though the taxpayer is urging no particular tax treatment of a proposed or prospective transaction, the taxpayer's views on the tax results of the proposed action and a statement of relevant authorities to support those views must be furnished. In addition, the taxpayer is encouraged to inform the Service, and discuss the implications of any legislation, tax treaties, court decisions, regulations, revenue rulings or revenue procedures that the taxpayer determines to be contrary to the position advanced. If the taxpayer determines that there are no contrary authorities, a statement in the ruling request to this effect would be helpful. Identification and discussion of contrary authorities will generally enable Service personnel to arrive more quickly at a full understanding of the issue and the relevant authorities. There is a further advantage to the taxpayer. When Service personnel receive the request, they will have before them the taxpayer's thinking on the effect and applicability of contrary authorities. Such information should, therefore, make research easier and lead to earlier action by the Service. Conversely, failure to disclose and distinguish significant contrary authorities may result in requests for additional memoranda that will delay action on the ruling request.

.10 To assist the Service in making the deletions required by section 6110(c) of the Code from the text of rulings and determination letters, to be made open to public inspection under section 6110(a), a deletions statement must accompany each request. The statement must either state that no information other than names, addresses, and identifying numbers need be deleted or, if more information is proposed to be deleted, the statement must indicate the deletions proposed by the person requesting the ruling or determination letter. If the latter alternative is chosen, the statement must be made in a separate document, and it must be accompanied by a copy of the request for a ruling or determination letter and supporting documents, on which must be shown, by the use of brackets, the material that the person making the request believes should be deleted pursuant to section 6110(c). The statement of proposed deletions must indicate the statutory basis, under section 6110(c), for each proposed deletion. The statement of proposed deletions must not appear or be referred to anywhere in the request for a ruling or determination letter. If the person making the request decides to ask for additional deletions before the ruling or determination letter is issued, additional statements may be submitted. The procedures in this paragraph also apply to additional information that is submitted after the initial request.

.11 A request by or for a taxpayer must be signed by the taxpayer or the taxpayer's authorized representative. If the request is signed by a representative, or if the representative is to appear before the Service in connection with the request, the representative must be:

1. an attorney who is a member in good standing of the bar of the highest court of any state, possession, territory, commonwealth, or the District of Columbia, and who files with the Service a written declaration that he or she is currently qualified as an attorney and is authorized to represent the taxpayer;

2. a certified public accountant who is qualified to practice in any state, possession, territory, commonwealth, or the District of Columbia, and who files with the Service a written declaration that he or she is currently qualified as a certified public accountant and is authorized to represent the taxpayer;

3. a person, other than an attorney or certified public accountant who is currently enrolled to practice before the Service, and who files with the Service a written declaration that he or she is currently enrolled (including in the declaration either the enrollment number or the expiration date of the enrollment card) and is authorized to represent the taxpayer. (See Treasury Department Circular No. 230 (31 CFR Part 10), 1983-2 C.B. 742, for the rules on who may practice before the Service); or

4. a foreign representative who has received a "Letter of Authorization" from the Director of Practice, pursuant to section 10.7(b) of Treasury Department Circular No. 230. Practitioners may make written request for a "Letter of Authorization" to: Office of Director of Practice, PM:HR:DP, Internal Revenue Service, 1111 Constitution Ave., N.W., Washington, D.C. 20224. Section 10.7(b) of Circular No. 230 authorizes the Commissioner to allow any person to represent another without enrollment for the purpose of a particular matter. Without a "Letter of Authorization," the foreign representative may not represent the taxpayer before the Service.

The requirements above do not apply to an individual representing his or her fulltime employer, or to a bona fide officer, administrator, administratrix, trustee, etc., representing a corporation, trust, estate, association, or organized group. An unenrolled preparer of a return (other than an attorney or certified public accountant referred to in (1) and (2) above) who is not a full-time employee or a bona fide officer, administrator, administratrix, trustee, etc., may not represent a taxpayer in connection with a ruling or a determination letter.

Any authorized representative. whether or not enrolled to practice must also comply with the conference and practice requirements of the Statement of Procedural Rules (26 CFR 601). Form 2848, Power of Attorney, and Form 2848-D, Authorization and Declaration, may be used with regard to rulings, closing agreements, and determination letters requested under this revenue procedure.

.12 If a taxpayer has more than one representative, it is sufficient to send a copy of the ruling to any one of them. Copies of a ruling will be sent to no more than two representatives, provided that they are located at different mailing addresses. If a payer does not designate which representative is to receive a copy of the ruling, a copy of the ruling will be sent to the first representative named on the latest power of attorney. If the original of the ruling is to be sent to a representative, the power of attorney should contain a statement to that effect and designate the mailing address of the representative.

.13 A request for a ruling letter by the National Office should be sent to the Internal Revenue Service, Associate Chief Counsel (Technical), Attention CC:CORP:T, P.O. Box 7604. Ben Franklin Station, Washington, D.C. 20044. Requests may be hand delivered to Room, 6561, 1111 Constitution Avenue, N.W., Washington, DC 20224 between 8:30 a.m. and 4:00 p.m. on working days. A request for a determination letter should be sent to the District Director of Internal Revenue whose office has or will have examination jurisdiction over the taxpayer's return.

.14 If a request for a ruling or determination letter does not comply with all the provisions of this revenue procedure, the request will be acknowledged, and the requirements that have not been met will be pointed out. If a request for a ruling lacks essential information, the taxpayer will be told that if the information is not received within 30 calendar days, the request will be closed. If the information is received after the request is closed, it will be reopened and treated as a new request as of the date the essential information is received. A request for a ruling letter sent to the District Director that does not comply with the provisions of this revenue procedure will be returned by the District Director for corrections before it is sent directly to the National Office.

.15 A taxpayer who wants to have a conference on the issue or issues involved should indicate this in writing when, or soon after, filing the request.

.16 The Service processes requests for ruling and determination letters in regular order and as expeditiously as possible. Consideration of a request for processing ahead of its regular order, or by a specified time, delays the processing of other matters. Requests for processing ahead of the regular order must be made in writing, preferably in a separate letter with, or soon after, the request. If the request is not made in a separate letter, then the letter in which the request is made should say, at the top of the first page: "Expeditious Handling Is Requested. See page ___ of this letter." The request should give a compelling need for such treatment. The Service cannot give assurance that any letter will be processed by the time requested. For example, the scheduling of a closing date for a transaction or a meeting of the board of directors or shareholders of a corporation, without regard for the time it may take to obtain a ruling or determination letter, will not be considered sufficient reason for handling a request ahead of its regular order. Nor will the possible effect of fluctuation in the market price of stocks on a transaction be considered sufficient reason for handling a request out of order. Requests by telegram will be treated in the same manner as requests by letter. Ruling and determination letters ordinarily are not issued by telegram. A request for expeditious handling will not cause the Communications and Records Unit to route the case to the Ruling Branch ahead of normal-processing; and a request for expeditious handling will not be considered until the underlying ruling request has been found to satisfy the section 6110 requirements.

.17 The Assistant Chief Counsel (Corporate) has primary responsibility for providing basic principles and rules for uniform interpretation and application of the federal tax laws in those areas involving distributions in connection with corporate organizations, reorganizations, and liquidations; consolidated returns; allocation of income and deductions among taxpayers; acquisitions made to evade or avoid income tax; and, income taxes and earnings and profits of corporate taxpayers.

.18 The Assistant Chief Counsel (Employee Benefits and Exempt Organizations) has primary responsibility for providing basic principles and rules for uniform interpretation and application of the federal tax laws in those areas involving: income tax and other tax aspects of executive compensation and employee benefit programs (other than those within the jurisdiction of the Assistant Commissioner (Employee Plans and Exempt Organizations)); and employment taxes and taxes on self-employment income.

.19 The Assistant Chief Counsel (Financial Institutions and Products) has primary responsibility for providing basic principles and rules for the uniform application of the federal income tax laws in those areas involving: income taxes of banks, savings and loan associations, real estate investment trusts (REITs), regulated investment companies (RICs), real estate mortgage investment conduits (REMICs), tax exempt obligations, insurance companies and products, and financial products.

.20 The Assistant Chief Counsel (Income Tax and Accounting) has primary responsibility for providing basic principles and rules for uniform application of the federal income tax laws in those areas involving: recognition and timing of income and deductions of individuals and corporations, sales and exchanges, capital gains and losses, administrative provisions, accounting methods and periods, installment sales, equipment leasing, inventories, and the alternative minimum tax.

.21 The Assistant Chief Counsel (Passthroughs and Special Industries) has primary responsibility for providing basic principles and rules for uniform interpretation and application of the federal income tax laws in those areas involving income taxes of S corporations (except accounting periods and methods) and certain noncorporate taxpayers (including partnerships and trusts); estate, gift, generation-skipping transfer, and certain excise taxes; depreciation, depletion, and other engineering issues; cooperative housing corporations; farmers' cooperatives (under section 521), the low-income housing credit, research and experimental expenditures, shipowners' protection and indemnity associations (under section 526), and certain homeowners associations.

.22 A taxpayer may obtain information regarding the status of a request by calling the person whose name and telephone number is shown on the acknowledgment of receipt of the request.

.23 After receiving the notice under section 6110(f)(1) of the Code of intention to disclose the ruling or determination letter (including a copy of the version proposed to be open to public inspection and notation of third-party communications under section 6110(d)), the person requesting the ruling or determination letter may protest the disclosure of certain information in the ruling or determination letter. That person must within 20 calendar days send a written statement to the Internal Revenue Service office indicated on the notice of intention to disclose identifying those deletions that the Service has not made and that the person requesting the ruling or determination letter believes should have been made. That person must also submit a copy of the versions of the ruling or determination letter proposed to be open to public inspection on which the person indicates, by use of brackets, the deletions proposed by the taxpayer that have not been made by the Service. Generally, the Service will not consider the deletion under this subparagraph of any material that the taxpayer did not propose to be deleted before the ruling or determination letter was issued. Within 20 days after it receives the response to the notice under section 6110(f)(1), the Service will mail to that person its final administrative conclusion regarding the deletions to be made. The taxpayer does not have the right to a conference to resolve any disagreements concerning material to be deleted from the text of the ruling. However, these matters may be taken up at any conference that is otherwise scheduled regarding the request.

.24 After receiving the notice under section 6110(f)(1) of the Code of intention to disclose (but not later than 60 calendar days after the notice is mailed), the person requesting a ruling or determination letter may send a request for delay of public inspection under either section 6110(g)(3) or (4). The request for delay must be sent to the Internal Revenue Service office indicated on the notice of intention to disclose. A request for delay under section 6110(g)(3) must contain the date on which it is expected that the underlying transaction will be completed. The request for delay under section 6110(g)(4) must contain a statement from which the Commissioner may determine that there are good reasons for the delay.

.25 A taxpayer who receives a ruling or determination letter before filing a return about any transaction that has been consummated and that is relevant to the return being filed should attach a copy of the ruling or determination letter to the return when it is filed.

.26 For appeal procedures with regard to adverse determination letters under section 521 of the Code and revocation or modification of exemption rulings and determination letters under section 521, see Rev. Proc. 84-46, 1984-1 C.B. 541, as amplified by Rev. Proc. 84-47, 1984-1 C.B. 545, and modified by Rev. Proc. 85-32, 1985-2 C.B. 415.

.27 In those situations when the National Office believes that the taxpayer's representative is not in compliance with Treasury Department Circular No. 230, the National Office will bring the matter to the attention of the Director of Practice.

SEC. 9. HANDLING OF RULING REQUESTS

.01 Within 21 calendar days after a ruling request is received in the Branch, Service personnel will contact the taxpayers to discuss informally the procedural and substantive issues in the ruling request.

.02 The following subject matters are included in the 21 calendar day procedure:

1. All matters within the jurisdiction of the Assistant Chief Counsel (Corporate).

2. All matters within the jurisdiction of the Assistant Chief Counsel (Employee Benefits and Exempt Organizations) involving

(a) Stock options,

(b) Employment and self-employment taxes (except ruling requests from individuals for employment status submitted on Forms SS-8), and

(c) Rental value of parsonages

3. All matters within the jurisdiction of the Assistant Chief Counsel (Financial Institutions and Products) except cases concerning insurance issues requiring actuarial computations.

4. All matters within the jurisdiction of the Assistant Chief Counsel (Income Tax and Accounting), except cases involving a request for change in accounting methods or periods, generally governed by Rev. Proc. 84-74, 1984-2 C.B. 736.

5. All matters within the jurisdiction of the Assistant Chief Counsel (Passthroughs and Special Industries).

.03 Procedures to be followed regarding ruling requests are:

1. Within 21 calendar days after a ruling request has been received in the Branch having jurisdiction, a representative of the Branch will contact the taxpayer to discuss the procedural issues in the ruling requests covered by this procedure. Considering the complexity of

some cases or the number of issues involved, it may not be possible for the Branch representative to discuss the substantive issues in the ruling request during this initial contact. However, when possible, as to each issue coming within the jurisdiction of the Branch, the Branch representative will tell the taxpayer:

(a) whether the Branch representative will recommend the Service rule as the taxpayer requested, rule adversely on the matter, or not rule;

(b) whether the taxpayer should submit additional information or representations to enable the Service to rule on the matter; or

(c) whether because of the nature of the transaction, or the issue presented, a tentative conclusion on the issue cannot be reached.

2. When the rulings requested involve matters within the jurisdiction of more than one Branch, a representative of the Branch that received the original ruling request will tell the payer within the initial 21-calendar-day contact period: (1) that the rulings requested involving matters within the jurisdiction of another Branch have been referred to the other Branch for consideration, and (2) that a representative of the other Branch will contact the taxpayer within 21 calendar days after receiving the referral to informally discuss the procedural and, to the extent possible, the substantive issues if covered by this procedure.

3. If something less than a fully favorable ruling is indicated, the Branch representative will tell the payer if minor modifications of the transaction or adherence to certain published positions will warrant the issuance of a favorable ruling. In addition, the Branch representative may tell the taxpayer what representations must be furnished in a document to comply with the requirements of the Service. However, the Branch representative will not suggest precise changes that would materially alter the form of the proposed transaction. If, at the conclusion of the discussion, the Branch representative determines that a meeting in the National Office would better serve the purpose of developing or exchanging information, a meeting will be offered and an early meeting date arranged. This meeting will not be the taxpayers conference of right, as described in this revenue procedure.

4. The Service will not be bound by the informal opinion expressed by the Branch representative or any other authorized Service representative under this procedure, and such an opinion cannot be relied upon as a basis for obtaining retroactive relief under the provisions of section 7805(b) of the Code.

5. The ruling request will then be processed under present procedures.

SEC. 10. CONFERENCES IN THE NATIONAL OFFICE

.01 A taxpayer may request a conference only in connection with a ruling request. Normally, a conference is scheduled only when the National Office considers it to be helpful in deciding the case or when an adverse decision is indicated. If conferences are being arranged for more than one request for a ruling involving the same taxpayer, they will be scheduled so as to cause the least inconvenience to the taxpayer. If a conference has been requested, the taxpayer will be notified by telephone, if possible, of the time and place of the conference. The conference must be held within 21 calendar days after such contact has been made. Procedures for requesting an extension of the 21-day period and notifying the taxpayer or the taxpayer's representative of the Service's decision are the same as those stated in section 8.06.

.02 A taxpayer is entitled, as a matter of right, to only one conference in the National Office unless one of the circumstances discussed in section 10.06 develops. This conference normally will be held at the Branch level and will be attended by a person who, at the time of the conference, has authority to sign the ruling letter in his or her own name or for the Branch Chief in the case being discussed. When more than one Branch has taken an adverse position on an issue within its jurisdiction presented in a ruling request, or when the position ultimately adopted by one Branch will affect another Branch's determination, a representative from each Branch with the authority to sign in his or her own name or for the Branch Chief will attend the conference. If more than one subject is to be discussed at the conference, the discussion will constitute a conference on each subject. In order to promote a free and open discussion of the issues, the conference usually will be held after the Branch has had an opportunity to study the case. However, at the request of the taxpayer or representative, the conference of right may be held at an earlier stage in the consideration of the case than the Service ordinarily would designate. No taxpayer has a "right" to appeal the action of a Branch to an Assistant Chief Counsel or to any other official of the Service.

.03 In employment tax matters, only the party entitled to the ruling is entitled to a conference

.04 Since conference procedures are informal, no tape, stenographic, or other verbatim recording of a conference will be made.

.05 The senior Service representative present at the conference insures that the taxpayer has full opportunity to present views on all of the issues that are in question. The Service representative explains the Service's tentative decision on the substantive issues and the reason for that decision. If the taxpayer advances prospective application under section 7805(b) of the Code, the Service representative will discuss the tentative recommendation concerning the request for relief and the reason for the tentative recommendation. No commitment will be made as to the conclusion that the Service will finally adopt.

.06 An invitation to an additional conference will be extended if, after the conference of right, an adverse holding is proposed but on a new issue or on the same issue but on different grounds from those discussed at the first conference. There is no right to another conference when a proposed holding is reversed at a higher level with a result less favorable to the taxpayer if the ground or arguments on which the reversal is based were discussed at the conference of right. The provision of this revenue procedure limiting the number of conferences to which a taxpayer is entitled will not prevent a taxpayer from attending further conferences when, in the opinion of National Office personnel. such conferences are necessary. All additional conferences of the type discussed in this paragraph are held only at the invitation of the Service.

.07 It is the responsibility of the taxpayer to furnish in writing to the National Office any additional data, lines of reasoning, precedents, etc., that are proposed by the taxpayer and discussed at the conference but that were not previously or adequately presented in writing. The taxpayer must furnish the additional information within 21 calendar days. If the additional information is not received within that time, a ruling will be issued on the basis of the information on hand or, if appropriate, no ruling will be issued. Procedures for requesting an extension of the 21-day period and notifying the taxpayer or the taxpayer's representative of the Service's decision are the same as those stated in section 8.06.

.08 In certain instances, it will be advantageous to both the Service and the taxpayer to hold a conference prior to submission of a ruling request to discuss substantive or procedural issues relating to a proposed transaction. Where the taxpayer intends to file a ruling request, pre-submission conferences will be held on a time-available basis, and generally the taxpayer will be requested to provide a draft ruling request or other detailed written description of the proposed transaction prior to the conference. Any discussion of substantive issues at a pre-submission conference is advisory only, is not binding on the Service, and cannot be relied upon as a basis for obtaining retroactive relief under the provisions of section 7805(b) of the Code. A ruling request submitted following the pre-submission conference will not necessarily be assigned to the Branch that held the pre-submission conference.

SEC. 11. DISTRICT OFFICE REFERRAL OF MATTERS TO THE NATIONAL OFFICE

.01 Request for determination letters received by District Directors that, under the provisions of this revenue procedure, may not be acted upon by a District Office, will be forwarded to the National Office for reply. The District Office will let the taxpayer know that this action has been taken. District Directors will also refer to the National Office any request for a determination letter that in their judgment should have the attention of the National Office.

.02 If the request involves an issue on which the Service will not issue a ruling or determination letter, the request will not be forwarded to the National Office. The District Office will let the taxpayer know that the Service will not issue a ruling or a determination letter on the issue. See section 7.01 of this revenue procedure.

SEC. 12. REFERRAL OF MATTERS TO DISTRICT OFFICES

Request for rulings received by the National Office that, under section 5 of this revenue procedure, may not be acted upon by the National Office will be forwarded to the District Office that has examination jurisdiction over the taxpayer's return. The taxpayer will be notified of this action. If the request is on an issue or in an area of the type discussed in section 7.01 and it is decided not to issue a ruling or an information letter, the National Office will let the taxpayer know and the request will then be forwarded to the appropriate District Office for association with the related return.

SEC. 13. REVIEW OF DETERMINATION LETTERS

Determination letters issued under section 6.01 are not reviewed by the National Office before they are issued. If a taxpayer believes that a determination letter of this type is in error, the taxpayer may ask the District Director to reconsider the matter. The taxpayer may also ask the District Director to request technical advice from the National Office. In such an event the procedures in Rev. Proc. 89-2 must be followed.

SEC. 14. WITHDRAWAL OF REQUESTS

A request for a ruling or determination letter may be withdrawn at any time before the signing of the letter of reply. If a request for a ruling is withdrawn, the National Office may give its views on the subject matter of the request to the District Director whose office will have examination jurisdiction over the taxpayer's return for consideration in connection with any later examination of the taxpayer's return. Even though a request is withdrawn, all correspondence and exhibits will be kept by the Service and will not be returned to the taxpayer. In appropriate cases, the Service may publish its findings in a revenue ruling or revenue procedure.

SEC. 15. ORAL ADVICE TO TAXPAYERS

.01 The Service does not issue rulings or determination letters on oral requests. However, personnel in the branches ordinarily will discuss with taxpayers or their representatives inquiries regarding: substantive tax issues; whether the Service will rule on particular issues; and questions relating to procedural matters about submitting ruling requests (including the application of section 8, of this revenue procedure, to a particular case). Any discussion of substantive issues will be at the discretion of the Service on a time available basis, will not be binding on the Service, and cannot be relied upon as a basis for obtaining retroactive relief under the provisions of section 7805(b) of the Code.

.02 A taxpayer may seek oral technical assistance from a Taxpayer Service Representative in a District Office or Service Center when preparing a return or report, under other established procedures. Oral advice is advisory only, and the Service is not bound to recognize it in the examination of the taxpayer's return.

SEC. 16. EFFECT OF RULINGS

.01 A taxpayer may not rely on a ruling issued to another taxpayer. A ruling, except to the extent incorporated in a closing agreement, may be revoked or modified at any time under appropriate circumstances. See section 4.08 for the effect of a closing agreement. If a ruling is revoked or modified, the revocation or modification applies to all years open under the statutes, unless the Commissioner or the Commissioner's delegate exercises the discretionary authority under section 7805(b) of the Code to limit the retroactive effect of the revocation or modification. The manner in which the authority generally is exercised is given later in this section. For information on rulings relating to the sale or lease of articles subject to the manufacturer's excise tax and the retailer's excise tax, see section 16.08.

.02 When determining a taxpayer's liability, the District Director must ascertain whether (1) any ruling previously issued to the taxpayer has been properly applied, (2) the representations upon which the ruling was based reflected an accurate statement of the material facts, and (3) the transaction actually was carried out substantially as proposed. If, in the course of determining the tax liability, the District Director finds that a ruling should be modified or revoked, the findings and recommendations of the District Director will be forwarded to the National Office for consideration before further action. Such a referral to the National Office will be treated as a request for technical advice and the procedures of Rev. Proc. 89-2 will be followed. Otherwise, the ruling is to be applied by the District Office in its determination of the taxpayer's liability.

.03 Appropriate coordination with the National Office will be undertaken if any field official having jurisdiction over a return or other matter proposes to reach a conclusion contrary to a ruling previously issued to the taxpayer.

.04 Except to the extent incorporated in a closing agreement, a ruling found to be in error or not in accord with the current views of the Service may be modified or revoked. Modification or revocation of a ruling may be made by (1) a notice to the taxpayer to whom the ruling was issued, (2) an enactment of legislation or ratification of a tax treaty, (3) a decision of the United States Supreme Court, (4) the issuing of temporary or final regulations, or (5) the issuing of a revenue ruling, a revenue procedure, or other statement published in the Internal Revenue Bulletin. Consistent with these provisions, if a ruling relates to a continuing action or a series of actions, the ruling will ordinarily be applied until any one of the actions described above has taken place, or until specifically withdrawn. Publication of a notice of proposed rulemaking will not affect the application of any ruling issued under the procedures stated in this revenue procedure.

.05 Except in rare or unusual circumstances, the revocation or modification of a ruling will not be applied retroactively to the taxpayer for whom the ruling was issued or to a taxpayer whose tax liability was directly involved in the ruling if (1) there has been no misstatement or omission of material facts, (2) the facts at the time of the transaction are not materially different from the facts on which the ruling was based, (3) there has been no change in the applicable law, (4) the ruling was originally issued with respect to a prospective or proposed transaction, and (5) the taxpayer directly involved in the ruling acted in good faith in reliance upon the ruling and the retroactive revocation would be to the taxpayer's detriment. For example, the tax liability of each shareholder is directly involved in a ruling on the reorganization of a corporation. However, the tax liability of members of an industry is not directly involved in a ruling issued to one of the members, and the holding in a revocation or modification of a ruling to one member of an industry may be retroactively applied to other members of the industry. By the same reasoning, a tax practitioner may not obtain the non-retroactive application to one client of a modification or revocation of a ruling previously issued to another client. If a ruling is revoked by letter with retroactive effect, the letter will, except in fraud cases, state the grounds upon which the revocation is being made and the reasons why the revocation is being applied retroactively.

.06 A ruling issued on a particular transaction represents a holding of the Service on that transaction only. Furthermore, except in rare or unusual circumstances, the application of that ruling to the transaction will not be affected by the later issuance of regulations (either temporary or final), if the conditions specified in section 16.05 are met. However, if the ruling is later found to be in error or no longer in accord with the position of the Service, it will not give the taxpayer protection for a like transaction in the same year or later year.

.07 However, if a ruling is issued covering a continuing action or series of actions and it is determined that the ruling was in error, or no longer in accord with the position of the Service, the Associate Chief Counsel (Technical) ordinarily will limit the retroactivity of the revocation or modification to a date that is not earlier than that on which the ruling is modified or revoked. To illustrate, if a taxpayer receives a ruling that certain payments are excludable from gross income for federal income tax purposes and it is later determined that the ruling is in error or no longer in accord with the position of the Service, the Associate Chief Counsel (Technical) ordinarily will restrict the retroactive application of the revocation or modification of the ruling. If a taxpayer rendered service or provided a facility that is subject to the excise tax on services or facilities, and in reliance on a ruling issued to the same taxpayer did not pass the tax on to the user of the service of the facility, the Associate Chief Counsel (Technical) ordinarily will restrict retroactive application of the revocation or modification of the ruling. If an employer incurred liability under the Federal Insurance Contributions Act, but in reliance on a ruling made to the same employer, neither collected the employee tax nor paid the employee and employer taxes under the Act, the Associate Chief Counsel (Technical) ordinarily will restrict the retroactive application of the revocation or modification of the ruling for both the employer tax and the employee tax. In the last situation, however, the restriction of retroactive application ordinarily will be conditioned on the furnishing by the employer of wage data, as may be required by section 31.6011(a)-1 of the Employment Tax Regulations.

.08 A ruling holding that the sale or lease of a particular article is subject to the manufacturer's excise tax or the retailer's excise tax may not retroactively revoke or modify an earlier ruling holding that the sale or lease of such an article was not taxable, if the taxpayer to whom the ruling was issued, in reliance upon the earlier ruling, parted with possession or ownership of the article without passing the tax on to the customer. Section 1108(b), Revenue Act of 1926.

.09 For rulings involving completed transactions other than those described in sections 16.07 and 16.08, taxpayers will not be given the protection against retroactive revocation provided in section 16.05, since they will not have entered into the transactions in reliance on the ruling.

SEC. 17. EFFECT OF DETERMINATION LETTERS

A determination letter issued by a District Director has the same effect as a ruling issued to a taxpayer under section 16 of this revenue procedure. However, if the District Director is of the opinion that a conclusion contrary to that expressed in the determination letter is indicated, the matter need not be referred to the National Office. A District Director may not limit the modification or revocation of a determination letter but may refer the matter to the National Office for the possible exercise by the Commissioner or the Commissioner's delegate of the authority to limit the modification or revocation.

SEC. 18. EFFECT OF INFORMATION LETTERS

An information letter issued by the National Office or by a District Director is advisory only and the provisions of section 16 do not apply.

SEC. 19. PROCEDURE FOR REQUESTING APPLICATION OF SECTION 7805(b) IN THE CASE OF RULINGS AND DETERMINATION LETTERS

.01 Pursuant to section 7805(b) of the Code, it is within the discretion of the Commissioner or the Commissioner's delegate to prescribe the extent, if any, to which any ruling (including determination letters) will be applied without retroactive effect.

A taxpayer to whom a ruling or determination letter has been issued may request that the Associate Chief Counsel (Technical), the Commissioner's delegate, exercise the discretionary authority under section 7805(b) of the Code to limit the retroactive effect of any subsequent revocation or modification of the ruling or determination letter.

.02 In the case of a ruling, a request to limit the retroactive effect of the revocation or modification of a ruling must be in the form of, and meet the requirements for, a ruling request generally. These requirements are set forth in section 8 of this revenue procedure. Specifically, the request must state that it is being made pursuant to section 7805(b), contain a statement of the relief sought and an explanation of the reasons and arguments in support of the relief requested, and also be accompanied by any documents bearing on the request. The explanation support of the application of section 7805(b) should include a discussion of the five items enumerated in section 16.05 of this revenue procedure as they relate to the taxpayer's particular situation.

A request for the application of section 7805(b) of the Code may take the form of a separate request for a ruling when, for example, a revenue ruling has the effect of modifying or revoking a ruling previously issued to the taxpayer or when the Service notifies the taxpayer of a change in position that will have the effect of revoking or modifying such a ruling. However, when such notice is given by the District Director during the course of an examination of the taxpayer's return, or during consideration by the Chief, Appeals Office, a request to limit the retroactive effect of the modification or revocation of a ruling must be made in the form of a request for technical advice. See section 12.03 of Rev. Proc. 89-2. When germane to a pending ruling request, a request for the application of section 7805(b) may be made as part of the request, either initially or at any time before the ruling is issued. When a ruling that concerns a continuing transaction is modified or revoked by, for example, a subsequent revenue ruling, a request to limit the retroactive effect of the modification or revocation of the ruling must be made before the return is examined that contains the transaction that is the subject of the request for a ruling.

.03 When a request for the application of section 7805(b) of the Code is made in a separate ruling request, the taxpayer has the right to a conference in the National Office in accordance with the provisions of section 10 of this revenue procedure. If the request is made initially as part of a pending ruling request or is made before the conference of right is held on the substantive issues, the section 7805(b) issue will be discussed at the taxpayer's one conference of right. (See section 10.05 of this revenue procedure). If the request for the application of section 7805(b) is made as part of a pending ruling request after a conference has been held on the substantive issue, and the Service determines that there is justification for having delayed the request, then the taxpayer will have the right to one conference of right concerning the application of section 7805(b) with the conference limited to discussion of this issue.

.04 In the case of a determination letter that the District Director proposes to modify or revoke, a request to limit the modification or revocation of the determination letter must be made by requesting the District Director who issued the determination letter to seek technical advice from the National Office, since a District Director has not been delegated authority under section 7805(b) of the Code to limit the modification or revocation of a determination letter. See section 12.03 of Rev. Proc. 89-2. The taxpayer's request must state that it is being made pursuant to section 7805(b), contain a statement of the relief sought and an explanation of the reasons and arguments in support of the relief requested, and also be accompanied by any documents bearing on the request. The explanation in support of the application of section 7805(b) should include a discussion of the five items enumerated in section 16.05 of this revenue procedure as they relate to the taxpayer's particular situation.

.05 When technical advice is requested with respect to the application of section 7805(b) of the Code under the circumstances set forth in section 19.04 above, the taxpayer has a right to a conference in the National Office to the same extent as does any taxpayer who is the subject of a technical advice request. See section 8 of Rev. Proc. 89-2.

SEC. 20. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 88-1 and 88-6 are superseded. Rev. Procs. 88-8, 88-18, 88-50, 88-32, and 88-33 are not superseded.

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26 CFR 601.105: Examination of returns and claims for refund, credit or abatement, determination of correct tax liability.

Rev. Proc. 89-2

CONTENTS

SECTION 1. PURPOSE

The purpose of this revenue procedure is to update Rev. Proc. 88-2, 1988-1 C.B. 571, which provides revised procedures for furnishing technical advice to District Directors and Chiefs, Appeals Office, by the Associate Chief Counsel (Technical). It also tells taxpayers about their rights when a District Director or a Chief, Appeals Office, requests such advice. Changes to this revenue procedure will be incorporated annually in a new revenue procedure published as the second revenue procedure of the year.

SEC. 2. SCOPE

.01 The Chief Counsel through the Associate Chief Counsel (Technical) provides principles and rules for uniformly interpreting and applying the federal tax laws under the jurisdiction of the Associate Chief Counsel (Technical.) The procedures for obtaining technical advice on specific issues involving the interpretation or application of the federal income tax laws and income tax treaties relating to international transactions are not contained in this revenue procedure but are contained in Rev. Proc. 87-5, 1987-1 C.B. 535. The procedures for obtaining technical advice specifically applicable to federal firearms, alcohol and tobacco taxes under subtitle E of the Internal Revenue Code are under the jurisdiction of the Bureau of Alcohol, Tobacco and Firearms. The procedures for obtaining technical advice specifically on issues under the jurisdiction of the Assistant Commissioner (Employee Plans and Exempt Organizations) are found in Rev. Proc. 80-26, 1980-1 C.B. 671, as modified by Rev. Proc. 83-41, 1983-1 C.B. 775. The procedures that apply to technical advice for employee plans and exempt organizations are followed in obtaining technical advice on exemption of farmers' cooperatives from tax under section 521 of the Code, even though the Associate Chief, Counsel (Technical) has jurisdiction for issuing technical advice under this section. The Associate Chief Counsel (Technical) also has the jurisdiction for issuing technical advice under section 526, on shipowners' protection and indemnity associations; and section 528, on certain homeowners associations, under this revenue procedure.

.02 In the Office of the Associate Chief Counsel (Technical), the authority to issue technical advice has been largely redelegated to the Branch Chiefs in the offices of the Assistant Chief Counsel (Corporate), The Assistant Chief Counsel (Employee Benefits and Exempt Organizations), the Assistant Chief Counsel (Financial Institutions and Products), the Assistant Chief Counsel (Income Tax and Accounting), and the Assistant Chief Counsel (Passthrough and Special Industries).

SEC. 3. CHANGES

.01 References throughout the revenue procedure to the Associate Chief Counsel (Technical, and International) are changed to the Associate Chief Counsel (Technical) to reflect that separate Associate Chief Counsel positions have been established for the Technical and International Organizations.

.02 Section 8.01 is amended to provide that an extension of the 21-day period for conferences must be approved by the Branch Chief, Senior Technician Reviewer or Assistant to the Branch Chief of the Branch to which the case is assigned.

.03 Section 8.07 is amended to provide that an extension of the 21-day period for post-conference submissions must be approved by the Branch Chief, Senior Technician Reviewer, or Assistant to the Branch Chief of the Branch to which the case is assigned.

SEC. 4. DEFINITIONS AND NATURE OF TECHNICAL ADVICE

.01 For purposes of this revenue procedure, the word "taxpayer" includes all persons subject to any provision of the Internal Revenue Code and, when appropriate, their representatives and issuers of section 103 obligations.

.02 Any reference to the National Office means only the Office of the Associate Chief Counsel (Technical).

.03 Any reference to District Director or District Office includes the office of the Director of the Foreign Operations District, where appropriate. Any reference to Chief, Appeals Office, includes Associate Chief, Appeals Office.

.04 "Technical advice" means advice or guidance furnished by the National Office upon requests of a District or an Appeals Office in response to any technical or procedural question that develops during any stage of any proceeding on the interpretation and proper application of tax law, tax treaties, regulations, revenue rulings, or other precedents published by the National Office to a specific set of facts. Such proceedings include (1) the examination of a taxpayer's return, (2) consideration of a taxpayer's claim for refund or credit, or (3) any other matter involving a specific taxpayer under the jurisdiction of the Chief, Examination Division, such as the consideration of a taxpayer's application to enter into an agreement about the useful life method, and rate of depreciation of business property provided by section 167(d) of the Code. These proceedings include an examination to determine whether obligations issued are described in section 103(a). They also include processing and considering nondocketed cases in an Appeals Office. Technical advice is furnished as a way of helping Service personnel close cases and establish and maintain consistent holdings throughout the Internal Revenue Service. A District Director or an Appeals Office may raise an issue in any tax period, even though technical advice may have been asked for and furnished for the same or a similar issue for another tax period. Technical advice does not include memoranda on matters of general technical application furnished to District or Appeals Offices when the issues are not raised in connection with a proceeding involving a specific taxpayer.

.05 If a District Director, Chief, Appeals Office, or a taxpayer requests technical advice on a determination letter under section 521 of the Code, the procedures under Rev. Proc. 80-26, 1980-1 C.B. 671, and Rev. Proc. 84-46, 1984-1 C.B. 541, as modified by Rev. Proc. 85-32, 1985-2 C.B. 414, as well as section 501.201(n) of the Statement of Procedural Rules, must be followed.

.06 Only the National Office can revoke a ruling letter. Therefore, if a District Director or a Chief, Appeals Office, thinks that a ruling letter previously issued to a taxpayer should be modified or revoked, including a ruling that involves a matter that is the subject of or is otherwise closely related to a criminal or civil fraud investigation or a jeopardy or termination assessment, the procedures in section 5 of this revenue procedure must be followed.

.07 The provisions of this revenue procedure apply only to a case under the jurisdiction of a District Director or Chief, Appeals Office. Technical advice may be requested on issues considered in a prior Appeals disposition, not based on mutual concessions for the same tax period of the same taxpayer, if the Appeals Office that had the case concurs in the request. A District Director may not request technical advice on an issue if an Appeals Office is currently considering an identical issue of the same taxpayer (or of a related taxpayer within the meaning of section 267 of the Code or a member of an affiliated group of which the taxpayer is also a member within the meaning of section 1504). A case remains under the jurisdiction of the District Director even through an Appeals Office has the identical issue under consideration in the case of another taxpayer (not related within the meaning of sections 267 and 1504, respectively) in an entirely different transaction. With respect to the same taxpayer or the same transaction, when the issue is under the jurisdiction of an Appeals Office, and the applicability of more than one kind of tax is dependent upon the resolution of that issue, a District Director may not request technical advice on the applicability of any of the taxes involved.

SEC. 5. REQUESTING TECHNICAL ADVICE

.01 The District Director or Chief, Appeals Office is responsible for determining whether to request technical advice on any issue being considered. Each request must be submitted through channels and signed by a person who is authorized to sign for the District Director or Chief, Appeals Office, and should include, in writing, a statement of applicable law and the arguments submitted by the District or Appeals Office in support of its position on the issue or issues. All requests for technical advice from Appeals Offices should be submitted to the Associate Chief Counsel (Technical) through the National Director of Appeals, CC:AP:PT. However, while the case is under the jurisdiction of the District Director or the Chief, Appeals Office, a taxpayer may request that an issue be referred to the national Office for technical advice. All requests for technical advice should be made at the earliest possible stage of the proceedings. The grounds for a request are that a lack of uniformity exists on the disposition of the issue or that the issue is unusual or complex enough to warrant consideration by the National Office. Taxpayers may also request technical advice when seeking an extension of time fixed by regulations for making an election or application for relief pursuant to section 1.9100-1 of the Income Tax Regulations. See section 5.11 of this revenue procedure for additional information. Although taxpayers are encouraged to make written requests setting forth the facts, law, and argument on the issue, and reasons for requesting National Office technical advice, they may make the request orally. If, after considering the taxpayer's request, the examining officer or Appeals Officer thinks that the circumstances do not warrant referral of the case to the National Office, the examining officer or Appeals Officer will tell the taxpayer. (See section 6 for taxpayer's appeal rights when an examining officer or an Appeals Officer declines to request technical advice).

.02 When technical advice is going to be requested, whether or not on the request of the taxpayer, the taxpayer will be told about it and given a copy of the arguments submitted by the District Director or Chief, Appeals Office, in support of its position on the issue or issues, except as noted in section 5.10. If the examining Officer or the Appeals Officer initiates the action, the Service will give the taxpayer a copy of the statement of the pertinent facts and the questions proposed for submission to the National Office. The request for technical advice should be worded to avoid possible misunderstanding in the National Office of the facts or the specific points at issue.

.03 If the Service initiates the request for technical advice, the taxpayer has 10 calendar days after receiving the statement of facts and specific questions to indicate in writing any disagreement about them. The taxpayer must justify in writing an extension of time beyond the 10 calendar days. The justification must be approved by the Chief, Examination Division, or the Chief, Appeals Office. Every effort should be made to reach agreement on the facts and the specific points at issue. If agreement cannot be reached, the taxpayer may send, within 10 calendar days after receipt of notice, a statement of the taxpayer's understanding of the new specific points at issue. This statement will be forwarded to the National Office with the request for technical advice. The taxpayer must justify in writing an extension of time beyond the 10 calendar days. The justification must be approved by the Chief, Examination Division, or the Chief, Appeals Office. When the District Director or the Chief, Appeals Office and the taxpayer cannot agree on material facts, the national Office, at its discretion, may refuse to provide technical advice.

.04 If the taxpayer initiates the action to request technical advice and the taxpayer's statement of the facts and point at issue is not wholly acceptable to the District or Appeals Office, the Service will tell the taxpayer in writing what the areas of disagreement are. The taxpayer has 10 calendar days after receiving the written notice to reply to it. The taxpayer must justify in writing an extension of beyond the 10 calendar days. The justification must be approved by the Chief, Examination Division or the Chief, Appeals Office. If agreement cannot be reached, both the statements of the taxpayer and the District or Appeals Office will be forwarded to the National Office with the request for technical advice. When the disagreement involves material facts essential to the preliminary assessment of the case, the District Director or Chief, Appeals Office, may, at its discretion, refuse referral to the National Office of a taxpayer initiated request for technical advice or, alternatively, the National Office may refuse to provide technical advice.

.05 If it has not already been done, the taxpayer may submit a statement explaining the taxpayer's position on the issues and citing precedents that the taxpayer believes will bear on the case. This statement will be forwarded to the National Office with the request for technical advice. If the taxpayer's statement is received after the request for technical advice has been forwarded to the National Office, it will be forwarded there to be associated with the request for technical advice. The taxpayer is encouraged to comment on any legislation, tax treaties, regulations, revenue rulings, revenue procedures, or court decisions contrary to the taxpayer's position.

.06 At the time the taxpayer is told that the matter is being referred to the National Office, the taxpayer will also be told about the right to a conference in the National Office if an adverse decision is indicated and will be asked to say whether such a conference is desired.

.07 In connection with requests for technical advice, the taxpayer also has the same 10 days as in sections 5.03 and 5.04 to submit the statement described in section 5.09 of proposed deletions under section 6110(c) of the Code. If the taxpayer does not submit the statement, the District Director or the Chief, Appeals Office, will tell the taxpayer that such a statement is required. If the District Director or the Chief, Appeals Office, does not receive that statement within 10 days after such notification, the District Director or the Chief, Appeals Office, may decline to submit the request for technical advice. If the District Director or the Chief. Appeals Office, decides to request technical advice in a case in which the taxpayer has not submitted the statement or proposed deletions, the National Office will make those deletions that the Commissioner determines are required by section 6110(c).

.08 The requirements for submitting statements and other material or proposed deletions in technical advice memoranda before public inspection is allowed do not apply to requests for any documents to which section 6104 of the Code applies.

.09 To help the National Office make the deletions required by section 6110(c) of the Code in technical advice memoranda to be made open to public inspection under section 6110(a), a deletions statement must accompany requests. The statement must either state that no information other than names, address, and identifying numbers need be deleted, or if more information is proposed to be deleted, the statement must indicate the deletions proposed by the taxpayer,. If the latter alternative is chosen, the statement must be made in a separate document, and it must be accompanied by a copy of all statements of facts and supporting documents that are submitted to the National Office under sections 5.03 and 5.04. The material that the taxpayer wants deleted must be shown in brackets. The statement of proposed deletions must show the statutory basis, under section 6110(c), for each proposed deletion. The statement of proposed deletions must not appear or be referred to anywhere in the request for technical advice. If the taxpayer decides to request additional deletions under section 6110(c) before the National Office replies to the request for technical advice, the taxpayer may submit additional statements. The procedures in this paragraph also apply to additional information submitted during consideration of the technical advice request.

.10 The provisions of this section (about referring issues upon the taxpayer's request, telling the taxpayer about the referral of issues, giving the taxpayer a copy of the arguments submitted by the District Director or Chief, Appeals Office, in support of its position on the issue or issues, submitting proposed deletions, and granting conferences in the national Office) do not apply to a technical advice memorandum, described in section 6110(g)(5)(A) of the Code, that involves a matter that is the subject of or is otherwise closely related to a criminal or civil fraud investigation or a jeopardy or termination assessment. However, in these cases after all proceedings in the investigations or assessments are complete but before the Commissioner mails the notice, under section 6110(f)(1), of intention to disclose the technical advice memorandum, a copy of the technical advice memorandum will be furnished to the taxpayer and the taxpayer may provide the statement of proposed deletions to the National Office.

.11 See Rev. Proc. 79-63, 1979-2 C.B. 578, which concerns applications for extension of time for making an election or application for relief pursuant to section 1.9100-1 of the Income Tax Regulations. If a taxpayer requests an extension of time under section 1.9100-1 during an examination or when being considered by an Appeals Office, the procedures of Rev. Proc. 89-2 are applicable, except for section 6. The examination officer or Appeals Officer is not authorized to deny consideration of a request for technical advice that involves section 1.9100-1 relief. All such requests must be referred to the National Office. See section 4.03 of Rev. Proc. 79-63.

.12 Form 4463, Request for Technical Advice, should be used for transmitting requests for technical advice to the National Office.

.13 Any authorized representative, as described in section 8.11 of Rev. Proc. 89-1, whether or not enrolled to practice, must comply with the conference and practice requirements of the Statement of Procedural Rules (26 CFR 601). Form 2848, Power of Attorney, and Form 2848-D, Authorization and Declaration, may be used with regard to requests for technical advice under this revenue procedure.

SEC. 6. APPEAL BY TAXPAYERS OF DISTRICT OR APPEALS OFFICE DETERMINATION NOT TO SEEK TECHNICAL ADVICE

.01 If the examining officer or Appeals Officer thinks that a taxpayer's request for referral of an issue to the National Office for technical advice does not warrant referral, the examining officer or Appeals Officer will tell the taxpayer.

.02 The taxpayer may appeal the decision of the examining officer or the Appeals Officer not to request technical advice by submitting to that official, within 10 calendar days after being told of the decision, a statement of the facts, law, and arguments on the issue, and the reasons why the taxpayer believes the matter should be referred to the National Office for technical advice. The tax payer must justify in writing a request for an extension of time beyond the 10 calendar days. The justification must be approved by the Chief, Examination Division, or the Chief, Appeals Office.

.03 The examining officer or the Appeals Officer submits the taxpayer's statement through channels to the Chief, Examination Division, or the Chief, Appeals Office, along with the examining officer's or the Appeals Officer's statement of why the issue should not be referred to the National Office. The Chief determines, on the basis of the statement, whether technical advice will be requested. If the Chief determines that technical advice is not warranted and proposes to deny the request, the taxpayer is told in writing about the determination. In the letter to the taxpayer, the Chief states the reasons for the proposed denial (except in unusual situations when doing so would be prejudicial to the best interests of the Government). The taxpayer has 10 calendar days after receiving the letter to notify the Chief of agreement or disagreement with the proposed denial. The taxpayer may not appeal the decision of the Chief, Examination Division, or the Chief, Appeals Office, not to request technical advice from the National Office. However, if the taxpayer does not agree with the proposed denial, all data on the issue for which technical advice has been sought, including, the taxpayer's written request and statements, will be submitted to the Assistant Commissioner (Examination) or the National Director of Appeals for review. If the Assistant Commissioner (Examination) or the National Director of Appeals thinks the circumstances warrant it, he or she may consult the Associate Chief Counsel (Technical) or his or her representatives. After this review, the District Office or the Appeals Office is notified whether the proposed denial is approved or disapproved, and, in turn, the District Office or the Appeals Office will notify the taxpayer.

.04 While the matter is being reviewed, the District Office or the Appeals Office suspends action on the issue (except when the delay would prejudice the Government's interest) until it is notified that the proposed denial is approved or disapproved. This notification is made within 45 calendar days after receipt of the data. The review is solely on the basis of the written record and no conference is held on the matter.

SEC. 7. WITHDRAWAL OF REQUESTS

.01 Only a District Director or Chief, Appeals Office, may withdraw a request for technical advice, even a request initiated by the taxpayer. The withdrawal request may be made at any time before the responding transmittal memorandum is signed. The District Director or Chief, Appeals Office, must notify the taxpayer in writing of an intent to withdraw the request for technical advice except (1) when the period of limitation on assessment is about to expire and the taxpayer has declined to sign a consent to extend the period or (2) when such notification would be prejudicial to the best interests of the Government. If the taxpayer does not agree that the request for technical advice should be withdrawn, the procedure in section 6 of this revenue procedure must be followed.

.02 When a request for technical advice is withdrawn, the National Office may send its views to the District Director or the Chief, Appeals Office, when acknowledging the withdrawal request. In an Appeals case, acknowledgment of the withdrawal request should be sent to the appropriate Appeals Office, through the National Director of Appeals, CC:AP:PT. In appropriate cases, the subject matter may be published as a revenue ruling or as a revenue procedure.

SEC. 8. CONFERENCES IN THE NATIONAL OFFICE

.01 If after an analysis of the technical advice request it appears that advice adverse to the taxpayer will be given, and if a conference has been requested, the taxpayer will be told, by telephone if possible, the time and place of the conference. The conference must be held within 21 calendar days after such contact has been made. If conferences are being arranged for more than one request for technical advice for the same taxpayer, they will be scheduled to cause the least inconvenience to the taxpayer. An extension of the 21-day period will be granted only if the taxpayer justifies it in writing and the Branch Chief, Senior Technician Reviewer, or Assistant to the Branch Chief of the Branch to which the case is assigned approves it. Because the purpose of these procedures is to facilitate the technical advice process, requests for extensions should be justified by compelling facts and circumstances. The request for extension should be submitted before the end of the 21-day period. If unusual circumstances near the end of the 21-day period make a written request impractical, within the 21-day period the National Office should be told orally about the problem and of the forthcoming written request for extension. These requests must be promptly submitted. The taxpayer or taxpayer's representative will be told promptly and later in writing of the approval or denial of the requested extension. There is no right to appeal the denial of an extension request. If it is not advised of problems with meeting the 21-day period, or if the request is not sent promptly after the National Office is notified of problems with meeting the 21-day period the, Service will process the case on the basis of the existing record.

.02 A taxpayer is entitled by right to only one conference in the National Office unless one of the circumstances discussed in this section exists. This conference is normally held at the Branch level. It is attended by a person who has authority to sign the transmittal memorandum discussed in section 9.09 on behalf of the Branch Chief. When more than one branch has taken an adverse position on an issue within its jurisdiction presented in a request for technical advice, or when the position ultimately adopted by one Branch will affect another Branch's determination, a representative from each Branch with authority to sign for the Branch Chief will attend the conference. In appropriate cases, the examining officer or the Appeals Officer may also attend the conference to clarify the facts in the case. If more than one subject is discussed at the conference, the discussion constitutes a conference for each subject. To promote a free and open discussion of the issues, the conference usually is held after the Branch has an opportunity to study the case. However, the taxpayer may request that the conference of right be held at a stage earlier in the consideration of the case than the Service would ordinarily designate. The taxpayer has no right to appeal the action of a Branch to an Assistant Chief Counsel or to any other official of the Service.

.03 In order to issue technical advice memoranda in a more efficient manner, the Branch representatives may offer the taxpayer an option of delaying the conference in order to submit a brief requesting section 7805(b) relief, discussed in section 12 of this revenue procedure, in the event of a final adverse determination by the Service. In such cases, a conference on the tentatively adverse position and the section 7805(b) relief request will be scheduled within 10 days of receipt of the taxpayer's section 7805(b) request.

.04 Because conference procedures are informal, no tape, stenographic, or other verbatim recording of a conference is made.

.05 The senior Service representative at the conference ensures that the taxpayer has full opportunity to present views on all the issues in question. The Service representatives explain the Service's tentative decision on the substantive issues and the reasons for it. If prospective application under section 7805(b) of the Code is advocated by the taxpayer, the Service representative will discuss the tentative recommendation concerning the request for relief and the reason for the tentative recommendation. No commitment will be made as to the conclusion that the Service will finally adopt.

.06 An invitation to an additional conference is made if, after the conference of right, an adverse holding is proposed either (1) on a new issue or (2) on the same issue but on grounds different from those discussed at the first conference. When a proposed holding is reversed at a higher level with a result less favorable to the taxpayer, the taxpayer has no right to another conference if the grounds or arguments on which the reversal is based were discussed at the conference of right. The limitation on the number of conferences to which a taxpayer is entitled does not prevent inviting a taxpayer to attend further conferences when National Office personnel think they are necessary. These additional conferences are held only at the invitation of the National Office.

.07 The taxpayer is responsible for furnishing in writing to the National Office within 21 calendar days after the conference any additional data, lines of reasoning, precedents, etc., that the taxpayer proposed and that were discussed at the conference but not previously or adequately presented in writing. A copy of the additional material submitted by the taxpayer must be sent by the taxpayer to the District Director or the Chief, Appeals Office, for comment. If the additional information is not received within 21 days, the technical advice memorandum will be issued on the basis of the existing record. An extension of the 21-day period may be granted only if the taxpayer justifies it in writing and the Branch Chief, Senior Technician Reviewer, or the Assistant to the Branch Chief of the Branch to which the case is assigned approves it. Procedures for requesting an extension of the 21-day period and notifying the taxpayer or the taxpayer's representative of the Service's decision are the same as those in section 8.01. Any additional material should be submitted in duplicate to the National Office. If the additional information would have a significant impact on the facts in the request for technical advice, the National Office will send a copy to the District Director or the Chief, Appeals Office, for comment on the facts contained in the additional information submitted. The District Director or the Chief, Appeals Office, gives the matter prompt attention.

.08 A taxpayer may get information on the status of the request for technical advice by contacting the District or Appeals Office that requested the technical advice.

.09 A District Director or a Chief, Appeals Office, may get current information on the status of the request for technical advice by calling the person whose name and telephone number are shown on the acknowledgement of receipt of his request for technical advice.

SEC. 9. PREPARATION OF TECHNICAL ADVICE MEMORANDUM BY THE NATIONAL OFFICE

.01 Requests for technical advice generally are given priority and processed expeditiously. At soon as the request for technical advice is assigned, the technical employee analyzes the file to see whether it meets all requirements of section 5. If it does not comply with the requirements of section 5.09 relating to the statement of proposed deletions, the National Office makes the deletions from the technical advice memorandum that the Commissioner determines are required by section 6110(c) of the Code.

.02 Usually, within 21 calendar days after the Branch receives the request for technical advice, a representative of the Branch telephones the District or Appeals Office to discuss the procedural and substantive issues in the request that come within the Branch's jurisdiction. The Branch representative informs the District or Appeals Office:

(a) that the case is being returned because substantial additional information is required to resolve an issue, because significant unresolved factual variances exist between the statement of facts submitted by the District or Appeals Office and the taxpayer, or because major procedural problems cannot be resolved by phone (A request for technical advice will not be returned or reply delayed merely because additional information not essential to the preliminary assessment of the case is needed.); or

(b) that the case is not being returned but more information is needed or minor procedural deficiencies exist; or

(c) What the Branch representative's tentative conclusion is and the estimated date that the technical advice memorandum will be mailed; or

(d) that a tentative conclusion has not been reached because of the complexity of the issue and the estimated date the tentative conclusion will be made.

.03 Within 21 calendar days after the Branch receives the additional information requested in section 9.02(b), the Branch representative telephones the District or Appeals Office to discuss the procedural and substantive issues in the request that come within the jurisdiction of the Branch. The representative indicates either (1) the tentative conclusion and the estimated date the technical advice memorandum will be mailed, or (2) the fact that a tentative conclusion has not been reached because of the complexity of the issue and the estimated date the tentative conclusion will be made.

.04 Because the Branch representative's tentative conclusion may change during the preparation and review of the technical advice memorandum, it is not, under any circumstances, considered final. The District or Appeals Office may not tell the taxpayer what the tentative conclusion is.

.05 When the technical advice request concerns matters within the jurisdiction of more than one Branch, a representative of the Branch that received the original technical advice request informs the District or Appeals Office within the initial 21-calendar day period: (1) that the matters within the jurisdiction of another Branch have been referred to the other Branch or office for consideration, and (2) that a representative of the other Branch will contact the District or Appeals Office about the referral of the technical advice request within 21 calendar days after receiving it in accordance with section 9.02.

.06 If during the analysis and development of the case it is determined after discussion with the Branch Chief or reviewer, that additional information essential to the preliminary assessment of the case is needed, a Branch representative will obtain the additional information in the most expeditious manner possible from the taxpayer or the District Director or Chief, Appeals Office. Any additional information requested from the taxpayer by the National Office must be submitted by letter appended by a penalties of perjury statement within 21 calendar days after the request for information is made. A written request for an extension of time to submit additional material must be received by the National Office within the 21-day period, setting forth compelling facts and circumstances justifying the proposed extension. The Branch Chief Senior Technician Reviewer, or Assistant to the Branch Chief of the Branch to which the case is assigned will determine whether to grant or deny the request for an extension of the 21-day period. There is no right to appeal the denial of an extension request. If the National Office does not receive the submission within the period of 21 days, plus any extensions granted by the Branch Chief, Senior Technician Reviewer, or Assistant to the Branch Chief the National Office will issue the technical advice memorandum based on the existing record.

.07 Any additional information submitted by the taxpayer should be sent to the National Office and a copy sent to either the District Director or the Chief, Appeals office, for comments on the additional information. If the District Director or Chief, Appeals Office, has comments, they must be furnished promptly to the appropriate Branch in the office of the Associate Chief Counsel (Technical).

.08 Generally, before replying to the request for technical advice, the National Office informs the taxpayer orally or in writing of the material likely to appear in the technical advice memorandum that the taxpayer proposed be deleted but that the Service determined should not be deleted. If so informed, the taxpayer may submit within 10 calendar days any further information, arguments, or other material that should be deleted. The Service attempts, if possible, to resolve all disagreements about proposed deletions before the National Office replies to the request for technical advice. However, the taxpayer does not have the right to a conference to resolve any disagreements about material to be deleted from the text of the technical advice memorandum. These matters, however, may be considered at any conference otherwise scheduled for the request.

.09 Replies to requests for technical advice are addressed to the District Director or the Chief, Appeals Office. When a request for technical advice is from Appeals, the response to the appropriate Appeals Office will be routed through the National Director of Appeals, CC:AP:PT. The replies to technical advice requests are in two parts. Each part identifies the taxpayer by name, address, identification number, and year or years involved. The first part of the reply is a transmittal memorandum. In unusual cases it is a way of giving the District or Appeals Office administrative information or other information that under the nondisclosure statues or for other reasons, may not be discussed with the taxpayer. The second part (the ''technical advice memorandum'') contains: (1) a statement of the issues; (2) a statement of the pertinent facts with respect to the issues; (3) a statement of the pertinent law, tax treaties, regulations, revenue rulings and other precedents published in the Bulletin, and court decisions; (4) a discussion of the rationale developed by the National Office; and (5) the conclusions of the National Office. The conclusions give direct answers, whenever possible, to the specific questions of the District or Appeals Office. The discussion of the issues is in enough detail so the District or Appeals officials know the reasoning underlying the conclusion. Accompanying the technical advice memorandum is a notice, under section 6110(f)(1) of the Code, of intention to disclose a technical advice memorandum (including a copy of the version proposed to be open to public inspection and notations of third party communications under section 6110(d)). The District Director or the Chief, Appeals Office, forwards this notice to the taxpayer when the District Director or the Chief, Appeals Office, gives a copy of the technical advice memorandum to the taxpayer according to section 9.08.

.10 A copy of the technical advice memorandum will be given to the taxpayers only after it has been adopted by the District Director or the Chief, Appeals Office. However, in the case of technical advice memoranda described in section 6110(g)(5)(A) of the Code, relating to cases involving criminal or civil fraud investigations and jeopardy or termination assessments, a copy of the technical advice memorandum is not given to the taxpayer until all proceedings in the investigations or assessments are completed.

.11 After receiving the notice under section 6110(f)(1) of the Code of intention to disclose the technical advice memorandum, the taxpayer may protest the disclosure of certain information in it. The taxpayer must submit a written statement within 20 calendar days identifying those deletions not made by the Service that the taxpayer believes should have been made. The taxpayer must also submit a copy of the version of the technical advice memorandum proposed to be open to public inspection with brackets around deletions that are proposed by the taxpayer but that have not been made by the National Office. Generally, the National Office does not consider the deletion of any material that the taxpayer has not proposed be deleted before the National Office reply is sent to the request for technical advice to the District Director or the Chief, Appeals Office. Within 20 days after it receives the taxpayer's response to the notice under section 6110(f)(1), the National Office must mail the taxpayer its final administrative conclusion about the deletions to be made.

SEC.10. ACTION ON TECHNICAL ADVICE IN DISTRICT AND APPEALS OFFICE

.01 The District Director or the Chief, Appeals Office, must process the taxpayer's case on the basis of the conclusions in the technical advice memorandum unless (1) the District Director or the Chief, Appeals Office, thinks that the conclusions reached by the National Office in a technical advice memorandum should be reconsidered, or (2) the Chief, Appeals Office, in the case of technical advice unfavorable to the taxpayer, decides to settle the issue in the usual manner under existing authority.

.02 The District Director or the Chief Appeals Office, gives the taxpayer (1) a copy of the technical advice memorandum described in section 9.09 , and (2) the notice under section 6110(f)(1) of the Code of intention to disclose the technical advice memorandum (including a copy of the version proposed to be open to public inspection and notations of third party communications under section 6110(d)). This requirement does not apply to technical advice memoranda involving civil fraud or criminal investigations; jeopardy or termination assessments, as described in section 5.10; or documents to which section 6104 applies.

.03 In those cases in which the National Office tells the District Director of the Chief, Appeals Office, that a copy of the technical advice memorandum should not be given to the taxpayer, the District Director or the Chief, Appeals Office tells this to the taxpayer if the taxpayer requests a copy.

SEC. 11. EFFECT OF TECHNICAL ADVICE

.01 A taxpayer may not rely on a ruling issued to, or a technical advice memorandum received from the Service by, another taxpayer. Except in rare or unusual circumstances, a holding in a technical advice memorandum that is favorable to the taxpayer is applied retroactively. Moreover, since technical advice, as described in section 4.04 of this revenue procedure, is issued only on closed transactions, a holding that is adverse to the taxpayer is also applied retroactively unless the Associate Chief Counsel (Technical) exercises the discretionary authority under section 7805(b) of the Code to limit the retroactive effect of the holding.

.02 A holding that modifies or revokes a holding in a prior technical advice memorandum is applied retroactively, with one exception. If the new holding is less favorable to the taxpayer than the earlier one, it generally is not applied to the period in which the taxpayer relied on the prior holding in situations involving continuing transactions.

.03 If a technical advice memorandum relates to a continuing action or a series of actions, it is ordinarily applied until specifically withdrawn or until the conclusion is modified or revoked by enactment of legislation, ratification of a tax treaty, or issuance of a United States Supreme Court decision, regulations (temporary or final), a revenue ruling, or other statement published in the Internal Revenue Bulletin. Publication of a notice of proposed rulemaking does not affect the application of a technical advice memorandum.

.04 Generally, a technical advice memorandum that revokes or modifies a letter ruling or another technical advice memorandum is not applied retroactively for either the taxpayer to whom or for whom the ruling or memorandum was originally issued or for a taxpayer whose tax liability was directly involved in such ruling or memorandum if: (1) there has been no misstatement or omission of material facts; (2) the facts at the time of the transaction are not materially different from the facts on which the ruling or memorandum was based; (3) there has been no change in the applicable law; (4) in the case of a ruling, it was originally issued on a prospective or proposed transaction; and (5) the taxpayer directly involved in the ruling or memorandum acted in good faith in relying on the ruling or memorandum and the retroactive revocation would be to the taxpayer's detriment. For example, the tax liability of each shareholder is directly involved in a ruling or memorandum on the reorganization of a corporation. However, the tax liability of members of an industry is not directly involved in a ruling or memorandum issued to one of the members, and the holding in a revocation or modification of a ruling or memorandum to one member of an industry may be retroactively applied to other members of the industry. By the same reasoning, a tax practitioner may not obtain the nonretroactive application to one client of a modification or revocation of a ruling or memorandum previously issued to another client. When a ruling to a taxpayer or a memorandum involving a taxpayer is revoked with retroactive effect, the notice to the taxpayer, except in fraud cases, sets forth the grounds on which the revocation is being made and the reasons why the revocation is being applied retroactively.

SEC. 12. PROCEDURES FOR REQUESTING APPLICATION OF SECTION 7805(b) IN THE CASE OF TECHNICAL ADVICE

.01 pursuant to section 7805(b) of the Code, it is within the discretion of the Commissioner or the Commissioner's delegate to prescribe the extent, if any, to which any ruling (including technical advice) will be applied without retroactive effect.

A taxpayer who has received a technical advice memorandum or with respect to whom a technical advice request is pending may request that the Associate Chief Counsel (Technical), the Commissioner's delegate, exercise the discretionary authority under section 7805(b) of the Code to limit the retroactive effect of any holding stated in the technical advice memorandum or to limit the retroactive effect of any subsequent modification or revocation of the technical advice memorandum.

.02 When a technical advice memorandum that concerns a continuing transaction is modified or revoked by, for example, a subsequent revenue ruling or final regulations, a request to limit the retroactive effect of the modification or revocation of the technical advice memorandum must be made in the form of a request for a ruling when the request is submitted before the return is examined that contains the transaction that is the subject of the request for ruling. See secion 19.02 of Rev. Proc. 89-1, page 740, this Bulletin.

.03 When a taxpayer is informed of the modification or revocation of a technical advice memorandum, ruling letter, or determination letter during the course of an examination of the taxpayer's return by the District Director or during consideration by the Chief, Appeals Office, a request to limit the retroactive application of the modification or revocation of the technical advice memorandum, ruling letter, or determination letter must itself be made in the form of a request for technical advice. See section 5 of this revenue procedure. However, the taxpayer must also submit a statement, which will be forwarded to the National Office with the request for technical advice, that the request for technical advice, that the request for technical advice is being made pursuant to section 7805(b) of the Code. This statement must also set forth the relief sought and an explanation of the reasons and arguments in support of the relief requested, and it must be accompanied by any documents bearing on the request. The explanation in support of the application of section 7805(b) should include a discussion of the five items enumerated in section 11.04 of this revenue procedure as they relate to the taxpayer's particular situation. The taxpayer's request for relief pursuant to section 7805(b) must be forwarded by the District Director or the Chief, Appeals Office to the National Office for consideration.

.04 A request to limit the retroactive effect of a holding in a technical advice memorandum that does not modify or revoke a technical advice memorandum may be made as part of that technical advice request, either initially, or at any time before the technical advice memorandum is issued by the National Office. In such a case, the taxpayer must also submit a statement in support of the application of section 7805(b) of the Code, as described in .03 above.

.05 When a request for technical advice concerns only the application of section 7805(b) of the Code, the taxpayer has the right to a conference in the National Office in accordance with the provisions of section 8 of this revenue procedure. If the request for application of section 7805(b) is included in the request for technical advice on the substantive issues or is made before the conference of right on the substantive issues, the section 7805(b) issues will be discussed at the taxpayers one conference of right. If the request for the application of section 7805(b) is made as part of a pending technical advice request after a conference has been held on the substantive issue, and the Service determines that there is justification for having delayed the request, then the taxpayer will have the right to one conference of right concerning the application of section 7805(b) with the conference limited to discussion of this issue.

SEC. 13. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 88-2 is superseded.

26 CFR 601.201: Rulings and determination letters:

Rev. Proc. 89-3

SECTION 1. PURPOSE AND NATURE OF CHANGES

.01 The purpose of this revenue procedure is to update Rev. Proc. 88-3, 1988-1 C.B. 579, as amplified and modified by subsequent revenue procedures, by providing a revised list of those areas of the Internal Revenue Code under the jurisdiction of the Associate Chief Counsel (Technical) relating to issues in which the Internal Revenue Service will not issue advance rulings or determination letters. For a list of areas under the jurisdiction of the Associate Chief Counsel (International) relating to international issues in which the Service will not issue advance rulings or determination letters, see Rev. Proc. 87-6, 1987-1 C.B. 541, as amplified by Rev. Proc. 87-39, 1987-2 C.B. 514, and Rev. Proc. 87-61, 1987-2 C.B. 765. When applicable, the Tax Reform Act of 1986 will be referred to as "TRA 1986", and the Tax Equity and Fiscal Responsibility Act of 1982 will be referred to as "TEFRA."

.02 Changes

1. Old sections 3.019, 3.0136, and 3.0138 have been deleted as a result of Rev. Rul. 88-27, 1988-1 C.B. 331.

2. New section 3.0123 modifies old section 3.0124. See Rev. Proc. 88-25, 1988-1 C.B. 803.

3. Old sections 3.0127 and 3.0128 have been deleted to reflect changes to the Code in TRA 1986 and the Revenue Act of 1987.

4. Old section 3.023 has been modified. See Rev. Proc. 88-50, 1988-2 C.B. 711.

5. New sections 4.014 and 4.017 modify old sections 4.014 and 4.017. See Rev. Proc. 88-26, 1988-1 C.B. 804.

6. Old section 4.015 has been deleted. See Rev. Proc. 88-47, 1988-2 C.B. 635.

7. New section 4.016 refers to section 141 of the Code, while old section 5.05 has been deleted. See Rev. Proc. 88-57, 1988-2 C.B. 727.

8. New section 4.019 refers to sections 162 and 262 of the Code, while old section 5.08 has been deleted. See Rev. Proc. 88-45, 1988-2 C.B. 634.

9. New sections 4.0112, 4.0125, 4.0128, and 4.0129 refer to sections 170, 642, 2055, and 2522 of the Code respectively. See Rev. Proc. 88-54, 1988-2 C.B. 715.

10. New sections 4.0114, 4.0123, and 4.0127 refer to sections 216, 351, and 1502 of the Code respectively, while old sections 5.10, 5.19, and 5.32 have been deleted. See Rev. Proc. 88-46, 1988-2 C.B. 634.

11. Old section 5.09 has been deleted. See Rev. Proc. 88-35, 1988-1 C.B. 837.

12. Old section 5.14 has been deleted. See Rev. Proc. 88-34, 1988-1 C.B. 837.

13. Old section 5.22 has been deleted. See Rev. Proc. 88-38, 1988-2 C.B. 562.

14. Old section 5.24 has been deleted. See Rev. Proc. 88-51, 1988-2 C.B. 711.

15. Old section 5.37 has been deleted. See Rev. Proc. 88-44, 1988-2 C.B. 634.

SEC. 2. BACKGROUND AND SCOPE OF APPLICATION

.01 Background

Whenever appropriate in the interest of sound tax administration, it is the policy of the Service to answer inquiries of individuals and organizations regarding their status for tax purposes and the tax effects of their acts or transactions, prior to the filing of returns or reports that are required by the revenue laws.

There are, however, certain areas in which, because of the inherently factual nature of the problems involved, or for other reasons, the Service will not issue advance rulings or determination letters. These areas are set forth in three sections of this revenue procedure. Section 3 reflects those areas in which advance rulings and determinations will not be issued. Section 4 sets forth those areas in which they will not ordinarily be issued. "Not ordinarily" connotes that unique and compelling reasons must be demonstrated to justify the issuance of a ruling or determination letter. Those sections reflect a number of specific questions and problems as well as general areas. Section 5 lists specific areas for which the Service is temporarily not issuing advance rulings and determinations because those matters are under extensive study. See Rev. Proc. 89-1, particularly section 7 captioned "Discretionary Authority to Issue Rulings and Determination Letters" for general instructions and other situations in which the Service will not or ordinarily will not issue rulings or determination letters.

With respect to the items listed, revenue rulings or revenue procedures may be published in the Internal Revenue Bulletin from time to time to provide general guidelines regarding the position of the Service.

Additions or deletions to this revenue procedure as well as restatement of items listed will be made by modification of this revenue procedure. Changes will be published as they occur throughout the year and will be incorporated annually in a new revenue procedure published as the third revenue procedure of the year. These lists should not be considered all-inclusive. Decisions not to rule on individual cases, as contrasted with those that present significant pattern issues, are not reported in this revenue procedure and will not be added to subsequent revisions.

.02 Scope of Application

This revenue procedure is not to be considered as precluding the submission of requests for technical advice to the National Office from the Office of a District Director of the Internal Revenue or a Chief, Appeals Office.

SEC. 3. AREAS IN WHICH RULINGS OR DETERMINATION LETTERS WILL NOT BE ISSUED.

.01 Specific questions and problems.

1. Section 79.—Group Term Life Insurance Purchased for Employees.—Whether a group insurance plan for 10 or more employees qualifies as group-term insurance if the amount of insurance is not computed under a formula that would meet the requirements of section 1.79-1(c)(2)(ii) of the Income Tax Regulations if the group consisted of fewer than 10 employees.

2. Section 83.—Property Transferred in Connection with Performance of Services.—Whether a restriction constitutes a substantial risk of forfeiture if the employee is a controlling shareholder. Also, whether a transfer has occurred if the amount of the property involves a nonrecourse obligation.

3. Section 105(h).—Amount Paid to Highly Compensated Individuals under Discriminatory Self-Insurance Medical Expense Reimbursement Plan.—Whether, following a determination that a self-insured medical expense reimbursement plan is discriminatory, that plan had previously made reasonable efforts to comply with tax discrimination rules.

4. Section 117.—Scholarships and Fellowship Grants.—Whether an employer-related scholarship or fellowship grant is excludable from the employee's gross income if there is no intermediary private foundation distributing the grants, as there was in Rev. Proc. 76-47, 1976-2 C.B. 670.

5. Section 119.—Meals or Lodging Furnished for the Convenience of the Employer.—Whether the value of meals or lodging is excludable from gross income by an employee who is a controlling shareholder of the employer.

6. Sections 121 and 1034.—One-Time Exclusion of Gain from Sale of Principal Residence by Individual Who Has Attained Age 55; Rollover of Gain on Sale of Principal Residence.—Whether property qualifies as the taxpayer's principal residence.

7. Section 162.—Trade or Business Expenses.—Whether compensation is reasonable in amount. Also, whether an action is "gross misconduct" within the meaning of section 162(k)(3)(B) (See section 3.05 of Rev. Proc. 87-28, 1987-1 C.B. 770, 771).

8. Section 163.—Interest.—The income tax consequences of transactions involving "shared appreciation mortgage" (SAM) loans in which a taxpayer, borrowing money to purchase real property, pays a fixed rate of interest on the mortgage loan below the prevailing market rate and will also pay the lender a percentage of the appreciation in value of the real property upon termination of the mortgage. This applies to all SAM arrangements where the loan proceeds are used for commercial or business activities, or where used to finance a personal residence if the facts are not similar to those described in Rev. Rul. 83-51, 1983-1 C.B. 48. (Also sections 61, 451, 461, 856, 1001, and 7701).

9. Section 170.—Charitable, Etc., Contributions and Gifts.—Whether a taxpayer who advances funds to a charitable organization and receives therefore a promissory note may deduct as contributions, on one taxable year or in each of several years, amounts forgiven by the taxpayer in each of several years by endorsement on the note.

10. Section 213(a).—Medical, Dental, Etc., Expenses.—Whether a capital expenditure for an item that is ordinarily used for personal, living, or family purposes, such as a swimming pool, has as its primary purpose the medical care of the taxpayer or the taxpayer's spouse or dependent, or is related directly to such medical care.

11. Section 264(b).—Certain Amounts Paid in Connection with Insurance Contracts.—Whether "substantially all" the premiums of a contract of insurance are paid within a period of 4 years from the date on which the contract is purchased. Also, whether an amount deposited is in payment of a "substantial number" of future premiums on such a contract.

12. Section 264(c)(1).—Certain Amounts Paid in Connection with Insurance Contracts.—Whether section 264(c)(1) of the Code applies.

13. Section 269.—Acquisitions Made to Evade or Avoid Income Tax.—Whether an acquisition is within the meaning of section 269 of the Code.

14. Section 274.—Disallowance of Certain Entertainment, Etc., Expenses.—Whether a taxpayer who is traveling away from home on business may, in lieu of substantiating the actual cost of meals, deduct a fixed per-day amount for meal expenses that differs from the amount prescribed in Rev. Proc. 83-71, 1983-2 C.B. 590, or any later revenue procedure that modifies Rev. Proc. 83-71.

15. Section 302.—Distributions in Redemption of Stock.—Whether section 302(b) of the Code applies when the consideration given in redemption by a corporation consists entirely or partly of its notes payable, and the shareholder's stock is held in escrow or as security for payment of the notes with the possibility that the stock may or will be returned to the shareholder in the future, upon the happening of specified defaults by the corporation.

16. Section 302.—Distributions in Redemption of Stock.—Whether section 302(b) of the Code applies when the consideration given in redemption by a corporation in exchange for a shareholder's stock consists entirely or partly of the corporation's promise to pay an amount based on, or contingent on, future earnings of the corporation, when the promise to pay is contingent on working capital being maintained at a certain level, or any other similar contingency.

17. Section 302.—Distributions in Redemption of Stock.—Whether section 302(b) of the Code applies to a redemption of stock if after the redemption the distributing corporation uses property that is owned by the shareholder from whom the stock is redeemed and the payments by the corporation for the use of the property are dependent upon the corporation's general creditors. Payments for the use of property will not be considered to be dependent upon future earnings merely because they are based on a fixed percentage of receipts or sales.

18. Section 302.—Distributions in Redemption of Stock.—Whether the acquisition or disposition of stock described in section 302(c)(2)(B) of the Code has, or did not have, as one of its principal purposes the avoidance of federal income taxes within the meaning of that section, unless the facts and circumstances are materially identical to those set forth in Rev. Rul. 56-556, 1956-2 C.B. 177, Rev. Rul. 56-584, 1956-2 C.B. 179, Rev. Rul. 57-387, 1957-2 C.B. 225, Rev. Rul. 77-293, 1977-2 C.B. 91, Rev. Rul. 79-67, 1979-1 C.B. 128, or Rev. Rul. 85-19, 1985-1 C.B. 94.

19. Sections 302(b)(4) and (e) (pre-TEFRA sections 346(a)(2) and (b)).—Partial Liquidation.—The amount of working capital attributable to a business or portion of a business terminated that may be distributed in partial liquidation.

20. Sections 311 and 336 (pre-TRA 1986).—Taxability of Corporation on Distribution; General Rule.—Upon distribution of property in kind by a corporation to its shareholders, in complete liquidation under section 331 of the Code (when under the facts a sale of the property by the corporation would not qualify under pre-TRA 1986 section 337) and section 346(a) (pre-TEFRA section 346(a)(1)), in partial liquidation under section 302(b)(4) and (e) (pre-TEFRA sections 346(a)(2) and (b)) or in redemption of stock under section 302(a), followed by a sale of the property, whether the sale can be deemed to have been made by the corporation under the doctrine of *Commissioner v. Court Holding Company*, 324 U.S. 331 (1945), 1945 C.B. 58.

21. Section 312.—Effect on Earnings and Profits.—The determination of the amount of earnings and profits of a corporation.

22. Section 368(a)(1)(B).—Definitions Relating to Corporate Reorganizations.—The acceptability of an estimation procedure or the acceptability of a specific sampling procedure to determine the basis of stock acquired by an acquiring corporation in a reorganization described in section 368(a)(1)(B).

23. Section 368(a)(1)(E).—Definitions Relating to Corporate Reorganizations.—Whether a transaction constitutes a corporate recapitalization within the meaning of section 368(a)(1)(E) of the Code (or a transaction that also qualified under section 1036) when either (i) the transaction involves a closely-held corporation or (ii) the issues involved are substantially similar to those described in the following revenue rulings:

Rev. Rul. 82-34, 1982-1 C.B. 59 (continuity of business enterprise);

Rev. Rul. 77-479, 1977-2 C.B. 119 (continuity of shareholder interest);

Rev. Rul. 77-238, 1977-2 C.B. 115 (conversion of shares of one class of stock into shares of another class, as permitted by certificate of incorporation);

Rev. Rul. 74-269, 1974-1 C.B. 87 (major shareholder's exchange of common stock for preferred stock);

Rev. Rul. 56-654, 1956-2 C.B. 216 (corporate charter amended to provide preferred stock with increased redemption and liquidation value, where common and preferred stock held pro rata);

Rev. Rul. 55-112, 1955-1 C.B. 344 (common stock exchanged for preferred stock); and

Rev. Rul. 54-482, 1954-2 C.B. 148 (old common stock exchanged for new common stock). The above no-ruling area does not apply, however, to any corporate recapitalization that is an integral part of a larger transaction if it is impossible to determine the tax consequences of the larger transaction without making a determination with regard to the recapitalization.

24. Section 451.—General Rule for Taxable Year of Inclusion.—The tax consequences of a nonqualified unfunded deferred compensation arrangement with respect to a controlling shareholder employee eligible to participate in the arrangement.

25. Sections 451 and 457.—General Rule for Taxable Year of Inclusion; Deferred Compensation Plans with Respect to Service for State and Local Governments.—The tax consequences to unidentified independent contractors in nonqualified unfunded deferred compensation plans. This applies to plans established under section 451 of the Code by employers in the private sector and to eligible state plans under section 457. However, a ruling with respect to a specific independent contractor's participation in such a plan may be issued.

26. Section 641.—Imposition of Tax.—Whether the period of administration or settlement of an estate is reasonable or unduly prolonged.

27. Section 642(c).—Deduction for Amounts Paid or Permanently Set Aside for a Charitable Purpose.—Allowance of an unlimited deduction for amounts set aside by a trust or estate for charitable purposes when there is a possibility that the corpus of the trust or estate may be invaded.

28. Section 704(e).—Family Partnerships.)—Matters relating to the validity of a family partnership when capital is not a material income producing factor.

29. Section 856.—Definition of a Real Estate Investment Trust.—Whether a corporation whose stock is "paired" with or "stapled" to stock of another corporation will qualify as a real estate investment trust under section 856 of the Code if the activities of the corporations are integrated.

30. Section 1221.—Capital Asset Defined.—Whether specialty stock allocated to an investment account by a registered specialist on a national securities exchange is a capital asset.

31. Section 1551.—Disallowance of Surtax Exemption and Accumulated Earnings Credit.—Whether a transfer is within section 1551 of the Code.

32. Section 2031.—Definition of Gross Estate.—Actuarial factors for valuing interests in the prospective gross estate of a living person.

33. Section 2512.—Valuation of Gifts.—Actuarial factors for valuing prospective or hypothetical gifts of a donor.

34. Section 7701.—Definitions.—Whether a foreign arrangement that is a participant in a domestic arrangement classified as a partnership for U.S. tax purposes will itself be classified as a partnership.

35. Section 7701.—Definitions.—Whether a foreign limited liability company will be classified as a partnership if the taxpayer requests classification as a partnership and (1) the taxpayer is a corporation and less than 20 percent of the interests in the limited liability company are held by independent parties or (2) the taxpayer is not a corporation and independent parties hold only a nominal interest in the company.

36. Section 7701.—Definitions.—Whether an organization, formed in a state that has a statute corresponding to the Uniform Limited Partnership Act or the Revised Uniform Limited Partnership Act, lacks the corporate characteristic of continuity of life where, in the case of the removal of a general partner, the partnership agreement allows less than a majority in interest of limited partners to elect a new one to continue the partnership.

37. Section 7701.—Definitions.—Whether a limited partnership will be classified as a partnership if the partnership agreement does not provide that, notwithstanding anything to the contrary that may be expressed or implied in the agreement, the interests of all of the general partners, taken together, in each material item of partnership income, gain, loss, deduction, or credit is equal to at least one percent of each such item at all times during the existence of the partnership. In determining the general partners' interests in such items, limited partnership interests owned by the general partners shall not be taken into account.

38. Section 7701.—Definitions.—Whether a limited partnership will be classified as a partnership if the partnership agreement does not expressly provide that, upon the dissolution and termination of the partnership, the general partners will contribute to the partnership an amount equal to: (a) the deficit balances in their capital accounts; or (b) the excess of 1.01 percent of the total capital contributions of the limited partners over the capital previously contributed by the general partners; or (c) the lesser of (a) or (b).

.02 General Areas

1. The results of transactions that lack bona fide business purpose or have as their principal purpose the reduction of federal taxes.

2. A matter upon which a court decision adverse to the government has been handed down and the question of following the decision or litigating further has not yet been resolved.

3. A matter involving the prospective application of the estate tax to the property or the estate of a living person, to the extent provided in section 4.04 of Rev. Proc. 88-50, 1988-2 C.B. 711. Rev. Proc. 88-50 generally provides for the issuance of advance estate tax rulings on a test basis until December 31, 1989.

4. A matter involving alternate plans of proposed transactions or involving hypothetical situations.

5. A matter involving the federal tax consequences of any proposed federal, state, local or municipal legislation. The Service may provide general information in response to an inquiry.

6. Whether under Subtitle F (Procedure and Administration) of the Code reasonable cause, due diligence, good faith, clear and convincing evidence or other similar terms that require a factual determination exist.

7. Whether a proposed transaction would subject the taxpayer to a criminal penalty.

8. A request that does not comply with the provisions of Rev. Proc. 89-1.

9. Whether, under the common law rules applicable in determining the employer-employee relationship, a professional staffing corporation (loan-out

corporation) or the subscriber is the employer of individuals if:

(a) the loan-out corporation hires employees of the subscriber and assigns the employees back to the subscriber or;

(b) the loan-out corporation assigns individuals to subscribers for more than a temporary period (1 year or longer).

SEC. 4. AREAS IN WHICH RULINGS OR DETERMINATION LETTERS WILL NOT ORDINARILY BE ISSUED

.01 Specific questions and problems.

1. Sections 38, 39, 46, and 48.—Investment Tax Credit.—Application of these sections where the formal ownership of property is in a party other than the taxpayer, except when title is held merely as security.

2. Section 61.—Gross Income Defined.—Determination as to who is the true owner of property in cases involving the sale of securities, or participation interests therein, where the purchaser has the contractual right to cause the securities, or participation interests therein, to be purchased by either the seller or a third party.

3. Sections 61 and 163.—Gross Income Defined; Interest.—Determinations as to who is the true owner of property or the true borrower of money in cases in which the formal ownership of the property or liability for the indebtedness is in another party.

4. Section 103.—Interest on State and Local Bonds.—Whether the interest on state and local bonds will be excludable from gross income under section 103(a) of the Code if the proceeds of issues of bonds (other than advance refunding issues) are placed in escrow or otherwise not expended for a governmental purpose for an extended period of time even though the proceeds are invested at a yield that will not exceed the yield on the state and local bonds prior to their expenditure.

5. Section 103.—Interest on Certain Governmental Obligations.—Whether an issue of industrial development bonds is exempt under section 103(b) of the Code when 10 percent or more of the proceeds of the issue (minus "neutral costs," as described in Rev. Rul. 80-171, 1980-2 C.B. 44) are used to finance a facility in which an owner (or a related person) or a lessee (or a related person), who was a user of the facility at any time before the bonds were issued, will be a user of the facility after the bonds are issued.

6. Section 141.—Private Activity Bond; Qualified Bond.—With respect to requests made pursuant to Rev. Proc. 88-33, 1988-1 C.B . 835, whether state or local bonds will meet the "private business use tests" and the "private security or payment test" under section 141(b)(1) and (2) of the Code in situations where the proceeds are used to finance certain output facilities and, pursuant to a contract to take, or take or pay for, a nongovernmental person purchases 30 percent or more of the actual output of the facility but 10 percent or less of the subparagraph (5) output of the facility as defined in section 1.103-7(b)(5)(ii)(*b*) of the regulations (issued under former section 103(b) of the Code). In similar situations, the Service will not ordinarily issue rulings or determination letters concerning questions arising under paragraphs (3), (4), and (5) of section 141(b).

7. Section 148.—Arbitrage.—Whether amounts received as proceeds from the sale of municipal bond financed property and pledged to the payment of debt service or pledged as collateral for the municipal bond issue are sinking fund proceeds within the meaning of section 1.103-13(g) of the regulations (issued under former section 103(c) of the Code) or replaced proceeds described in section 148(a)(2) of the Code (or former section 103(c)(2)(B)).

8. Section 162.—Trade or Business Expenses.—Whether the requisite risk shifting and risk distribution necessary to constitute insurance are present for purposes of determining the deductibility under section 162 of the Code of amounts paid (premiums) by a taxpayer for insurance, unless the facts of the transaction are within the scope of Rev. Rul. 77-316, 1977-2 C.B. 53, or Rev. Rul. 78-338, 1978-2 C.B. 107.

9. Sections 162 and 262.—Commuting Expenses.—Whether expenses are nondeductible commuting expenses.

10. Section 167.—Depreciation.

(a) Useful lives of assets.

(b) Depreciation rates.

(c) Salvage value of assets.

11. Sections 167 and 168.—Depreciation; Accelerated Cost Recovery System.—Application of those sections where the formal ownership of property is in a party other than the taxpayer, except when title is held merely as security.

12. Section 170.—Charitable, Etc., Contributions and Gifts.—Whether a transfer to a pooled income fund described in section 642(c)(5) of the Code qualifies for a charitable deduction under section 170(f)(2)(A).

13. Section 170(c).—Charitable, Etc., Contributions and Gifts.—Whether a taxpayer who transfers property to a charitable organization and thereafter leases back all or a portion of the transferred property, may deduct the fair market value of the property transferred and leased back as a charitable contribution.

14. Section 216.—Deduction of Taxes, Interest, and Business Depreciation by Cooperative Housing Corporation Tenant Stockholder.—If a cooperative housing corporation (CHC), as defined in section 216(b)(1) of the Code, transfers an interest in real property to a corporation (not a CHC) in exchange for stock or securities of the transferee corporation, which engages in commercial activity with respect to the real property interest transferred, whether (1) the income of the transferee corporation derived from the commercial activity, and (2) any cash or property (attributable to the real property interest transferred) distributed by the transferee corporation to the CHC will be considered as gross income of the CHC for the purpose of determining whether 80 percent or more of the gross income of the CHC is derived from tenant-stockholders within the meaning of section 216(b)(1)(D).

15. Section 302.—Distribution in Redemption of Stock.—The tax effect of the redemption of stock for notes, when the payments on the notes are to be made over a period in excess of 15 years from the date of issuance of such notes.

16. Sections 302(b)(4) and (e) (pre-TEFRA section 346(a)(2)).—Partial Liquidation.—Whether a distribution will qualify as a distribution in partial liquidation under section 302(b)(4) and (e)(1)(A) (pre-TEFRA section 346(a)(2)) of the Code, unless it results in a 20 percent or greater reduction in (1) gross revenue, (2) net fair market value of assets, and (3) employees.

17. Sections 302(b)(4) and (e) (pre-TEFRA sections 346(a)(2) and (b)), 331, 332, pre-TRA 1986 section 333 and section 346(a) (pre-TEFRA section 346(a)(1)).—Effects on Recipients of Distributions in Corporate Liquidations.—The tax effect of the liquidation of a corporation preceded or followed by the reincorporation of all or a part of the business and assets when more than a nominal amount of the stock (that is, more than 20 percent in value) of both the liquidating corporation and the transferee corporation is owned by the same shareholders; or when a liquidation is followed by the sales of the corporate assets by the shareholders to another cor-

poration in which such shareholders own more than a nominal amount of the stock (that is, more than 20 percent in value).

18. Section 306.—Disposition of Certain Stock.—Whether the distribution or disposition or redemption of "section 306 stock" in a closely held corporation is in pursuance of a plan having as one of its principal purposes the avoidance of federal income taxes within the meaning of section 306(b)(4) of the Code.

19. Sections 331 and 346(a).—Gain or Loss to Shareholders in Corporate Liquidations.—The tax effect of the liquidation of a corporation by a series of distributions, when the distributions in liquidation are to be made over a period in excess of 3 years from the adoption of the plan of liquidation.

20. Section 336 (pre-TRA 1986 section 337).—Gain or Loss: Certain Liquidations.—The application of this section to a corporation upon the sale of property, in connection with its liquidation, to another corporation, when more than a nominal amount of the stock (that is, more than 20 percent in value) of both the selling corporation and the purchasing corporation is owned by the same persons.

21. Section 341.—Collapsible Corporations.—Whether a corporation will be considered to be a "collapsible corporation," that is, whether it was "formed or availed of" with the view of certain tax consequences. However, ruling requests will be considered on this matter when the enterprise (1) has been in existence for at least 20 years or has clearly demonstrated that it has realized two-thirds of the taxable income to be derived from the manufacturing, constructing, producing, or purchasing of property as stated in section 341(b)(1)(A) of the Code and as described in Rev. Rul. 72-48, 1972-1 C.B. 102; (2) has had an aggregate change in the shareholders' interests of not more than 10 percent during that period (except for transfers among family members, as defined in section 267(c)(4), or redemptions of stock to pay death taxes pursuant to section 303); and (3) has conducted substantially the same trade or business during that period. The period referred to in (2) and (3) above is the lesser of 20 years of corporate existence or the period in which the enterprise has realized two-thirds of the taxable income from activities specified in section 341(b)(1)(A).

22. Section 351.—Transfers to a Controlled Corporation.—The tax effect of the transfer when part of the consideration received by the transferors consists of an instrument that is a bond, debenture, or any other evidence of indebtedness of the transferee and either (1) the terms of the instrument permit, at the option of the issuer or holder, the payment of all or part of the principal on the instrument in less than 10 years from its issuance, or (2) a determination as to whether the "indebtedness" is properly classified as debt or equity is required in order to establish that the requirements of section 351 of the Code are met.

23. Section 351.—Transfer to Corporation Controlled by Transferor.—Whether section 351 of the Code applies to the transfer of an interest in real property by a cooperative housing corporation (as described in section 216(b)(1)) to a corporation in exchange for stock or securities of the transferee corporation if the transferee engages in commercial activity with respect to the real property interest transferred.

24. Section 355.—Distribution of Stock and Securities of a Controlled Corporation.—Whether the active business requirement of section 355(b) of the Code is met when, within the 5-year period described in section 355(b)(2)(B), a distributing corporation acquired control of a controlled corporation as a result of the distributing corporation transferring cash or other liquid or inactive assets to the controlled corporation in a transaction in which gain or loss was not recognized as a result of the transfer meeting the requirements of section 351(a) or 368(a)(1)(D).

25. Section 642.—Pooled Income Funds.—Whether a pooled income fund satisfies the requirements described in section 642(c)(5) of the Code.

26. Section 816.—Definition of Life Insurance Company.—Whether the requisite risk shifting and risk distribution necessary to constitute insurance are present for purposes of determining if a company is an "insurance company" under section 1.801-3(a) of the regulations, unless the facts of the transaction are within the scope of Rev. Rul. 77-316, 1977-2 C.B. 53, or Rev. Rul. 78-338, 1978-2 C.B. 107.

27. Section 1502.—Regulations.—Whether a parent cooperative housing corporation (as defined in section 216(b)(1) of the Code) will be permitted to file a consolidated income tax return with its transferee subsidiary if the transferee engages in commercial activity with respect to the real property interest transferred to it by the parent.

28. Section 2055.—Transfers for Public, Charitable and Religious Uses.—Whether a transfer to a pooled income fund described in section 642(c)(5) of the Code qualifies for a charitable deduction under section 2055(e)(2)(A).

29. Section 2522.—Charitable and Similar Gifts.—Whether a transfer to a pooled income fund described in section 642(c)(5) of the Code qualifies for a charitable deduction under section 2522(c)(2)(A).

30. Section 7701.—Definitions.—Whether what is generally known as a foreign corporation will be classified as a partnership for U.S. tax purposes if the taxpayer requests classification as a partnership.

31. Section 7701.—Definitions.—Whether a foreign partnership will be classified as an association for U.S. tax purposes if the taxpayer requests classification as an association.

.02 General areas.

1. Any matter in which the determination requested in primarily one of fact, e.g., market value of property, or whether an interest is a corporation is to be treated as stock or indebtedness.

2. The tax effect of any transaction to be consummated at some indefinite future time.

3. Any matter dealing with the question of whether property is held primarily for sale to customers in the ordinary course of trade or business.

4. The tax effect of a transaction if any part of the transaction is involved in litigation among the parties affected by the transaction; except for transactions involving bankruptcy reorganizations.

SEC. 5. 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.

.01 Section 61.—Gross Income Defined.—Whether amounts voluntarily deferred by a taxpayer under a deferred compensation plan maintained by an organization described in section 501 of the Code are currently includable in the taxpayer's gross income.

.02 Sections 61 and 162.—Gross Income Defined; Trade or Business Expenses.—The tax consequences with respect to a salary reduction arrangement under which an employee receives and returns salary amounts to the employer. (Also sections 3121, 3306 and 3401).

.03 Section 79.—Group-Term Life Insurance Purchased for Employees.—Whether life insurance provided for employers under a "retired lives reserve" plan will be considered group-term insurance (also sections 61, 72, 83, 101, 162, 264, and 641).

.04 Section 101.—Certain Death Benefits.—Whether proceeds of "self-insured" life and survivor benefit plans established through a trust qualified under section 501(c)(9) of the Code are excludable from the beneficiary's gross income as amounts paid by reason of the death of the insured under section 101(a).

.05 Section 105.—Amounts Received Under Accident and Health Plans.—Whether a medical reimbursement plan, funded by employer contributions, containing a provision allowing unused amounts to be carried over and accumulated in an employee's account qualifies as an accident and health plan under section 105 of the Code.

.06 Section 162.—Trade or Business Expenses.—Whether payments paid or accrued by a corporation to an exempt organization as described in sections 501(c)(7), (c)(9), (c)(17), or (c)(20) of the Code, are deductible under section 162.

.07 Sections 302(b)(4) and (e) (also pre-TEFRA section 346(a)(2) and (b)).—Partial Liquidation.—Whether the absence of an actual redemption of stock is a meaningless gesture within the meaning of Rev. Rul. 79-257, 1979-2 C.B. 136, as amplified by Rev. Rul. 81-3, 1981-1 C.B. 125, when:

(i) The corporation has outstanding more than one class of stock and there are priorities as to dividend or liquidating distributions or any other differences in stock rights, or

(ii) Either under the terms of the stock or as established contractually, there are outstanding any rights affecting the corporation's stock, such as, but not limited to, warrants, options, convertible securities, shareholder agreements, or rights of first refusal.

.08 Section 306(b)(4).—Transactions Not in Avoidance.—Whether section 306(b)(4) of the Code applies to the distribution and disposition or redemption of "section 306 stock" that is subject to mandatory redemption.

.09 Section 331, pre-TRA 1986 section 337, and sections 453 and 1239.—The Tax Effects of Installment Sales of Property Between Entities with Common Ownership.—The tax effects of a transaction in which there is a transfer of property by a corporation to a partnership or other noncorporation entity (or the transfer of stock to such entity followed by a liquidation of the corporation) when more than a nominal amount of the stock of such corporation and the capital or beneficial interests in the purchasing entity (that is, more than 20 percent in value) is owned by the same persons, and the consideration to be received by the selling corporation or the selling shareholders includes an installment obligation of the purchasing entity.

.10 Section 334(b)(2) (pre-TEFRA).—Liquidation of Subsidiary.—Whether an acquiring corporation may treat the life insurance reserves received in the liquidation as unsecured liabilities assumed.

.11 Section 336 (pre-TEFRA).—Distribution of Property in Liquidation.—Whether the liquidation of a life insurance subsidiary is a termination pursuant to section 815(d)(2) as in effect before the enactment of the Tax Reform Act of 1984.

.12 Section 338 (pre-TEFRA section 334(b)(2)).—Certain Stock Purchases Treated as Asset Acquisitions.—The tax consequences, under subchapter L, from the stock purchase and the deemed purchase of the assets of a life insurance subsidiary.

.13 Section 351.—Transfer to Corporation Controlled by Transferor.—Whether section 351 of the Code applies to the transfer of widely held developed or undeveloped real property or interests therein; widely held oil and gas properties or interests therein; or any similarly held properties or interests to a corporation in exchange for shares of stock of such corporation when (i) the transfer is the result of solicitation by promoters, brokers, or investment houses, or (ii) the transferee corporation's stock is issued in a form designed to render it readily tradable.

.14 Section 368.—Definitions Relating to Corporate Reorganizations.—Whether a transaction qualifies under either section 368(a)(1)(B) or section 351(a) of the Code by reason of Rev. Rul. 67-448, 1967-2 C.B. 144, when the same transaction is structured under sections 368(a)(1)(A) and 368(a)(2)(E) (as a reverse triangular merger) and fails to qualify for an advance ruling under those sections merely because the "substantially all" requirement set forth in section 3.01 of Rev. Proc. 77-37, 1977-2 C.B. 568, as amplified by Rev. Proc. 86-42, 1986-2 C.B. 722, is not met.

.15 Section 422A.—Incentive Stock Options.—Whether Holding (1) of Rev. Rul. 80-244, 1982 C.B. 234, relating to section 1036, applies to incentive stock options.

.16 Section 671.—Trust Income, Deductions, and Credits Attributable to Grantors and Others as Substantial Owners.—Whether the grantor will be considered the owner of any portion of a trust when (1) the trust corpus consists or will consist substantially of insurance policies on the life of the grantor or the grantor's spouse, (2) the trustee or any other person has a power to apply the trust's income or corpus to the payment of premiums on policies of insurance on the life of the grantor or the grantor's spouse, (3) the trustee or any other person has a power to use the trust's assets to make loans to the grantor's estate or to purchase assets from the grantor's estate, and (4) there is a right or power in any person that would cause the grantor to be treated as the owner of all or a portion of the trust under sections 673 to 677.

.17 Section 721.—Nonrecognition of Gain or Loss on Contribution.—Whether section 721 applies to the contribution of widely held developed or undeveloped real property or interests therein; widely held oil and gas properties or interests therein; or any similarly held properties or interests to a partnership in exchange for an interest in the partnership when (i) the contribution is the result of solicitation by promoters, brokers, or investment houses, or (ii) the interest in the transferee partnership is issued in a form designed to render it readily tradable.

.18 Section 801(b).—Life Insurance Company Taxable Income Defined.—Whether the liquidation of a life insurance subsidiary pursuant to either section 334(b)(2) (pre-TEFRA) or section 338 (added by TEFRA) is a termination under section 815(d)(2) (as in effect before the enactment of the Tax Reform Act of 1984) causing a distribution from the subsidiary's policyholders surplus account.

.19 Section 805(a)(8).—Other Deductions.—Whether a portion of the purchase price of the stock of the life insurance subsidiary is properly allocable to insurance in force.

.20 Section 811(b)(34).—Amortization of Premium and Accrual of Discount-Exception.—Whether the difference between the face value of bonds held by a life insurance subsidiary liquidating under section 334(b)(2) (pre-TEFRA) or section 338 (added by TEFRA) and the amount allocable to such bonds pursuant to the liquidation is market discount and need not be accrued.

.21 Section 815(d)(2) as in effect before the enactment of the Tax Reform Act of 1984.—Termination as Life Insurance Company.—Whether the liquidation of a life insurance subsidiary pursuant to section 334(b)(2) (pre-TEFRA) or section 338 (added by TEFRA) is a termination requiring the application of section 801(c) or section 802(b)(3) as in effect before the enactment of the Tax Reform Act of 1984.

.22 Section 816(b).—Life Insurance Reserves Defined.—Whether the life insurance reserves acquired in the liquidation of a life insurance subsidiary qualify as unsecured liabilities assumed by the acquiring corporation for purposes of section 334(b)(2) (pre-TEFRA) and section 338 (added by TEFRA).

.23 Section 818(b).—Treatment of Capital Gains and Losses, etc.—Whether the purchase of the stock of a life insurance subsidiary and its subsequent liquidation under section 334(b)(2) (pre-TEFRA) or section 338 (added by TEFRA) is, in fact, a purchase of the subsidiary's insurance contracts.

.24 Section 2503.—Taxable Gifts.—Whether the transfer of property to a trust will be a gift of a present interest in property when (1) the trust corpus consists or will consist substantially of insurance policies on the life of the grantor or the grantor's spouse, (2) the trustee or any other person has a power to apply the trust's income or corpus to the payment of premiums on policies of insurance on the life of the grantor or the grantor's spouse, (3) the trustee or any other person has a power to use the trust's assets to make loans to the grantor's estate or to purchase assets from the grantor's estate, (4) the trust beneficiaries have the power to withdraw, on demand, any additional transfers made to the trust, and (5) there is a right or power in any person that would cause the grantor to be treated as the owner of all or a portion of the trust under sections 673 to 677.

.25 Section 2514.—Powers of Appointment.—If the beneficiaries of a trust permit a power of withdrawal to lapse, whether section 2514(e) of the Code will be applicable to each beneficiary in regard to the power when (1) the trust corpus consists or will consist substantially of insurance policies on the life of the grantor or the grantor's spouse, (2) the trustee or any other person has a power to apply the trust's income or corpus to the payment of premiums on policies of insurance on the life of the grantor or the grantor's spouse, (3) the trustee or any other person has a power to use the trust's assets to make loans to the grantor's estate or to purchase assets from the grantor's estate, (4) the trust beneficiaries have the power to withdraw, on demand, any additional transfers made to the trust, and (5) there is a right or power in any person that would cause the grantor to be treated as the owner of all or a portion of the trust under sections 673 to 677.

.26 Sections 3121, 3306, and 3401.—Employment Taxes.—Who is the employer of an "employee-owner" as defined in section 269A of the Code.

.27 Section 7701.—Definitions.—The classification of arrangements formed as trusts under local law, in which the trust borrows money to purchase equipment or property and leases it to third parties, and in which the grantor or grantors have a beneficial interest in the trust and the power to manage the activities of the trust.

.28 Section 7701.—Definitions.—The classification of separately tradable instruments that are issued by a corporation as a unit, the components of which collectively contain the attributes of stock.

.29 Section 7701.—Definitions.—The classification of an instrument that has certain voting and liquidation rights in an issuing corporation but whose dividend rights are determined by reference to the earnings of a segregated portion of the issuing corporation's assets, including assets held by a subsidiary.

SEC. 6. EFFECT ON OTHER REVENUE PROCEDURES

Rev. Procs. 88-3, 88-25, 88-26, 88-34, 88-35, 88-38, 88-44, 88-45, 88-46, 88-47, 88-51, 88-54, and 88-57 are superseded. Rev. Proc. 88-50 is not superseded.

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26 CFR 601.201: Rulings and determination letters.

Rev. Proc. 89-4

SECTION 1. PURPOSE

This revenue procedure makes certain changes in the user fee program of the Internal Revenue Service that was established pursuant to section 10511 of the Revenue Act of 1987 (Title X of the Omnibus Budget Reconciliation Act of 1987), Public Law 100-203, enacted December 22, 1987. The program, which requires the payment of user fees to the Service for requests for rulings, opinion letters, and determination letters, and for similar requests, was first described in Rev. Proc. 88-8, 1988-1 C.B. 628.

SEC. 2. CHANGES

.01. Revenue Procedure 88-8 invited the public to submit written comments regarding the user fee program and provided that, if the comments reflected a need, a public meeting would be held to discuss the comments. Written comments were received, and a public meeting was held on May 19, 1988. The Service has given consideration to all comments, written and oral, that were received. Some of these comments, the Service's disposition of these comments, and other changes made to Revenue Procedure 88-8 are discussed below.

.02 *Limitation of Amount of Fees Applicable to Certain Mass Submitter Plan Adoptions.* Comments were received objecting to the fee of $100 per adoption agreement charged for a sponsor's word-for-word identical adoption of a mass submitter's plan. The fee schedule in section 4.03 of Rev. Proc. 88-8 has been modified to reduce the $100 fee to $50. There is also a $15,000 cap on the aggregate amount of such fees payable by the mass submitter on behalf of such sponsoring organizations within each 12-month period ending January 31.

.03 *Volume Submitter Plans.* The Service received comments that the fee for adoption of a volume submitter plan (a plan that conforms to a volume submitter specimen or lead plan according to procedures established by IRS district offices), which was subject to the fees under Rev. Proc. 88-8 applicable to individually designed plans, should be reduced. Under the revised fee schedule, volume submitter plans are no longer subject to the fees for individually designed plans. Instead, the term "volume submitter plan" has been defined solely for the purpose of determining the user fee that must be submitted with an application for a determination letter as to the qualification of such a plan. The fee applicable to volume submitter specimen or lead plans is $1,000; the fee applicable to adoptions of volume submitter plans is $100.

.04 *Computation of Exclusion Allowance under Section 72(b).* The Service received comments objecting to the $50 user fee for the calculation of the exclusion ratio for annuity payments under section 72(b) of the Code. The Service considered these comments, but decided to leave the $50 fee unchanged. However, the Service recently issued Notice 88-118, 1988-2 C.B. 450, which provides a simplified safe-harbor method for determining the tax-free and taxable portions of certain annuity payments that may be used by annuitants such as federal retirees for income tax purposes and by payors for reporting purposes. It is expected that most annuitants will be able to calculate the simplified safe-harbor method on their own, and will not need to ask the Service for this calculation.

.05 *Fee Increases for Employee Plans Determination and Notification Letter Program.* Consistent with section 10511 of OBRA '87 relating to the average fee to be received by each program of the Service, the fees have been increased for certain categories of requests under the Employee Plans Determination and Notification Letter Program. Specifically, the $400 and $600 fees have been increased to $450 and $750, respectively; the $500 fee for requests from collectively bargained plans has been increased to $550; and the $200 and $350 fees for terminating plans have been increased to $225 and $450, respectively.

.06 *New Exempt Organization Ruling Fee Category.* A new exempt organization ruling fee category has been added for advance approval of scholarship grant-making procedures of a private foundation that has an agreement for the administration of the scholarship program with the National Merit Scholarship Corp., or similar organization administering a scholarship program shown to meet Service requirements. The fee for these requests will be $100.

.07 *Reduced Fee for Small Exempt Organizations.* Rev. Proc. 88-8 provided a reduced fee of $150 for an initial application for exemption under section 501 of the Code for organizations that had average annual gross receipts over the preceding four years of not more than $5,000, and for new organizations that did not anticipate having gross receipts during each of their first four years of more than $5,000. Comments were received that the $5,000 threshold was too low, so that the reduced fee was not available to many organizations that had been intended to benefit from the reduced fee. Thus, the threshold has been raised from $5,000 to $10,000 in order to broaden the availability of the reduced fee.

.08 *Exemption for Requests Submitted on Form SS-8.* An exemption from the user fee has been provided with respect to requests submitted on Form SS-8, Information for Use in Determining Whether a Worker is an Employee for Federal Employment Taxes and Income Tax Withholding.

.09 *Discontinuance of Interim Practice with Respect to Certain Submissions.* Effective February 1, 1989, with respect to applications for determination letters as to the qualification of employee plans in categories for which the fee has not been increased, the Service will return to the submitter any request that is not accompanied by a properly completed check or money order for the correct amount. With respect to applications involving categories for which the user fee has been increased, until March 31, 1989, applications that are not accompanied by the correct amount will not be returned for this reason, but will be processed as described in Section 6.08(2) of this revenue procedure. With respect to all other requests, the Service will exercise discretion in deciding whether to immediately return submissions that are deficient with regard to the user fee.

SEC. 3. BACKGROUND

.01 Section 10511 of the Revenue Act of 1987 ("Act") provides that the Secretary of the Treasury or his delegate ("Secretary") shall establish a program requiring the payment of user fees for requests to the Service for rulings, opinion letters, determination letters, and similar requests. Section 10511 provides that such fees shall apply with respect to requests made on or after the 1st day of the second calendar month beginning after the date of enactment and before September 30, 1990. The fees charged under the program are to vary according to categories (or subcategories) established by the Secretary; they are to be determined after taking into account the average time for, and difficulty of, complying with requests in each category and subcategory; and they are to be payable in advance. The Secretary is to provide for such exemptions and reduced fees under the program as he determines to be appropriate, but the average fee applicable to each category must not be less than the amount specified in the statute.

.02 Rev. Proc. 88-8, which established the user fee program mandated by Section 10511 of the Act, was modified by Rev. Proc. 88-13, 1988-1 C.B. 639, and Rev. Proc. 88-27, 1988-1 C.B. 804.

.03 Rev. Proc. 88-8 invited the public to submit written comments on the user fee program and stated that, if the comments reflected a need, a public meeting would be held to discuss suggested changes. A public meeting for that purpose was held on May 19, 1988, pursuant to Announcement 88-69, 1988-15 I.R.B. 50.

SEC. 4. RELATED REVENUE PROCEDURES

.01 Rev. Proc. 89-1, page 740, this Bulletin, provides, other than for international issues, procedures for issuing rulings and information letters and for entering into closing agreements on specific issues involving the interpretation or application of the federal tax laws under the jurisdiction of the Associate Chief Counsel (Technical). It also provides, other than for international issues, procedures for issuing determination letters on matters that relate to sections of the Code under the jurisdiction of the Associate Chief Counsel (Technical).

.02 Concerning international issues, Rev. Proc. 87-4, 1987-1 C.B. 529, as modified by Rev. Proc. 88-4, 1988-1 C.B. 586, provides procedures for obtaining rulings, closing agreements, and information letters on federal tax issues under the jurisdiction of the Associate Chief Counsel (International) and provides information concerning determination letters under the jurisdiction of the Assistant Commissioner (International) and the District Directors.

.03 Rev. Proc. 78-37, 1978-2 C.B. 540, sets forth the procedure by which a plan administrator or plan sponsor may obtain approval of the Secretary of the Treasury for a change in funding method as provided by section 412(c)(5) of the Code and section 302(c)(5) of the Employee Retirement Income Security Act of 1974 (ERISA).

.04 Rev. Proc. 79-18, 1979-1 C.B. 525, outlines the procedure by which a plan administrator or plan sponsor may file notice with and obtain approval from the Secretary of the Treasury for a retroactive plan amendment described in section 412(c)(8) of the Code and section 302(c)(8) of ERISA.

.05 Rev. Proc. 79-61, 1979-2 C.B. 575, outlines the procedure by which a plan administrator or plan sponsor may request and obtain approval for an extension of an amortization period in accordance with section 412(e) of the Code and section 304(a) of ERISA.

.06 Rev. Proc. 79-62, 1979-2 C.B. 576, outlines the procedure by which a plan sponsor or administrator may request a determination that a plan amendment is reasonable and provides for only de minimis increases in plan liabilities in accordance with section 412(f)(2)(A) of the Code and section 304(b)(2)(A) of ERISA.

.07 Rev. Proc. 80-30, 1988-1 C.B. 685, sets forth the general procedures of the various offices of the Service pertaining to the issuance of determination letters on the qualification of pension, annuity, profit-sharing and stock bonus plans involving sections 401, 403(a), 409 and 4975(e)(7) of the Code, and the status for exemption of any related trusts or custodial accounts under section 501(a).

.08 Rev. Proc. 83-36, 1983-1 C.B. 763, as modified by Rev. Proc. 87-40, 1987-2 C.B. 514, sets forth the general procedures of the Service in issuing rulings, determination letters, opinion letters, notification letters, and information letters to taxpayers and in entering into closing agreements on specific issues as to the interpretation or application of the federal tax laws in the employee plan and exempt organization areas.

.09 Rev. Proc. 83-41, 1983-1 C.B. 775, as modified by Rev. Proc. 88-5, 1988-1 C.B. 587, and Rev. Proc. 88-29, 1988-1 C.B. 828, outlines the procedures of the Service with respect to applications for waivers of the minimum funding standard under either section 412(d) of the Code or section 303 of ERISA.

.10 Rev. Proc. 84-23, 1984-1 C.B. 457, sets forth the procedures of the Service pertaining to the issuance of opinion letters relating to master or prototype pension, annuity, and profit-sharing plans involving sections 401 and 403(a) of the Code, as amended by the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), and the status for exemption of related trusts or custodial accounts under section 501(a).

.11 Rev. Proc. 84-46, 1984-1 C.B. 541, provides procedures for applications for recognition of exemption from federal income tax under sections 501 and 521 of the Code.

.12 Rev. Proc. 84-86, 1984-2 C.B. 787, sets forth the procedures of the Service for issuing notification letters and determination letters relating to the qualification of certain defined contribution and defined benefit plans and any related trusts or custodial accounts under sections 401, 403(a), and 501(a) of the Code, as amended by TEFRA, the Tax Reform Act of 1984 (TRA '84), and the Retirement Equity Act of 1984 (REA). Rev. Proc. 84-86 establishes a means whereby certain "sponsors" may submit "uniform plans" to key district directors for approval as to form.

.13 Rev. Proc. 87-50, 1987-2 C.B. 647, updates and consolidates in one revenue procedure the procedures of the Service relating to the issuance of rulings and opinion letters with respect to the establishment of individual retirement accounts and annuities (IRAs) under section 408 of the Code, the entitlement to exemption of related trusts or custodial accounts under section 408(e), and the acceptability of the form of prototype simplified employee pension (SEP) agreements under sections 408(k) and 415.

SEC. 5. SCOPE

Except as provided in section 6.10 below, all requests for rulings, determination letters or opinion letters submitted on or after February 1, 1989, and before September 30, 1990, by or on behalf of taxpayers, sponsoring organizations or other entities must be accompanied by the appropriate user fee as determined from the schedule set forth in section 6.03 below. Except as provided in section 6.10, user fees apply to all requests for reconsideration of rulings, determination letters or opinion letters, but may be refunded in certain situations (see section 6.09(2) below). User fees do not apply to requests for information letters.

SEC. 6. PROCEDURE

.01 *Definitions*. The terms "ruling," "determination letter," "opinion letter," "notification letter," "information letter," "master plan," "prototype plan," "sponsoring organization," "mass submitter," "basic plan document," "adoption agreement," and "uniform plan" as used in this revenue procedure have the same meaning as they have in the pertinent revenue procedure referred to in section 4 above. The term "volume submitter plan" has the meaning given in subsection .02 below.

.02 *Volume Submitter Plan*. The following definition is effective February 1, 1989, and applies solely for the purpose of determining the amount of the user fee that is required to be submitted with an application for a determination letter as to the qualification of a volume submitter plan: A "volume submitter plan" is a pension, profit-sharing or stock bonus plan the form of which meets certain criteria established by an individual key district and which is submitted pursuant to procedures established by the key district for filing determination letter applications under the district's volume submitter program. At a minimum:

(1) The determination letter application submitted by a practitioner on behalf of an employer must relate to a plan that is substantially identical in form to a specimen or "lead" plan of the same practitioner, the form of which was previously approved by the key district to which the application is submitted, and

(2) The practitioner must have certified at the time of submission of the specimen or lead plan that he or she would submit no fewer than 30 determination letter applications described in paragraph (1) immediately above for each type of plan (for example, unit benefit plan, fixed benefit plan, profit-sharing plan, stock bonus plan) following the district's approval of the specimen or lead plan.

.03 *Fee Schedule*. The amount of the user fee payable with respect to each category or subcategory of submission is as set forth in the following schedule:

(1) *Associate Chief Counsel (Technical) and Associate Chief Counsel (International) Rulings*

Applications with respect to accounting periods (Forms 1128 and 2553)	$150
Change in accounting method (Form 3115)	$200
All other rulings (which includes accounting period, accounting method, and earnings and profits requests other than those submitted on Forms 1128, 2553, 3115 and 5452)	$300

(2) *Employee Plans Rulings and Opinion Letters*

(a) *Rulings*

Computation of exclusion for annuitant under section 72	$50
Change in plan year (Form 5308)	$150
Change in funding method	$200
Requests for approval to become a nonbank trustee (see section 1.401-12(n) of the Income Tax Regulations)	$1,000
Waiver of minimum funding:	
$1,000,000 and over	$1,000
Under $1,000,000	$750
All other rulings	$400

(b) *Opinion Letters on Master and Prototype Plans*

(The terms "mass submitter," "word-for-word identical adoption," and "minor modification" as used in this subcategory are explained in section 17 of Rev. Proc. 84-23.)

Mass submission, per basic plan document (new or amended, regardless of number of adoption agreements) $1,000

Sponsoring organization's word-for-word identical adoption of mass submitter's basic plan document, per adoption agreement (mass submitters which are sponsoring organizations in their own right are liable for this fee).................$50

NOTE: Beginning February 1, 1989, if a mass submitter submits, in any 12-month period ending January 31, more than 300 applications on behalf of word-for-word adopters with respect to a particular adoption agreement, only the first 300 such applications will be subject to the fee; no fee will apply to those in excess of the first 300 such applications submitted within the 12-month period.

Sponsoring organization's minor modification of mass submitter's plan document, per affected document $400

Non-mass submission by sponsoring organization, per adoption agreement................$1,000

Sponsoring organization's adoption of model section 401(k) amendment, per adoption agreement $100

(c) *Opinion Letters on Prototype Individual Retirement Accounts/Annuities and Simplified Employee Plans*

(The terms "mass submitter," "word-for-word identical adoption," and "minor modification" as used in this subcategory are explained in section 7 of Rev. Proc. 87-50.)

Mass submission, per plan document, new or amended........$1,000

Sponsoring organization's word-for-word identical adoption of mass submitter's prototype IRA or SEP, per plan document.......................$50

NOTE: Beginning February 1, 1989, if a mass submitter submits, in any 12-month period ending January 31, more than 300 applications on behalf of word-for-word adopters with respect to a particular adoption agreement, only the first 300 such applications will be subject to the fee; no fee will apply to those in excess of the first 300 such applications submitted within the 12-month period.

Sponsoring organization's minor modification of mass submitter's prototype IRA or SEP, per plan document $400

Non-mass submission by sponsoring organization, per plan document....................$1,000

(3) *Exempt Organization Rulings*

Change in accounting period (Form 1128)...................$150

Change in accounting method (Form 3115)...................$200

Advance approval of scholarship grant-making procedures of a private foundation that has an agreement for the administration of the scholarship program with the National Merit Scholarship Corp., or similar organization administering a scholarship program shown to meet Service requirements...................$100

All other rulings................$400

(4) *Employee Plans Determination Letters and Notification Letters*

Defined benefit and defined contribution plans (Forms 5300 and 5301):

Under 100 participants.........$450

100 or more participants $750

(For user fee purposes, the total number of participants referred to in this subcategory is the same as the number referred to on transmittal Form 8717, User Fee for Employee Plan Determination Letter Request.)

Collectively bargained plans (Form 5303)...................$550

Adopters of master and prototype plans, volume submitter plans, uniform plans, or other pre-approved plans as designated by the Assistant Commissioner (Employee Plans and Exempt Organizations) (Form 5307)........................$100

Terminating plans (Form 5310):

(The fee applies only if Form 5310 is being used to request a determination letter; it does not apply if the form is being used merely to notify the Service of a merger, consolidation or transfer of plan assets or liabilities.)

Under 100 participants.........$225

100 or more participants $450

(For user fee purposes, the total number of participants referred to in this subcategory is the same as the number referred to on transmittal Form 8717, User Fee for Employee Plan Determination Letter Request.)

Short amendments (Form 6406) ...$100

Volume submitter specimen or lead plans (Form 5300, 5301 or 5303)......................$1,000

Uniform plans (Form 4461).......$500

Group trusts contemplated by Rev. Rul. 81-100, 1981-1 C.B. 326 ....$400

(5) *Exempt Organization Determination Letters*

Initial application for exemption under section 501 from organizations (other than pension, profit-sharing, and stock bonus plans described in section 401) that have had annual gross receipts averaging not more than $10,000 during the preceding four years, or new organizations which anticipate gross receipts averaging not more than $10,000 during their first four years $150

(Organizations seeking this reduced fee must sign a certification with their application that the receipts are or will be not more than the indicated amounts.)

Initial application for exempt status from organizations otherwise described above whose actual or anticipated gross receipts exceed the $10,000 average annually................$300

Request for termination of private foundation status............$200

(6) *Other Determination Letters*

Determination letters governed by Rev. Proc. 89-1 and Rev. Proc. 87-4 concerning income tax, estate tax, gift tax, excise tax, employment tax, and administrative matters............$200

.04 *Submissions Involving Several Offices, Subcategories, Issues, or Unrelated Transactions.* If a request dealing with only one transaction involves more than one of the offices within the National Office of the Service (for example, one issue is under the jurisdiction of the Associate Chief Counsel (Technical) and another issue is under the jurisdiction of the Assistant Commissioner (Employee Plans and Exempt Organizations)), or if a ruling request is within more than one subcategory, only one fee applies, namely the highest fee that otherwise would apply to each of the offices or subcategories involved. A separate fee will apply with respect to each unrelated transaction where a request involves several unrelated transactions or the request is changed by the addition of an unrelated transaction not contained in the initial submission. However, the addition of a new issue relating to the same transaction will not result in an additional fee, except when the issue places the transaction in a higher fee category.

.05 *Method of Payment.* Each request to the Service for a ruling, determination letter or opinion letter must be accompanied by a check or money order, payable to the Internal Revenue Service, in the appropriate amount. (However, the user fee check or money order should not be attached to the Form 2553, Election by a Small Business Corporation, when it is filed at the Service Center. If on the Form 2553 the corporation requests a ruling that it be permitted to use a fiscal year under section 6.03 of Rev. Proc. 87-32, the Service Center will forward such request to the National Office. When the National Office receives the Form 2553 from the Service Center, it will notify the taxpayer that the fee is due.) Requesters should not send cash.

.06 *Mailing Address for Requesting Rulings, Determination Letters, etc.*

(1) A request for a ruling letter submitted pursuant to Rev. Proc. 89-1 should be sent to the Internal Revenue Service, Associate Chief Counsel (Technical). Attention: CC:CORP:T, P.O. Box 7604, Ben Franklin Station, Washington, D.C. 20044. Requests may be hand-delivered to Room 6561, 1111 Constitution Avenue, N.W., Washington, D.C., by 4:00 p.m. on business days; after 4:00 p.m., such requests may be deposited in the lock box located just within the entrance on the 12th Street side of the building.

(2) A request for a ruling letter submitted pursuant to Rev. Proc. 87-4 should be sent to the Internal Revenue Service, Associate Chief Counsel (International), Attention: CC:CORP:T, P.O. Box 7604, Ben Franklin Station, Washington, D.C. 20044. Requests may be hand-delivered to Room 6561, 1111 Constitution Avenue, N.W., Washington, D.C., or deposited in the lock box as described above.

(3) A request for a determination letter submitted pursuant to Rev. Proc. 89-1 or Rev. Proc. 87-4 should be sent to the District Director of Internal Revenue whose office has or will have examination jurisdiction over the taxpayer's return.

(4) Requests for rulings or opinion letters submitted pursuant to Rev. Proc. 78-37, 79-18, 79-61, 79-62, 83-36, 83-41, 84-23 or 87-50 should be sent to the address set forth below. Such requests may be hand-delivered to Room 6052, 1111 Constitution Avenue, N.W., Washington, D.C., by 4:00 p.m. on business days; after 4:00 p.m., such requests may be deposited in the lock box located just within the entrance on the 12th Street side of the building.

(a) *Employee Plans Rulings*
Internal Revenue Service
Assistant Commissioner (Employee Plans and Exempt Organizations)
Attention: E:EP:R
P.O. Box 14073, Ben Franklin Station
Washington, D.C. 20044

(b) *Exempt Organizations Rulings*
Internal Revenue Service
Assistant Commissioner (Employee Plans and Exempt Organizations)
Attention: E:EO
P.O. Box 120, Ben Franklin Station
Washington, D.C. 20044

(c) *Employee Plans Opinion Letters*
Internal Revenue Service
Assistant Commissioner (Employee Plans and Exempt Organizations)
Attention: E:EP:Q
P.O. Box 14073, Ben Franklin Station
Washington, D.C. 20044

(5) Requests for determination letters submitted pursuant to Rev. Procs. 80-30, 83-36, 84-46, or 84-86, and requests for notification letters submitted pursuant to Rev. Proc. 84-86, should be sent to the following address:

If entity is in this IRS District:	*Send request for determination letter or notification letter to this address:*
For Employee Plans and Exempt Organizations	
Brooklyn, Albany, Augusta, Boston, Buffalo, Burlington, Hartford, Manhattan, Portsmouth, Providence	Internal Revenue Service EP/EO Division P.O. Box 1680, GPO Brooklyn, NY 11202
Baltimore, District of Columbia, Pittsburgh, Richmond, Newark, Philadelphia, Wilmington, any U.S. possession or foreign country	Internal Revenue Service EP/EO Division P.O. Box 17010 Baltimore, MD 21203
Atlanta, Birmingham, Columbia, Fort Lauderdale, Greensboro, Jackson, Jacksonville, Little Rock, Nashville, New Orleans	Internal Revenue Service EP/EO Division Room 1112 P.O. Box 941 Atlanta, GA 30301
Cincinnati, Cleveland, Detroit, Indianapolis, Louisville, Parkersburg	Internal Revenue Service EP/EO Division P.O. Box 3159 Cincinnati, OH 45201
Dallas, Albuquerque, Austin, Cheyenne, Denver, Houston, Oklahoma City, Phoenix, Salt Lake City, Wichita	Internal Revenue Service EP/EO Division Mail Code 4950 DAL 1100 Commerce Street Dallas, TX 75242

For Employee Plans Only

Chicago, Aberdeen, Des Moines, Fargo, Helena, Milwaukee, Omaha, St. Louis, St. Paul, Springfield	Internal Revenue Service EP/EO Division 230 S. Dearborn DPN 20-6 Chicago, IL 60604
Honolulu, Laguna Niguel, Las Vegas, Los Angeles, San Jose	Internal Revenue Service EP Application Receiving Room 5127 P.O. Box 536 Los Angeles, CA 90053-0536
Sacramento, San Francisco	Internal Revenue Service EP Application Receiving Stop SF 4446 P.O. Box 36001 San Francisco, CA 94102
Anchorage, Boise, Portland, Seattle	Internal Revenue Service EP Application Receiving P.O. Box 21224 Seattle, WA 98111

For Exempt Organizations Only

Chicago, Aberdeen, Des Moines, Fargo, Helena, Milwaukee, Omaha, St. Louis, St. Paul, Springfield	Internal Revenue Service EP/EO Division 230 S. Dearborn DPN 20-5 Chicago, IL 60604
Anchorage, Las Vegas, Boise, Los Angeles, Honolulu, Portland, Laguna Niguel, San Jose, Seattle	Internal Revenue Service EO Application Receiving Room 5127 P.O. Box 486 Los Angeles, CA 90053-0486
Sacramento, San Francisco	Internal Revenue Service EO Application Receiving Stop SF 4446 P.O. Box 36001 San Francisco, CA 94102

.07 *Transmittal Forms.* Form 8717, User Fee for Employee Plan Determination Letter Request, and Form 8718, User Fee for Exempt Organization Determination Letter Request, are intended to be used as attachments to determination letter applications. Space is reserved for the attachment of the applicable user fee check or money order. No similar form has been designed to be used in connection with requests for rulings, opinion letters or notification letters.

.08 *Effect of Nonpayment or Payment of Incorrect Amount.* It will be the general practice of the Service that:

(1) Beginning February 1, 1989, if a request for a determination letter as to the qualification of an employee plan in a category for which the fee has not been increased is not accompanied by a properly completed check or money order (for example, a check has not been signed), or if the request is accompanied by a check or money order for less than the correct amount, the entire submission will be returned to the submitter, along with the check or money order. With respect to submissions received prior to February 1, 1989, key district offices will exercise discretion in deciding, on a case-by-case basis, whether to immediately return such submissions or to return them only after the submitter has been contacted and given a reasonable amount of time to submit the proper fee, if the fee has not been received within that time.

(2) Until March 31, 1989, submissions involving categories for which the user fee has been increased that are not accompanied by the correct fee will not be returned for this reason. Instead, the submitter will be contacted and given a reasonable time to submit the proper fee. If the fee is not received in a reasonable time, the entire submission will be returned. However, the Service, in its discretion, may defer substantive consideration of the submission until proper payment has been received.

(3) The return of a submission to the submitter may adversely affect substantive rights if the submission is not perfected and resubmitted to the Service within 30 days of the date of the cover letter returning the submission. For example, where an application for a determination letter is submitted prior to the expiration of the remedial amendment period under section 401(b) of the Code and is returned because no user fee was attached, the submission will be timely if it is resubmitted by the expiration of the remedial amendment period or, if later, within 30 days after the application was returned.

(4) If a check or money order is for more than the correct amount, the submission will be accepted and the amount of the excess payment will be returned to the submitter.

(5) An application for a determination letter will not be returned merely because Form 8717 or Form 8718 was not attached.

(6) Except in the case of requests received on or after February 1, 1989, for determination letters as to the qualification of employee plans (see paragraph (1) above), or in the case of requests involving categories for which the fee has been increased (see paragraph (2) above), the respective offices within the Service that are responsible for issu-

ing rulings, determination letters, etc. will exercise discretion in deciding whether to immediately return submissions that are not accompanied by a properly completed check or money order or that are accompanied by a check or money order for less than the correct amount. In those instances where the submission is not immediately returned, the submitter will be contacted and given a reasonable amount of time to submit the proper fee. If the proper fee is not received within a reasonable amount of time, the entire submission will then be returned. However, the respective offices of the Service, in their discretion, may defer substantive consideration of a submission until proper payment has been received.

.09 *Refunds*. In general, the fee will not be refunded unless the Service declines to rule on all issues for which a ruling is requested.

(1) The following are examples of situations in which the fee will not be refunded:

(a) The request for a ruling, determination letter, etc. is withdrawn at any time subsequent to its receipt by the Service.

(b) The request is procedurally deficient, although accompanied by the proper fee or an overpayment and is not timely perfected by the submitter. Where there is a failure to timely perfect the request, the case will be considered closed and the failure to perfect will be treated as a withdrawal for purposes of this revenue procedure.

(c) A ruling, determination letter, etc. is revoked in whole or in part at the initiative of the Service. The fee paid at the time the original ruling, determination letter, etc. was requested will not be refunded.

(d) The request contains several issues and the Service rules on some, but not all, of the issues. The highest fee applicable to the issues on which the Service rules will not be refunded.

(e) The taxpayer asserts that a ruling the taxpayer received covering a single issue is erroneous or not responsive (other than with respect to any issue on which the Service has declined to rule) and requests reconsideration. The Service, upon reconsideration, does not agree that the ruling is erroneous or not responsive. The fee accompanying the request for reconsideration will not be refunded.

(f) The situation is the same as described in subparagraph (e) immediately above except that the ruling covered several unrelated transactions. The Service, upon reconsideration, does not agree with the taxpayer that the ruling is erroneous or not responsive with respect to all of the transactions, but does agree that it is erroneous with respect to one transaction. The fee accompanying the request for reconsideration will not be refunded except to the extent applicable to the transaction with respect to which the Service agrees the ruling was in error.

(g) The request is for a supplemental ruling, determination letter, etc. concerning a change in facts (whether significant or not) relating to the transaction ruled on.

(h) The request is for reconsideration of an adverse or partially adverse ruling or a final adverse determination letter, and the taxpayer submits arguments and authorities not submitted before the original ruling or determination letter was issued.

(2) The following are examples of situations in which the fee will be refunded:

(a) In a situation to which section 6.09(1)(h) above does not apply, the taxpayer asserts that a ruling the taxpayer received covering a single issue is erroneous or not responsive (other than with respect to any issue on which the Service declined to rule) and requests reconsideration. The Service agrees, upon reconsideration, that the ruling is erroneous or not responsive. The fee accompanying the taxpayer's request for reconsideration will be refunded.

(b) In a situation to which section 6.09(1)(h) above does not apply, the taxpayer requests a supplemental ruling, determination letter, etc. to correct a mistake that the Service agrees it made in the original ruling, determination letter, etc., such as a mistake in the statement of facts or in the citation of a Code section. Once the Service agrees that it made a mistake, the fee accompanying the request for the supplemental ruling will be refunded.

(c) The taxpayer requests and is granted relief under section 7805(b) of the Code in connection with the revocation in whole or in part, of a previously issued ruling, determination letter, etc. The fee accompanying the request for relief will be refunded.

.10 *Exemptions*.

(1) The user fee requirement of this revenue procedure shall not apply to departments, agencies, or instrumentalities of the United States that certify that they are seeking a ruling, determination letter, opinion letter or similar letter on behalf of a program or activity funded by federal appropriations. The fact that a user fee is not charged shall have no bearing on whether an applicant is treated as an agency or instrumentality of the United States for purposes of any provision of the Internal Revenue Code.

(2) The user fee requirements of this revenue procedure shall not apply to requests as to whether a worker is an employee for federal employment taxes and income tax withholding purposes (chapters 21, 22, 23, and 24, subtitle C, of the Internal Revenue Code) submitted on Form SS-8, Information for Use in Determining Whether a Worker Is an Employee for Federal Employment Taxes and Income Tax Withholding, or its equivalent.

SEC. 7. QUESTIONS AS TO APPLICABILITY OR AMOUNT OF FEE

A taxpayer or organization that believes the user fee charged by the Service for its request for a ruling, determination letter, etc. is either not applicable or incorrect may request reconsideration and, if desired, the opportunity for an oral discussion by sending a letter to the Internal Revenue Service at the applicable Post Office Box or other address given in section 6.06 above. Both the incoming envelope and the letter requesting such reconsideration should be prominently marked "USER FEE RECONSIDERATION REQUEST," and the request should be marked for the attention of:

If the matter involves primarily:	*Mark for attention of:*
Associate Chief Counsel (Technical) ruling requests submitted pursuant to Rev. Proc. 89-1	Assistant Chief Counsel ( ) (complete by using whichever of the following designations applies) (Corporate) (Financial Institutions and Products) (Employee Benefits & Exempt Organizations) (Income Tax and Accounting) (Passthroughs and Special Industries)
Associate Chief Counsel (International) ruling requests submitted pursuant to Rev. Proc. 87-4	Assistant Chief Counsel (International)
Employee plan ruling and opinion letter requests	Chief, Rulings Branch E:EP:R
Exempt organization ruling requests	Chief, Rulings Branch E:EO:R
Employee plan and/or exempt organization determination letter requests	Chief, Technical Staff ________Key District Office (add name of key district office handling the request)
Determination letter requests submitted pursuant to Rev. Proc. 89-1 or Rev. Proc. 87-4	Chief, Examination Division __________District Office (add name of district office handling the request)

SEC. 8. EFFECT ON OTHER DOCUMENTS

.01 Rev. Procs. 80-30, 83-36, 84-23, 84-46, 84-86, 87-4, 87-50, and 89-1 are modified and amplified to the extent that this revenue procedure provides for an additional requirement that must be satisfied in requesting a ruling, determination letter or opinion letter pursuant to those revenue procedures.

.02 Rev. Procs. 88-8, 88-13 and 88-27 are superseded with respect to requests for rulings, determination letters, etc. postmarked or, if not mailed, received by the Service on or after February 1, 1989. Rev. Proc. 88-8, as modified by Rev. Procs. 88-13 and 88-27, continues to be in effect with respect to requests for rulings, determination letters, etc., received on or after February 1, 1988, and before February 1, 1989.

SEC. 9. EFFECTIVE DATE

Except for paragraph (2) of Section 6.10, which is effective February 1, 1988, this revenue procedure is effective as of February 1, 1989. It does not apply to requests filed on or after September 30, 1990.

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26 CFR 601.201: Rulings and determination letters.
(Also Part I, Section 103; 1.103-14.)

Rev. Proc. 89-5

SECTION 1. PURPOSE

This revenue procedure provides that, in general, the Internal Revenue Service will not issue rulings to persons that wish to extend the temporary period during which the proceeds of certain state and local bonds are arbitraged and are seeking rulings that the extension will not cause the bonds to be taxable "arbitrage bonds" within the meaning of former section 103 (c)(2) of the Internal Revenue Code. In addition, however, this procedure describes a class of situations in which such rulings may be issued (see section 5), and it prescribes the information that must be submitted as part of any request for such a ruling (see section 6).

SEC. 2. BACKGROUND

.01 Under former section 103(c)(1) of the Code a bond is an arbitrage bond, and thus interest paid thereon is not tax-exempt, if a major portion of the proceeds of the issue is invested in taxable obligations or securities with a yield that is materially higher than the yield on the governmental obligation (that is, the bond proceeds are arbitraged). However, under former section 103(c)(4)(A) of the Code and section 1.103-14(b) of the Income Tax Regulations, an issuer could arbitrage proceeds of a non-refunding bond for a temporary period prior to their expenditure for the governmental purpose of the issue if certain requirements are met. One of these requirements is that an amount equal to 85 percent of the spendable proceeds of the issue be spent by the end of the three-year period following issuance of the bonds. In the case of certain construction issues, a five-year period may be used if the issuer, by means of a certification of an independent architect or engineer, establishes that a longer period not exceeding five years is needed to expend 85 percent of the spendable proceeds. Sections 1.103-13(a)(2)(ii)(E) and 1.103-14(b)(5)(ii) of the regulations.

.02 The exception for temporary period investment, however, is not available if the issuer (or another party with a material financial interest in the issuance of the bonds) deliberately acts to prolong the period between issuance of the bonds and expenditure of the proceeds by issuing (or having the issuer issue) the bonds prematurely. Rev. Rul. 80-204, 1980-2 C.B. 51. Similarly, the exception for temporary period investment is not available if bonds are issued prematurely to avoid requirements of new federal, state, or local laws, to earn additional arbitrage profits, or for other reasons not consistent with ordinary financial practice.

.03 Depending on the particular circumstances, the foregoing restrictions are of practical importance primarily for bonds that were issued before January 1, 1985, January 1, 1986, or September 1, 1986, which were the effective dates for former section 103(c)(6) of the Code and section 148(f).

SEC. 3. SCOPE

This revenue procedure applies to requests that the Service issue a ruling or determination letter concluding that a state or local governmental obligation is not an arbitrage bond solely by reason of the investment of the bond proceeds in acquired nonpurpose obligations at a materially higher yield more than three years after issuance of the bonds, or five years after issuance of the bonds in the case of a construction issue described in section 1.103-13(a)(2)(ii)(E) of the regulations.

SEC. 4. PROCEDURE

.01 The Service will not issue a ruling described in section 3 unless the bonds meet the requirements in section 5.

.02 Any request for a ruling to which this revenue procedure applies, in addition to meeting all other applicable requirements, must contain the information described in section 6.

SEC. 5. REQUIREMENTS

.01 A bond issue meets the requirements of this section if the following circumstances apply:

(1) The proceeds of the issue of which the bonds are a part were expected as of the date of issue to be used to finance a construction project. An issue of bonds does not fail the requirements of this paragraph merely because an amount of original proceeds of the issue not exceeding 40 percent of the net original proceeds was expected to be used for the acquisition of land or equipment that is directly related and integral to the operation of the buildings or structures that are part of the construction project. For purposes of this revenue procedure, net original proceeds are original proceeds as defined in section 1.103-13(b)(2)(i) of the regulations, minus amounts deposited in a reasonably required reserve or replacement fund as defined in section 1.103-14(d).

(2) By the end of the three-year period, an amount of original proceeds equal to more than 15 percent of the net original proceeds of the issue of bonds was spent for costs relating to construction of the project (including acquisition of any land and equipment described in paragraph (1)). If the bonds are part of a construction issue described in section 1.103-13(a)(2)(ii)(E) of the regulations, the preceding sentence shall be applied by substituting "five-year period" for "three-year period" and "25 percent" for "15 percent." For purposes of this paragraph, expenditures of bond proceeds are considered made first from investment earnings (earnings from investments in both acquired nonpurpose obligations and tax-exempt bonds) and then from original proceeds.

(3) By the end of the applicable three-year or five-year period, an amount of original proceeds equal to more than 5 percent of the net original proceeds of the issue of bonds was spent for direct costs of labor, equipment, and materials used on the construction site (for example, the cost of site preparation or foundation construction but not capitalized interest).

(4) The failure to expend 85 percent of the spendable proceeds by the end of the applicable three-year or five-year period was caused by events that were not reasonably anticipated at the time of issue and were beyond the control of the governmental issuer or true obligor on the bonds.

(5) Due diligence was exercised and will continue to be exercised in expending the proceeds of the bonds in a manner consistent with the intended purpose of the financing. To meet the condition imposed by this paragraph, there must be established with reasonable certainty a specific reasonable date by which all bond proceeds, other than a minor portion, will be expended in a manner consistent with the intended purpose of the bonds. If the issuer or true obligor proposes to invest the bond proceeds in materially higher yielding acquired nonpurpose obligations for a period of more than three years after the end of the original applicable three-year or five-year period, then there is a rebuttable presumption that the issuer or true obligor will take deliberate and intentional actions to produce arbitrage within the meaning of Rev. Rul. 80-91, 1980-1 C.B. 30, Rev. Rul. 80-92, 1980-1 C.B. 31, and Rev. Rul. 80-188, 1980-2 C.B. 47.

(6) If bonds are to be secured, directly or indirectly, primarily by revenues from the project being financed with bond proceeds and, pending generation of such revenues, the bond proceeds, directly or indirectly, provide part or all of the security for the bonds, then the bonds must satisfy the following additional conditions:

(a) Within six months after issuance of the bonds, the governmental issuer or true obligor on the bonds entered into a binding contract to incur expenditures that exceeded 10 percent of the cost of construction of the project to be financed with proceeds of the issue of bonds.

(b) Construction of the project commenced within one year after issuance of the issue of bonds. Construction commences when physical work on the project begins.

.02 For purposes of section 5, if original proceeds were used to make prepayments prior to the time when payment is customary, then those prepayments are not considered spent prior to that customary time.

.03 If an issue of bonds finances more than one project, then the portion of the proceeds being used to finance each such project shall be treated as a separate issue of bonds for purposes of applying the requirements of paragraphs (1), (2), (3), (5), and (6) of section 5.01. If any project fails to meet the requirements as so applied, then no ruling will be issued with respect to the entire issue of bonds. Whether a bond issue finances more than one project will be determined on a case by case basis. This determination shall be made with reference to factors such as whether the buildings and structures were expected to be (a) used as part of an integrated operation, (b) owned and operated by the same person, (c) located on a single or contiguous parcel(s) of land, and (d) placed in service for federal income tax purposes within 12 months of one another.

SEC. 6. REQUIRED INFORMATION

.01 Any request for a ruling described in section 3 of this revenue procedure, must (a) meet the requirements of Rev. Proc. 88-33, 1988-1 C.B. 835, (b) meet the requirements of any other revenue procedures that relate to submission to the Service of requests for rulings, for example, Rev. Proc. 89-1, and (c) contain all of the information specified in subsection .02.

.02 The information specified in this subsection is:

(1) Copies of studies discussing the feasibility of the project, the economic viability of the project, the feasibility of the plan of bond financing, and other similar matters.

(2) A copy of the final official statement that was prepared in connection with the issuance of the bonds.

(3) A copy of the certificate as to arbitrage that was prepared in connection with the issuance of the bonds.

(4) A description of the acquired nonpurpose obligations that were purchased with the original and investment proceeds of the bonds, including the yield on such obligations.

(5) The yield on the governmental obligations, determined on the basis of the issue price within the meaning of sections 1273 and 1274 of the Code.

(6) A statement setting forth (a) the gross amount earned on investment of

the original proceeds of the bonds and the investment of such earnings during each year of the applicable three-year or five-year period and (b) the principal and interest paid on the bonds during each year of such three year or five-year period.

(7) A list detailing the type and amount of costs of issuance of the bonds, including underwriters' discount.

(8) Copies of the original construction and expenditure schedule for the project and the current construction and expenditure schedule for the project.

SEC. 7. MODIFICATION OF REV. PROC. 89-3

This revenue procedure modifies section 4.01 of Rev. Proc. 89-3, page 761, this Bulletin, relating to areas in which rulings or determination letters will not ordinarily be issued, by adding the following new paragraph:

> Section 103.—Interest on Certain Governmental Obligations.—Whether a state or local governmental obligation that does not meet the criteria of section 5 of Rev. Proc. 89-5 is an "arbitrage bond" within the meaning of former section 103(c)(2) of the Code solely by reason of the investment of the bond proceeds in acquired nonpurpose obligations at a materially higher yield more than three years after issuance of the bonds or five years after issuance of the bonds in the case of construction issues described in section 1.103-13(a)(2)(ii)(E) of the regulations.

SEC. 8. EFFECT ON OTHER REVENUE PROCEDURES

Rev. Proc. 89-3 is modified.

SEC. 9. EFFECTIVE DATE

This revenue procedure is effective with respect to any ruling requests currently under consideration by the Service and ruling requests received after this time.

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26 CFR 601.201: Rulings and determination letters.

Rev. Proc. 89-6

SECTION I. PURPOSE AND NATURE OF CHANGES

.01 Purpose.

The purpose of this revenue procedure is to update Rev. Proc. 87-6, 1987-1 C.B. 45, as amplified and amended by subsequent revenue procedures, by providing a list of subject matters under the jurisdiction of the Associate Chief Counsel (International) in which the Internal Revenue Service will not issue advance rulings or determination letters. Rev. Proc. 89-3, page 761, this Bulletin, amplified by Rev. Proc. 89-7, page 778, this Bulletin, lists the subject matters under the jurisdiction of the Associate Chief Counsel (Technical) in which the Service will not issue advance rulings or determination letters.

.02 Changes.

1. Old section 3.012 has been deleted because the regulations on which it was based have been amended.

2. New section 3.012 refers to section 954 of the Code. See Rev. Proc. 87-61, 1987-2 C.B. 765.

3. New section 3.021 modifies old section 3.021. See Rev. Proc. 88-50, 1988-2 C.B. 711.

4. New section 3.022 modifies old section 3.022.

5. New section 3.026 refers to issues subject to the taxpayer's pending request for competent authority assistance under a United States tax treaty.

6. New section 4.011 refers to section 367 of the Code.

7. New section 4.013 modifies old section 4.012.

8. New section 4.014 refers to section 882 of the Code.

9. New section 4.016 refers to section 892 of the Code.

10. New section 4.017 refers to section 893 of the Code.

11. New section 4.0112 refers to section 894 of the Code. See Rev. Proc. 87-39, 1987-2 C.B. 514.

12. New section 4.0113 refers to section 894 of the Code. See Rev. Proc. 87-39, 1987-2 C.B. 514.

13. Old section 4.019 has been deleted because regulations have been issued under section 897(e) of the Code.

14. New section 4.0115 refers to section 985 of the Code.

15. New section 4.0116 refers to section 989 of the Code.

16. Old section 4.0111 has been deleted as obsolete.

17. New section 4.0117 modifies old section 4.013.

18. New section 4.0118 modifies old sections 4.0112 and 4.0113.

19. New section 4.0119 refers to section 7701 of the Code.

20. New section 4.02 refers to a taxpayer's business purpose for a transaction or arrangement.

SEC. 2. BACKGROUND AND SCOPE OF APPLICATION

01. Background.

Whenever appropriate to sound tax administration, the Service answers inquiries from individuals and organizations about their status for tax purposes and the tax effects of their acts or transactions, before the filing of returns or reports that are required by the Internal Revenue Code. There are, however, areas where the Service will not issue advance rulings or determination letters, either because the issues are inherently factual or for other reasons. This revenue procedure lists those areas.

Section 3 gives areas in which advance rulings and determinations will not be issued under any circumstances. Section 4 gives areas in which they will not ordinarily be issued; in these areas, unique and compelling reasons may justify issuing a ruling or determination letter. The Service may provide a general information letter in response to inquiries in areas on either list.

These lists are not all-inclusive. Future revenue procedures may add or delete items. The Service may also decline to rule on an individual case for reasons peculiar to that case; such decisions will not be announced in the Bulletin.

02. Scope of Application.

This revenue procedure does not preclude District Directors, the Assistant Commissioner (International), or Appeals Offices from submitting requests for technical advice in the areas listed to the National Office.

SEC. 3 AREAS IN WHICH RULINGS OR DETERMINATION LETTERS WILL NOT BE ISSUED

01. Specific Questions and Problems.

1. Section 871(g).—Special Rules for Original Issue Discount.—Whether a debt instrument having original issue discount within the meaning of section 1273 of the Internal Revenue Code of 1986 is not an original issue discount obligation within the meaning of section 871(g)(1)-(B)(i) when the instrument is payable 183 days or less from the date of original issue (without regard to the period held by the taxpayer) and the instrument is issued by a domestic corporation and purchased by its controlled foreign corporation.

2. Section 954.—Foreign Base Company Income.—The effective rate of tax that a foreign country will impose on income.

3. Section 7701.—Definitions.— Whether a foreign arrangement that is a participant in a domestic arrangement classified as a partnership for United States tax purposes will itself be classified as a partnership.

4. Section 7701.—Definitions.— Whether a foreign limited liability company will be classified as a partnership, if a taxpayer who holds an interest therein seeks the partnership classification and (1) the taxpayer is a corporation and independent parties hold less than 20 percent of the interests in the limited liability company, or (2) the taxpayer is not a corporation and independent parties hold only a nominal interest in the company.

02. General Areas.

1. The prospective application of the estate tax to the property or the estate of a living person, except that rulings may be issued on any international issues in a ruling request accepted pursuant to Rev. Proc. 88-50, 1988-2 C.B. 711.

2. The federal tax consequences of proposed federal, state, local, municipal, or foreign legislation.

3. Whether reasonable cause exists under Subtitle F (Procedure and Administration) of the Code.

4. Whether a proposed transaction would subject a taxpayer to criminal penalties.

5. Any area, where the ruling request does not comply with the requirements of Rev. Proc. 87-4, 1987-1 C.B. 33, as modified by Rev. Proc. 88-4, 1988-1 C.B. 586, and modified and amplified by Rev. Proc. 88-8, 1988-1 C.B. 628 (as modified by Rev. Proc. 88-13, 1988-1 C.B. 639, and Rev. Proc. 88-27, 1988-1 C.B. 804 and Rev. Proc. 89-4, page 767, this Bulletin.

6. Any area, where the same issue is the subject of the taxpayer's pending request for competent authority assistance under a United States tax treaty.

SEC. 4. AREAS IN WHICH RULINGS OR DETERMINATION LETTERS WILL NOT ORDINARILY BE ISSUED

01. Specific Questions and Problems.

1. Section 367(a).—Transfers of Property from the United States.—Whether an oil or gas working interest is transferred from the United States for use in the active conduct of a trade or business for purposes of section 367(a)(3) of the Code; and whether any other property is so transferred, where the determination requires extensive factual inquiry.

2. Section 367(b).—Other Transfers.— Whether a foreign corporation is considered a corporation for purposes of any nonrecognition provision listed in section 367(b), and related issues, unless the ruling presents a significant legal issue. (These matters are dealt with in detail in section 7.367(b) of the Temporary Income Tax Regulations.)

3. Section 864.—Definitions and Special Rules.—Whether a taxpayer is engaged in a trade or business within the United States, and whether income is effectively connected with the conduct of a trade or business within the United States; and in particular, whether a taxpayer trading in stocks, securities, or commodities is engaged in a trade or business within the United States under section 1.864-2(c) and (d) of the regulations.

4. Section 882.—Tax on Income of Foreign Corporations Connected with United States Business.—Under section 1.882-5(b) of the regulations, whether a taxpayer using the actual ratio may change to the fixed ratio, and whether a taxpayer electing either the branch book/dollar pool method or the separate currency pools method may change methods.

5. Section 892.—Income of Foreign Governments and of International Organizations.—Whether income received by local governmental authorities of the United Kingdom from certain United States investments of money allocable to their super annuation funds is exempt from federal income taxation.

6. Section 892.—Income of Foreign Governments and of International Organizations.—Whether a foreign government is engaged in commercial activities for purposes of section 892, and whether income received by a foreign government is derived from the conduct of such commercial activities.

7. Section 893.—Compensation of Employees of Foreign Governments and International Organizations.—Whether a foreign government is engaged in commercial activities for purposes of section 893, and whether the services of an employee of a foreign government are primarily in connection with such commercial activities.

8. Section 894.—Income Affected by Treaty.—Whether a taxpayer has a permanent establishment in the United States for purposes of any United States income tax treaty.

9. Section 894.—Income Affected by Treaty.—Whether the income received by a nonresident alien student for services performed for a university or other educational institution is exempt from federal income tax or withholding under United States income tax treaties with Belgium, China, Cyprus, Egypt, Finland, France, Iceland, Japan, Korea, Morocco, the Netherlands, Norway, Pakistan, the Philippines, Poland, Romania, and Trinidad and Tobago.

10. Section 894.—Income Affected by Treaty.—Whether the income received by a nonresident alien performing research or teaching at a university is exempt from federal income tax or withholding under United States income tax treaties with Belgium, China, Egypt, Finland, France, Hungary, Iceland, Italy, Jamaica, Japan, Korea, Luxembourg, the Netherlands, Norway, the Philippines, Poland, Romania, Sweden, Trinidad and Tobago, the Union of Soviet Socialist Republics, and the United Kingdom.

11. Section 894.—Income Affected by Treaty.—Whether the income received by a nonresident alien teaching at a university is exempt from federal income tax or withholding under United States income tax treaties with Austria, Denmark, the Federal Republic of Germany, Greece, Ireland, Pakistan, and Switzerland.

12. Section 894.—Income Affected by Treaty.—Whether a foreign recipient of payments made by a United States person is ineligible to receive the benefits of a United States tax treaty under the principles of Rev. Rul. 84-152, 1984-2 C.B. 381, and Rev. Rul. 84-153, 1984-2 C.B. 383.

13. Section 894.—Income Affected by Treaty.—Whether a recipient of payments is or has been a resident of a country for purposes of any United States tax treaty. Pursuant to section 1.884-5T(f) of the temporary regulations, however, the Service will rule whether a corporation representing that it is a resident of a country is a qualified resident thereof for purposes of section 884.

14. Section 901.—Taxes of Foreign Countries and of Possessions of United States.—Whether a person claiming a credit has established, based on all of the relevant facts and circumstances, the amount (if any) paid by a dual capacity taxpayer under a qualifying levy that is not paid in exchange for a specific economic benefit. See section 1.901-2A(c)(2) of the regulations.

15. Section 985.—Functional Currency.—Whether a currency is the functional currency of a qualified business unit.

16. Section 989(a).—Qualified Business Unit.—Whether a unit of the taxpayer's trade or business is a qualified business unit.

17. Section 7701.—Tax on Nonresident Alien Individuals.—Whether an alien individual is either a resident or nonresident of the United States, in situations where the determination depends on facts that cannot be confirmed until the close of the taxable year (including, for example, the length of the alien's stay or the nature of the alien's activities).

18. Section 7701.—Definitions.—Whether a foreign corporation will be classified as a partnership for United States tax purposes, if the taxpayer seeks the partnership status; and whether a foreign partnership will be classified as an association for United States tax purposes, if the taxpayer seeks the association status. Requests for advance rulings about the classification of foreign entities should be submitted according to Rev. Proc. 89-1, page 740, this Bulletin. The Office of the Associate Chief Counsel (Technical) coordinates the response to such requests with the Office of the Associate Chief Counsel (International).

19. Section 7701.—Definitions.—Whether an estate or trust is a foreign estate or trust for federal income tax purposes.

02. General Areas.

Whether a taxpayer has a business purpose for a transaction or arrangement.

SEC. 5. EFFECT ON OTHER REVENUE PROCEDURES

Rev. Proc. 87-6, Rev. Proc. 87-39, and Rev. Proc. 87-61 are superseded.

SEC. 6. EFFECTIVE DATE

This revenue procedure applies to all ruling requests on file in the National Office on February 27, 1989, and to all requests received thereafter.

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26 CFR 601.201: Rulings and determination letters.

Rev. Proc. 89-7

SECTION 1. BACKGROUND

Rev. Proc. 89-3, page 761, this Bulletin sets forth areas in which advance rulings or determination letters will not be issued by the Internal Revenue Service. Section 5 of Rev. Proc. 89-3 is entitled "Area 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."

SEC. 2. PROCEDURE

Rev. Proc. 89-3 is hereby amplified by adding to section 5 the following new section:

Sections 3121 and 3306. - Definitions. - Whether payments made to former employees in the event of a plant closing, layoff, or reduction in force are wages for purposes of the Federal Insurance Contributions Act (FICA) and the Federal Unemployment Tax Act (FUTA).

SEC. 3. EFFECTIVE DATE

This revenue procedure will apply to all ruling requests on hand in the National Office on January 17, 1989, the date of publication of this revenue procedure in the Internal Revenue Bulletin, as well as to requests received thereafter.

SEC. 4. EFFECT ON OTHER REVENUE PROCEDURES

Rev. Proc. 89-3 is amplified.

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26 CFR 601.201: Rulings and determination letters.

Rev. Proc. 89-8

SECTION 1. PURPOSE

.01 This revenue procedure sets forth the procedures that the Internal Revenue Service and taxpayers will use to resolve issues arising when a taxpayer is or may be subject to inconsistent tax treatment by the Service and the tax authorities of Puerto Rico, the Virgin Islands, American Samoa, or Guam. The issues generally involve: (1) allocations of income, deductions, credits, or allowances between related persons; (2) determinations of residency; and (3) determinations of the source of income and related expenses. This revenue procedure does not provide procedures to be used by the tax authorities of any possession.

.02 An Implementation Agreement between the United States and the Virgin Islands was signed on February 24, 1987, and took effect on that date. This agreement superseded the prior Coordination Agreement (Announcement 78-21, 1978-7 I.R.B. 42). Article 6 of the Implementation Agreement deals with the mutual agreement procedure on potential double taxation.

.03 An Implementation Agreement between the United States and American Samoa was signed by the Government of American Samoa on December 10, 1987, and by the Government of the United States on January 7, 1988; it generally became effective on January 1, 1988. Article 6 of the Implementation Agreement deals with the mutual agreement procedure on potential double taxation.

.04 The 1977 Agreement on Coordination of Tax Administration entered into between the United States and Guam has been amended to add section 10. The amendment was signed by the Government of Guam on January 10, 1985, and by the Government of the United States on July 12, 1985. Section 10 deals with the mutual agreement procedure on potential double taxation.

.05 This revenue procedure supersedes Rev. Proc. 80-57, 1980-2 C.B. 852, as supplemented by Rev. Proc. 85-23, 1985-1 C.B. 557.

SEC. 2. BACKGROUND

.01 The Service has entered into agreements for coordinating tax administration (the Agreements) with the Commonwealth of Puerto Rico (Announcement 79-84, 1979-23 I.R.B. 19); the Virgin Islands, as described in Section 1.02; American Samoa, as described in Section 1.03; and Guam, as described in Section 1.04. The tax authorities of the other parties to the Agreements are hereinafter referred to as the "possession tax agencies." In accordance with the Agreements, the Service has established cooperative programs to resolve tax disputes arising from inconsistent positions taken by the Service and a possession tax agency. The procedures under these cooperative programs are hereinafter referred to as the "mutual agreement procedures."

.02 The Agreements provide that the Assistant Commissioner (International) is the person in charge of exchanging United States tax returns and tax return information with a possession and developing and coordinating cooperative programs designed to improve the administration and enforcement of the tax laws of the United States and the possessions.

.03 The Agreements provide generally that when, by reason of inconsistent positions taken by the Service and a possession tax agency, a taxpayer is or may be subject to inconsistent tax treatment by the two jurisdictions, the Assistant Commissioner (International) and the designated possession tax official shall seek to avoid double taxation. In particular, but not by way of limitation, the parties may exchange views to reach agreement on: (a) the same allocation of income, deductions, credits, or allowances between related persons; (b) the same determination of residency of a particular taxpayer; and (c) the same determination of the source of particular items of income.

SEC. 3. PROCEDURES TO BE FOLLOWED

.01 A taxpayer, or a related person in a possession, that is potentially subject to double taxation because of inconsistent tax treatment by the Service and a possession tax agency may request assistance in accordance with this revenue procedure.

.02 In addition to the tax assistance request, the taxpayer should file a claim for credit or refund of any overpayment of United States tax that was paid on the income in question, provided the period of limitations prescribed under section 6511 of the Internal Revenue Code, with respect to the claim for credit or refund, has not expired. The taxpayer, or a related person in a possession, should also take whatever steps are required under a possession tax code to prevent the expiration of the period of limitations with respect to a claim for credit or refund of a possession tax.

.03 When, in conjunction with a request for assistance under this revenue procedure, a taxpayer seeks relief in the form of a credit or refund of tax due to either a possession or the United States, the allowance of such relief is subject to the applicable tax and procedural rules of the possession and the United States.

.04 A United States income tax claim is to be made, as appropriate, on: Form 1040X, Amended U.S. Individual Income Tax Return; Form 1120X, Amended U.S. Corporation Income Tax Return; or Form 1041, U.S. Fiduciary Income Tax Return. The taxpayer should indicate on the appropriate form that a request for assistance under the mutual agreement procedure with the possession has been filed pursuant to this revenue procedure and should attach a copy of the request to that form.

.05 Similarly, if any tax issues subject to consideration under a mutual agreement procedure are expected to recur, the taxpayer should, before the statute of limitations expires, file a protective claim for credit or refund of any United States tax that was paid with respect to the issue. The claim should describe the action or expected action of the possession tax agency and state that the taxpayer has filed or plans to file a request for assistance under the mutual agreement procedure. The taxpayer should send a copy to the Assistant Commissioner (International). If the taxpayer later decides not to file the request for assistance, the Assistant Commissioner (International) should be promptly notified by the taxpayer. The taxpayer, or a related person in a possession, should also take whatever steps are required under the possession tax code to prevent the expiration of the period of limitations with respect to a claim for credit or refund of a possession tax.

.06 With respect to the computation of the foreign tax credit, either Form 1116, Computation of Foreign Tax Credit — Individual, Fiduciary, or Nonresident Alien Individual (which also covers credits for foreign tax on income received from foreign partnerships and other business organizations), or Form 1118, Computation of Foreign Tax Credit — Corporations, must be attached to the Form 1040X, Form 1120X, or Form 1041.

.07 The taxpayer should file a written request for assistance with the Assistant Commissioner (International), Internal Revenue Service, 950 L'Enfant Plaza South SW, Washington, D.C. 20024, as soon as it appears that the taxpayer is or may be subject to inconsistent tax treatment by the Service and a possession tax agency. Prompt action will: (1) insure consideration while the facts are more easily obtainable; (2) insure adequate time for the representatives of the two jurisdictions to exchange views to reach an agreement before any procedural barriers under the law of the United States or a possession are imposed; and (3) avoid unnecessary delay in the final determination of tax liability.

.08 Without the consent of the Chief Counsel of the Service, the Assistant Commissioner (International) will not accept any taxpayer's request for consideration of a case that is pending in court. If the case is pending in the United States Tax Court, the Chief Counsel may in appropriate cases request the court to delay trial pending mutual agreement action. If the case is pending in any other court, the Chief Counsel will consult with the Department of Justice. In all cases the final decision to delay trial rests with the court. The suspension of litigation pending any mutual agreement consideration will not relieve the United States taxpayer from any obligation to act with respect to that litigation.

.09 A request for assistance under this revenue procedure must be signed by the taxpayer or a person having authority to sign the taxpayer's United States income tax return; contain a statement that assistance is requested under the mutual agreement procedure with the possession; and include the following:

1 the taxpayer's name, address, and employer identification number or social security number, and (where a related person in the possession is involved) the name, address, and employer identification number or social security number of the related person;

2 the tax year or years in question and the Service Center where the taxpayer's federal income tax return was filed or, if no return was filed, a statement to that effect;

3 if income tax is involved, the type of income at issue (such as salary, dividends, or interest); a description of the transaction, activities, or other circumstances pertinent to the issue; and the respective positions taken by a possession tax agency and the taxpayer on the issue raised;

4 the amount of the particular item involved in the issue raised and the amount of tax the possession assessed or proposed for assessment;

5 when applicable, a description of the control and business relationships between the United States taxpayer and the related person in the possession;

6 when applicable, a statement of the status of the tax liability of the taxpayer and the related person in the possession for the year or years in question, as well as a statement whether the taxpayer or related person is entitled to any possession tax incentive or subsidy program benefits for the year or years in question;

7 a copy of any relevant correspondence received from the possession tax agency and copies of any briefs, protests, and other relevant material submitted to the possession tax agency;

8 a copy of the possession tax returns for the year or years in question;

9 a statement whether the federal tax return of the taxpayer and, when applicable, the tax return of the related person in the possession, for the year or years in question were examined, or are being examined;

10 a statement whether a foreign tax credit was claimed on the taxpayer's federal tax return for the tax year or years in question and, if a credit was claimed, whether the credit was claimed for all or part of the possession tax paid or accrued with respect to the particular item that is the subject of the request for assistance;

11 on a separate document, a statement signed and dated by a person having authority to sign the taxpayer's United States tax return that the United States taxpayer consents to the disclosure to the designated possession tax official of any or all of the items of information set forth in, or enclosed with, the request for assistance under this revenue procedure; and

12 other pertinent material the taxpayer may wish to submit.

SEC. 4. NOTIFICATION TO TAXPAYER

.01 The taxpayer will be notified whether the facts submitted provide a basis for assistance under the mutual agreement procedure.

.02 The Assistant Commissioner (International) will not assist the taxpayer if:

1 under the facts and circumstances the taxpayer is not entitled to such assistance (for example, the facts do not indicate that inconsistent positions have been taken by the Service and a possession tax agency);

2 the taxpayer is unwilling to accept an agreement under the mutual agreement procedure except under conditions that are clearly unreasonable or unfairly prejudicial to the interests of the United States; or

3 the taxpayer does not furnish, upon request, sufficient information to determine the applicability of the mutual agreement procedure or otherwise fails to act as required by this revenue procedure.

.03 If the Assistant Commissioner (International) accepts a request for assistance, the continuing cooperation of the taxpayer is essential. The taxpayer must submit any additional information needed to resolve the case and keep the Assistant Commissioner (International) informed of proceedings in the possession and any other pertinent developments. The taxpayer may also be requested to execute a consent extending the period of limitations for assessment of tax for the tax year or years in question.

.04 The Assistant Commissioner (International) will notify a taxpayer requesting assistance under this revenue procedure of any agreement or partial agreement that the Service and a possession tax agency reach with respect to the taxpayer's request. If the agreement or partial agreement is not acceptable to the taxpayer, the taxpayer may pursue all rights to administrative and judicial review otherwise available under the laws of the possession and the United States.

.05 When appropriate, in cases covered by this revenue procedure, the taxpayer will be requested to enter into a closing agreement in accordance with sections 6.07 and 6.17 of Rev. Proc. 68-16, 1968-1 C.B. 770.

.06 Rev. Proc. 65-17, 1965-1 C.B. 833, provides that a taxpayer who desires the treatment provided by that revenue procedure must request it in writing with the appropriate district director before any closing action is taken on issues arising under section 482 of the Code. Accordingly, if a taxpayer desires both assistance under this revenue procedure and the benefits provided by Rev. Proc. 65-17, a statement should be made in the request filed under this revenue procedure that the taxpayer desires the benefits of Rev. Proc. 65-17.

SEC. 5. OTHER APPLICATIONS OF THIS REVENUE PROCEDURE

At the time of publication of this revenue procedure, the United States is negotiating agreements with Puerto Rico, Guam, and the Commonwealth of the Northern Mariana Islands that may provide for mutual agreement procedures. When any such agreements become effective, the procedures set forth in this revenue procedure must be followed by taxpayers seeking relief.

SEC. 6. EFFECTIVE DATE

This revenue procedure is effective January 23, 1989.

SEC. 7. EFFECT ON OTHER REVENUE PROCEDURES

Rev. Proc. 80-57 and Rev. Proc. 85-23 are superseded.

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26 CFR 601.201: Rulings and determination letters.

Rev. Proc. 89-9

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SECTION 1. PURPOSE

This revenue procedure updates Rev. Proc. 84-23, 1984-1 C.B. 457, to set forth the procedures of the Internal Revenue Service pertaining to the issuance of opinion letters relating to master or prototype (M&P) pension, profit-sharing and annuity plans involving sections 401 and 403(a) of the Internal Revenue Code, as amended by the Tax Reform Act of 1986 (TRA '86), Pub. L. 99-514, 1986-3 (Vol.1) C.B. 1, the Omnibus Budget Reconciliation Act of 1986 (OBRA '86), Pub. L. 99-509, the Omnibus Budget Reconciliation Act of 1987 (OBRA '87), Pub. L. 100-203, and the Technical and Miscellaneous Revenue Act of 1988 (TAMRA), Pub. L. 100-647, and to the status for exemption of related trusts or custodial accounts under section 501(a) of the Code.

SEC. 2. GENERAL INFORMATION

.01 Rev. Proc. 83-36, 1983-1 C.B. 763, as modified by Rev. Proc. 87-40, 1987-2 C.B. 514, sets forth the general procedures of the Service relating to the issuance of rulings, determination letters, opinion letters, and notification letters on Employee Plans and Exempt Organization matters.

.02 Rev. Proc. 80-30, 1980-1 C.B. 685, sets forth the general procedures relating to the issuance of determination letters on the qualification of pension, profit-sharing, and stock bonus plans under sections 401(a) and 403(a), and the status for exemption of any related trusts or custodial accounts under section 501(a) of the Code.

.03 Rev. Proc. 84-23, as modified by Rev. Proc. 84-83, 1984-2 C.B. 781, sets forth the general procedures relating to the issuance of opinion letters by the National Office as to the acceptability of the form of master and prototype plans.

.04 Rev. Proc. 89-4, page 767, this Bulletin, sets forth the procedures relating to the payment of user fees for requests to the Service for rulings, opinion letters, determination letters, and similar requests.

.05 TRA '86 substantially altered the requirements that a plan must meet in order to be qualified under section 401(a) of the Code. Many of the TRA '86 qualification changes are effective for years beginning after December 31, 1986. Other TRA '86 qualification requirements are not effective until years beginning after December 31, 1988. OBRA '86 and OBRA '87 also altered the requirements that a plan must meet in order to be qualified. The qualification requirements under OBRA '86 and OBRA '87 are generally effective for plan years beginning after December 31, 1987. TAMRA contains technical corrections to TRA '86, OBRA '86, and OBRA '87, as well as other changes affecting qualified plans.

.06 Section 1140 of TRA '86 provides that a qualified plan must be amended retroactively, not later than the first plan year beginning on or after January 1, 1989, to comply with the requirements of TRA '86. Section 1.401(b)-1 of the Income Tax Regulations extends until the end of the remedial amendment period described therein the time by which plans must be amended to comply with provisions of TRA '86 that are effective before the first day of the first plan year beginning after December 31, 1989, provided certain conditions are satisfied. In general, the remedial amendment period described in section 1.401(b)-1 of the regulations also applies in the case of amendments necessary to conform to the requirements of OBRA '86, OBRA '87, and other changes to the qualification requirements described in section 5.11. The Service has issued substantive guidelines, including those cited later in this revenue procedure, for conforming plans to the TRA '86, OBRA '86, and OBRA '87 requirements.

SEC. 3. DEFINITIONS

.01 Master Plan — A "master plan" is a plan (including a plan covering self-employed individuals) that is made available by a sponsoring organization (see section 3.07) for adoption by employers and for which a single funding medium (for example, a trust or custodial account) is established, as part of the plan, for the joint use of all adopting employers. A master plan consists of two separate documents, a basic plan document and an adoption agreement (see sections 3.03 and 3.04).

.02 Prototype Plan — A "prototype plan" is a plan (including a plan covering self-employed individuals) which is made available by a sponsoring organization for adoption by employers and under which a separate funding medium is established for each adopting employer. A prototype plan consists of two separate documents, a basic plan document and an adoption agreement.

.03 Basic Plan Document — A "basic plan document" is the portion of the plan containing all the non-elective provisions applicable to all adopting employers. No options (including blanks to be completed) may be provided in the basic plan document, except as provided in section 18.031 of this revenue procedure regarding flexible plans.

.04 Adoption Agreement — For purposes of this revenue procedure, with respect to an adopting employer, an "adoption agreement" is the portion of the M&P plan containing all the options that may be selected by such adopting employer.

.05 Opinion Letter — An "opinion letter" is a written statement issued by the National Office to a sponsoring organization pursuant to this revenue procedure as to the acceptability of the form of a master or prototype plan and any related trust or custodial account under sections 401, 403(a), and 501(a) of the Code.

.06 Favorable TEFRA Opinion Letter — A "favorable TEFRA opinion letter" is a favorable opinion letter issued by the National Office after July 18, 1985, under Rev. Proc. 84-23, which considers the effect of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), Pub. L. 97-248, 1982-2 C.B. 462, the Deficit Reduction Act of 1984, Pub. L. 98-369, 1984-3 (Vol. 1) C.B. 1, and the Retirement Equity Act of 1984, Pub. L. 98-397.

.07 Sponsoring Organization — A "sponsoring organization" is a bank (as defined in section 581 of the Code), an insured credit union within the meaning of section 101(6) of the Federal Credit Union Act, a person that has been approved by the Service in accordance with section 1.401-12(n) of the regulations, to act as a nonbank trustee, an insurance company, a regulated investment company (as defined in section 851 of the Code), an investment advisor that has an advisory contract with one or more regulated investment companies, or a principal underwriter that has a principal underwriting contract with one or more regulated investment companies. The term "sponsoring organization" also includes a trade or professional organization having characteristics similar to those described in section 1.501(c)(6)-1 of the regulations which markets its plan only to its members in their capacity as adopting employers. (See sections 6.03 and 12 regarding the effect of adoption of a plan sponsored by a trade or professional organization by an employer that is not a bona fide member of such organization.)

.08 Standardized Form Plan — A "standardized form plan" is a master or prototype plan which meets the following requirements:

1 The provisions governing eligibility and participation are such that the plan by its terms must cover all employees described in section 5.09 (regardless of whether any employer is treated as operating separate lines of business under section 414(r)) except those that may be excluded under sections 410(a)(1) or (b)(3) of the Code. For example, a plan providing full and immediate vesting may exclude employees who do not have at least two years of service. However, the adoption agreement may provide options as to whether some or all of the employees described in sections 410(a)(1) or (b)(3) are to be excluded.

2 The eligibility requirements under the plan are not more favorable for highly compensated employees (as defined in section 414(q) of the Code) than for other employees.

3 The vesting schedule in the plan provides vesting at a rate at least as favorable for every year as would be required by the schedules set forth in section 416(b)(1)(A) or (B) of the Code if the plan were top-heavy for every year after 1983.

4 Except for contributions made under a qualified cash or deferred arrangement, as defined in section 401(k) of the Code and the regulations (including proposed) thereunder, the contributions (including forfeitures) provided under the plan (if a defined contribution plan other than a target benefit plan) or the benefits (if a defined benefit plan or a target benefit plan that complies with Rev. Rul. 76-464, 1976-2 C.B. 115) are a uniform percentage of total compensation within the meaning of section 414(s) of the Code, excluding compensation in excess of the limitation under section 401(a)(17). A plan will not be treated as failing to meet this requirement merely because it involves integration with Social Security benefits or contributions provided (a) the form of the plan meets the permitted disparity limitations of section 401(l), or (b) the plan is a defined benefit plan with a final pay limitation that satisfies the requirements of section 401(a)(5)-(D). Also, this section does not preclude a sponsoring organization from submitting a standardized defined benefit or target benefit plan which uses a unit benefit formula based on years of service. (See Section 8 of this revenue procedure for rules governing contributions made under a cash or deferred arrangement.)

.09 Paired Plans — "Paired plans" are either a combination of two or more defined contribution standardized form plans or a combination of one or more defined contribution standardized form plans and one defined benefit standardized form plan (for example, a money purchase pension plan, a profit-sharing plan and a unit benefit or flat benefit pension plan), so designed that if any single plan, or combination of plans, is adopted by an employer, each plan by itself, or the plans together, will meet the anti-discrimination rules set forth in section 401(a)(4) of the Code, the contribution and benefit limitations set forth in section 415 of the Code, and the top-heavy provisions set forth in section 416 of the Code. Paired plans must have the same sponsoring organization. In addition, only one of the paired plans that an employer adopts may provide for disparity in contributions or benefits that is permitted under section 401(l). If one of the paired plans is a defined benefit plan that includes a final pay limitation as described in section 401(a)(5)(D), then the paired defined contribution plan(s) may not provide for disparity in contributions.

.10 Replacement Plan — A "replacement plan" is a plan submitted by a sponsoring organization pursuant to this revenue procedure which restates or amends a prior plan (or plans) of that sponsoring organization for which a favorable TEFRA opinion letter has been issued. Except to the extent permitted under regulations sections 1.401(a)-4 and 1.411(d)-4, a replacement plan must preserve all section 411(d)(6) protected benefits which were provided under the replaced plan(s) (see section 5.03). The replacement plan must be the same type of plan as the plan(s) replaced (e.g., both plans are money purchase pension plans or both plans are profit-sharing plans). Thus, if a basic plan document with two profit-sharing plan adoption agreements is replaced by a basic plan document with one profit-sharing plan adoption agreement and one money purchase pension plan adoption agreement, only the profit-sharing adoption agreement may be considered as a replacement plan for both prior profit-sharing plans. In addition, the prior basic plan document can only be replaced by one amended or restated basic plan document, although each prior adoption agreement may be replaced by more than one amended, restated or additional adoption agreement. Thus, for example, a basic plan document with one profit-sharing adoption agreement could be replaced by one amended or restated basic plan document with one or more profit-sharing adoption agreements, but could not be replaced by two or more basic plan documents each with profit-sharing adoption agreements.

.11 National Sponsoring Organization — A national sponsoring organization is a sponsoring organization which has either (a) 30 or more adopting employers in each of 30 or more states (treating, for this purpose, the District of Columbia as a state) or (b) 3000 or more adopting employers. The determination as to whether there are 3000 or more adopting employers or 30 or more adopting employers in each of 30 or more states may be made on any one date during the 12 month period ending on the date 90 days after the effective date of this revenue procedure. For this purpose, an adopting employer is any employer that has adopted any M&P plan of the sponsoring organization which plan has a favorable TEFRA opinion letter.

SEC. 4. OVERVIEW OF THE REVENUE PROCEDURE

.01 Except as described in this section or as required because of changes to plan qualification rules, this revenue procedure generally preserves the structure and requirements of the M&P opinion letter program as set forth in Rev. Proc. 84-23.

.02 Reliance — As under Rev. Proc. 84-23, whether an employer who adopts an M&P plan with a favorable opinion letter receives reliance on the opinion letter (i.e., automatic assurance that any disqualification of the plan on account of the form of the plan will ordinarily be non-retroactive) without the need to obtain a favorable determination letter depends on the form of the M&P plan the employer adopts.

1 An employer who adopts a standardized form defined contribution plan, or paired standardized form defined contribution plans, will not, except under certain circumstances, have to obtain a determination letter because the qualification of such plans does not depend on the particular facts and circumstances of the employer.

2 An employer who adopts a standardized form defined benefit plan, or paired standardized form defined benefit and defined contribution plans may rely on the opinion letter(s) issued to the sponsoring organization with respect to such plan(s) only if the employer's standardized (paired) defined benefit plan satisfies one of the safe-harbors provided in regulations under section 401(a)(26) with respect to its prior benefit structure or is deemed to satisfy section 401(a)(26) under such regulations. However, in connection with the initial adoption or amendment by an employer of a standardized (paired) defined benefit plan, such employer may request a determination letter if the employer wishes to have reliance as to whether its plan satisfies section 401(a)(26) with respect to its prior benefit structure.

3 In all other cases (i.e., the adoption of non-standardized form plans), the employer must obtain a favorable determination letter in order to have reliance.

.03 Continued, Interim, and Extended Reliance —

1 This revenue procedure provides that an employer who adopts a master or prototype plan which received a favorable TEFRA opinion letter under Rev. Proc. 84-23 may continue to rely on such a letter provided the sponsoring organization submits to the Service a replacement plan which meets the

requirements of this revenue procedure by March 31, 1990, and the employer adopts the approved replacement plan by the later of the last day of the twelfth month beginning after a favorable opinion letter is issued under this procedure, or the end of the remedial amendment period under section 401(b) of the Code and the regulations thereunder. To be entitled to this reliance, certain other conditions must be satisfied, including, for example, the condition that a plan must comply operationally, as of the applicable effective dates, with those requirements of TRA '86 that are effective before 1989. This reliance is not provided in the case of a plan which did not receive a favorable opinion letter under Rev. Proc. 84-23.

2 This revenue procedure also provides a period of extended reliance in the case of any M&P plan (including a new plan) which is submitted in accordance with the requirements of this procedure by March 31, 1990, and is subsequently approved by the Service. An employer who adopts such a plan and is otherwise entitled to reliance under this revenue procedure or under Rev. Proc. 80-30 may rely on the favorable opinion letter issued under this procedure (or on a determination letter, if required) until the earlier of the date established for plan amendment by subsequent legislation or the last day of the last plan year beginning before January 1, 1995.

.04 Mass Submitter Program —

1 Under this revenue procedure, the mass submitter program is established as a permanent program to provide expedited review of plans submitted in accordance with the requirements of section 18 of this revenue procedure. Under this revenue procedure, an entity must submit, along with its initial submission of the mass submitter plan, applications for at least 10 sponsoring organizations that will sponsor a plan which is word-for-word identical to the mass submitter's plan, as approved by the Service. Once the mass submitter submits applications for at least 10 identical adopters, it may submit additional applications for sponsoring organizations that will sponsor the mass submitter's plan with minor modifications, as provided in section 18.032.

2 Under this revenue procedure, the Service will issue opinion letters to mass submitters with respect to flexible plans. A "flexible plan" is a mass submitter plan which contains certain optional provisions which an adopting sponsoring organization may choose to include in or delete from the plan it makes available to adopting employers. (See section 18.031(b) for a list of the types of optional provisions which may be included in a flexible plan.) A sponsoring organization's adoption of a plan which differs from the mass submitter's flexible plan only because the sponsoring organization has deleted certain optional provisions will be deemed to be an adoption of a plan that is word-for-word identical to the mass submitter's plan. If the sponsoring organization's plan differs in any other way from the mass submitter's plan, such difference(s) must constitute a minor modification under section 18.032 or the sponsoring organization's plan will not receive expedited review.

3 If a mass submitter wishes to amend its plan, it must notify the Service of its intent to amend the plan. The Service will then send a list to the mass submitter showing all sponsoring organizations that have adopted the mass submitter's plan prior to its amendment. The mass submitter must then identify each of the sponsoring organizations that are adopting the amended plan. Those sponsoring organizations that wish to adopt the amended plan and are identified by the mass submitter will, for purposes of issuing new opinion letters, automatically be deemed to have made such amendments while those not so identified will no longer be considered to have adopted a plan that is identical to or a minor modification of a mass submitter's plan. (But see section 18.031(c) for the procedures relating to the addition of certain optional provisions to a mass submitter's approved flexible plan.)

4 Within 30 days after the effective date of this revenue procedure, the Service will mail to each entity which was approved as a mass submitter under Rev. Proc. 84-23 a list of those sponsoring organizations that have previously adopted plans that are word-for-word identical to the mass submitter's plans along with such plans' file folder numbers. Mass submitters should use these lists, in accordance with the instructions provided with such lists, in applying for opinion letters under this procedure with respect to those sponsoring organizations' plans.

5 In order to reduce the paperwork burdens on mass submitters and sponsoring organizations which use mass submitter plans, the Service has designed a simplified application form, Form 4461-B, to be used to request applications on behalf of sponsoring organizations which are adopting plans that are identical to or minor modifications of mass submitter plans. This form should be used in those circumstances where the aforementioned list may not be used (e.g., in the case of new sponsoring organizations, new plans or minor modifier plans). Form 4461-B will be processed using optical scanning equipment and must therefore be prepared as described in this revenue procedure (see section 18.02).

.05 Multiple Plans —

1 A sponsoring organization may utilize one basic plan document with respect to several plans. For example, a sponsoring organization may submit four plans with respect to a given defined benefit basic plan document (an integrated standardized form plan, a non-integrated standardized form plan, a non-integrated non-standardized form plan, and an integrated non-standardized form plan). A sponsoring organization may also use one defined contribution basic plan document for a money purchase plan, a target benefit plan, and a profit-sharing plan. One basic plan document may not be used with respect to both defined benefit and defined contribution plans. A separate adoption agreement and completed application form must be submitted with respect to each defined benefit plan and each defined contribution plan. In the case of a simultaneous submission of plans using the same basic plan document, only one copy of the basic plan document need be provided. If the requests are not simultaneous, the sponsoring organization must submit a copy of the basic plan document with each submission and include a cover letter identifying the original submission. The number of such basic plan document must remain the same as in the prior submission.

2 Paired plans (as defined in section 3.09) must be submitted simultaneously. Paired plans are paired by the basic plan documents. Two defined contribution plans that are paired (for example, a profit-sharing plan and a money purchase plan) must share one basic plan document.

3 Under Rev. Proc. 84-23, a sponsor was limited to one set of paired plans. This revenue procedure eliminates the limitation on the number of sets of paired plans which a sponsor may adopt. However, each set may include no more than two basic plan documents as provided above. In addition, this rev-

enue procedure provides that only one of the paired plans which an employer adopts may provide for disparity in contributions or benefits that is permitted under section 401(l).

.06 Special Provisions Required in Master and Prototype Plans —

1 Because of the nature of the M&P program, this revenue procedure requires that special provisions be included in every master or prototype plan. Section 5 includes some of these requirements. Thus, for example, M&P plans must contain language permitting the sponsor to amend the plan. Furthermore, provisions must be included to ensure compliance with section 411(a)(10) and (d)(6) of the Code, such as in the event an adopting employer amends the plan by revising the options selected in the adoption agreement. The plan language is required in order that the employer's plan may remain in the M&P program and still satisfy the requirements of sections 411(a)(10) and (d)(6).

2 This revenue procedure requires every master or prototype plan to include in the adoption agreement the address and telephone number of the sponsoring organization or the sponsoring organization's authorized representative. The purpose of this requirement is to ensure that the sponsoring organization is available to answer employer inquiries regarding plan provisions, adoption of the plan, and the effect of an opinion letter. This requirement does not oblige a sponsoring organization to provide legal advice or administrative services to adopting employers.

3 Under this revenue procedure, the Service will not issue an opinion letter with respect to any plan (other than a plan which includes a qualified cash or deferred arrangement (CODA) under section 401(k) of the Code or a master plan (i.e., a plan with a single master trust for all adopting employers) that designates the sponsoring organization as plan administrator) that provides for contributions which are subject to the special non-discrimination requirements of section 401(m).

4 Master and prototype plans may be adopted by an employer that has other plans covering the same employees. Such plans must be aggregated for purposes of section 415 of the Code. Aggregation may also be required under section 416 of the Code. It is impossible for sponsors of M&P plans to include form language that properly aggregates such M&P plan with any other plan of an adopting employer. Therefore, provision is made to enable adopting employers to add additional language to an M&P plan.

.07 Special Requirements for Plans That Include a Cash or Deferred Arrangement — Under Rev. Proc. 84-23, the National Office did not issue opinion letters with respect to plans containing a cash or deferred arrangement (CODA) as described in section 401(k) of the Code. Rev. Proc. 87-18, 1987-1 C.B. 709, modified Rev. Proc. 84-23 to provide for the issuance of opinion letters with respect to plans which are drafted or amended to contain CODAs. This revenue procedure supersedes Rev. Proc. 87-18 and provides that in order to receive a favorable opinion letter, a master or prototype plan which includes a CODA must comply with the special requirements set forth in section 8.

.08 Submission Period for Master and Prototype Applications — Generally, no applications for approval of master or prototype plans may be submitted prior to July 7, 1989. However, mass submitters (as defined in section 18.01) and national sponsoring organizations (as defined in section 3.11) may submit applications beginning April 10, 1989.

SEC. 5. PROVISIONS REQUIRED IN EVERY MASTER OR PROTOTYPE PLAN

.01 Sponsor Amendments — Master or prototype plans must provide a procedure for sponsor amendment, so that changes in the Code, regulations, revenue rulings, other statements published by the Internal Revenue Service, or corrections of prior approved plans may be applied to all employers who have adopted the plan.

.02 Employer Amendments — An employer that amends any provision of an approved master or prototype plan including its adoption agreement (other than to change the choice of options, if the plan permits or contemplates such a change) or an employer that chooses to discontinue participation in a plan as amended by its sponsoring organization and does not substitute another approved master or prototype plan is considered to have adopted an individually designed plan. However, this rule does not apply in the case of amendments permitted under section 5.04, and certain model amendments published by the Service, which specifically provide that their adoption by an adopter of an M&P plan will not cause such plan to be treated as individually designed. An employer that amends a master or prototype plan because of a waiver of the minimum funding requirement under section 412(d) of the Code will also be considered to have an individually designed plan. The procedures stated in Rev. Proc. 80-30 relating to the issuance of determination letters for individually designed plans, will then apply to the plan as adopted by the employer.

.03 Anti-Cutback Provisions — Master and prototype plans must specifically provide for the protection provided under section 411(a)(10) and (d)(6) of the Code in the event that the employer amends the plan in any manner such as by revising the options selected in the adoption agreement or by adopting a new master or prototype plan. An M&P sponsor may not amend its plan in a manner that could result in the elimination of a benefit protected under section 411(d)(6) with respect to the plan of any adopting employer, unless permitted to do so under regulation sections 1.401(a)-4 and 1.411(d)-4. In addition, a master or prototype plan that does not contain vesting for all years which is at least as favorable to participants as that provided in section 416(b) of the Code, must specifically provide that any vesting which occurs while the plan is top-heavy will not be cut back if the plan ceases to be top-heavy.

.04 Adopting Employer Modification to Satisfy Sections 415 and 416 — Master or prototype plans must provide that the plan provisions may be amended by overriding plan language completed by the employer in the adoption agreement where such language is necessary to satisfy section 415 or 416 of the Code because of the required aggregation of multiple plans under these sections. In the event of such an amendment the adopting employer must obtain a determination letter in order to continue reliance on the plan's qualified status. Generally, a space should be provided in the adoption agreement with instructions for the employer to add such language as necessary to satisfy sections 415 and 416. In addition, a space must be provided in the adoption agreement for the employer to specify the interest rate and mortality tables used for purposes of establishing the present value of accrued benefits in order to compute the top heavy ratio under section 416. Such a space must be included in both defined contribution plans and defined benefit plans.

.05 Defined Contribution Section 415 Aggregation — Plan language must be incorporated that aggregates all defined contribution master and prototype plans to satisfy section 415(c) and (f) of the Code. Sample language provided in the

Employee Plans Technical & Actuarial Division's Listing of Required Modifications may be obtained by writing to the Internal Revenue Service, Employee Plans Technical & Actuarial Division, Washington, D.C. 20224, Attention E:EP:Q.

.06 Top-Heavy Requirements — Except to the extent described in section 7.03, relating to paired plans, each plan must either provide that all the additional requirements applicable to top-heavy plans (described in section 416 of the Code) apply at all times or provide that such requirements apply automatically if the plan is top-heavy regardless of how the adoption agreement is completed. In any case where the latter option is chosen, all the requirements for determining whether the plan is top-heavy must be included in the plan. (See Questions T-35 and T-36 of regulation section 1.416-1.)

.07 Additional Top-Heavy Minimums to Satisfy Section 415(e) — Each plan must provide automatically or by optional provisions the additional minimums described in section 416(h)(2)(A) of the Code.

.08 Provisions Required in Adoption Agreements — In order to avoid unnecessary confusion as to the scope of an opinion letter, sponsoring organizations must include in the adoption agreement of all master or prototype plans (other than standardized form and paired plans), in close proximity to the signature blank, a statement that adopting employers may not rely on an opinion letter issued by the National Office with respect to the qualification of that plan and should apply to the appropriate key district for a determination letter in order to obtain reliance. Standardized form and paired plans must also include a similar statement in the adoption agreement that the adopting employer may not rely on the opinion letter issued by the National Office and should apply for a determination letter if the employer maintains or later adopts another plan in addition to the standardized form plan or paired plans. In the case of a standardized defined benefit plan, this statement must also advise the adopting employer that the opinion letter may be relied on with respect to whether the plan meets the minimum participation requirements of section 401(a)(26) of the Code only if the plan satisfies one of the safe-harbors provided in regulations under section 401(a)(26) with respect to its prior benefit structure or is deemed to satisfy section 401(a)(26) under such regulations. However, in connection with the initial adoption or amendment by an employer of a standardized (paired) defined benefit plan, such employer may request a determination letter if the employer wishes to have reliance as to whether its plan satisfies section 401(a)(26) with respect to its prior benefit structure. For this purpose, a plan that is properly replaced by the adoption of a standardized form plan is not considered another plan. The adoption agreement must state that it is to be used with one and only one specific basic plan document. In addition, the adoption agreement must contain a cautionary statement to the effect that the failure to properly fill out the adoption agreement may result in disqualification of the plan. The adoption agreement must also contain a statement which provides that the sponsoring organization will inform the adopting employer of any amendments made to the plan or of the discontinuance or abandonment of the plan.

.09 Definition of Employee / Sections 414(b), (c), (m), (n) and (o) — Each master or prototype plan must include a definition of employee as any employee of the employer maintaining the plan or any other employer aggregated under section 414(b), (c), (m) or (o) of the Code and the regulations thereunder. The definition of employee shall also include any individual deemed under section 414(n) (or under regulations under section 414(o)) to be an employee of any employer described in the previous sentence.

.10 Definition of Service / Sections 414(b), (c), (m), (n), and (o) — Each master or prototype plan must specifically credit all service with any employer aggregated under section 414(b), (c), (m) or (o) of the Code and the regulations thereunder as service with the employer maintaining the plan. In addition, in the case of an individual deemed under section 414(n) (or under regulations under section 414(o)) to be the employee of any employer described in the previous sentence, service with such employer must be credited to such individual.

.11 Other requirements — In addition to the requirements listed in section 10.07 and any other substantive requirements, master or prototype plans must comply with the requirements of all revenue rulings, notices, legislation, and regulations including:

1 Final regulations under the Retirement Equity Act of 1984 (REA);

2 Final regulations under sections 401(a)(4) and 411(d)(6) of the Code on limitations on availability of benefits;

3 If the plan includes a cash or deferred arrangement, final regulations under section 401(k) of the Code;

4 If the plan is an integrated defined benefit plan, Rev. Rul. 86-74, 1986-1 C.B. 205 (modifications to guidelines for social security integration under Rev. Rul. 71-446) with respect to plan years beginning after the relevant effective date specified in section 6 of the revenue ruling and before January 1, 1989.

.12 Sponsoring Organization Telephone Numbers — Master or prototype plan adoption agreements must include the sponsoring organization's address and telephone number (or a space for the address and telephone number of the sponsoring organization's authorized representative) for inquiries by adopting employers regarding the adoption of the plan, the sponsoring organization's intended meaning of any plan provisions, or the effect of the opinion letter.

SEC. 6. STANDARDIZED FORM PLANS

.01 Reliance — An employer adopting a standardized form plan or paired plans may rely on its opinion letter, except as provided in subsections .02, .03, and .04, below, if the provisions of section 15.011 of Rev. Proc. 80-30, as modified by section 19.03 of this revenue procedure, are satisfied.

.02 Non-Reliance by Employer Maintaining More than One Plan — Except in the case of a combination of paired plans, an employer may not rely on opinion letters for standardized form plans, without obtaining a determination letter, if the employer maintains at any time, or has maintained at any time, another plan, including a standardized form plan, that was qualified or determined to be qualified covering some of the same participants. For this purpose, a plan that has been properly replaced by the adoption of a standardized form plan is not considered another plan. The plan that has been replaced and the standardized form plan must be of the same type (e.g., both money purchase pension plans) in order for the employer to be able to rely on the standardized form plan without obtaining a determination letter.

.03 Reliance by Employer Adopting a Standardized Defined Benefit Plan — An employer that has adopted a standardized defined benefit master or prototype plan may rely on an opinion letter only if the plan satisfies one of the safe-harbors provided in regulations under section 401(a)(26) with respect to its prior benefit structure or is deemed to satisfy section 401(a)(26) under such regulations.

However, in connection with the initial adoption or amendment by an employer of a standardized (paired) defined benefit plan, such employer may request a determination letter if the employer wishes to have reliance as to whether the plan satisfies section 401(a)(26) with respect to its prior benefit structure.

.04 Reliance by Employers Adopting Standardized Plans Sponsored by Trade or Professional Organizations — A standardized form plan sponsored by a trade or professional organization which is adopted by an employer that is not a bona fide member of such organization will be considered an individually designed plan and the procedures in Rev. Proc. 80-30 regarding the issuance of determination letters for individually designed plans will apply to the employer's plan.

.05 Sharing Basic Plan Document By Standardized and Non-Standardized Plans — A sponsoring organization may establish a basic plan document that applies to both a standardized form plan and a non-standardized form plan. Such plans may differ only by the different adoption agreements. For example, the adoption agreement for the plan that is a non-standardized form plan may have additional coverage options.

SEC. 7. SPECIAL REQUIREMENTS FOR PAIRED PLANS

.01 Limits of Section 415(e) Must Be Provided in Defined Benefit Plan Only — The benefits under a defined benefit plan in a combination of paired plans must be limited by the requirements of section 415(e) of the Code relating to the aggregation of defined benefit and defined contribution plans. Adjustments to satisfy the requirements of section 415(e) may only be provided in the defined benefit plan with respect to benefits thereunder.

.02 Section 416(h) Adjustment to Section 415(e) Limits — Paired plans that include a defined benefit plan must compute the denominators of defined benefit and defined contribution fractions in a manner satisfying section 416(h)(1) of the Code unless the requirements of section 416(h)(2) are satisfied. Paired plans providing the unreduced section 415(e) limits must provide, regardless of how the adoption agreement is completed, the additional top-heavy minimums described in section 416(h)(2)(A) and provide that the unreduced section 415(e) limits will not apply if the plan is super top-heavy as described in question T-33 of section 1.416-1 of the Income Tax Regulations. In testing for super top-heavy, all the requirements of questions T-35 and T-36 of section 1.416-1 of the regulations must be included in the plan.

.03 Coordination of Minimum Benefits and Contributions Under Top-Heavy Plans — Paired plans, subject to the limits of section 415 of the Code, may provide duplication of the minimum benefits and contributions in each of the plans being paired. The paired plans (when they become top-heavy) may, however, provide minimum contributions and benefits that are not duplicative. In that case, only two methods may be used:

1 The defined benefit plan must provide the 2% (3% if the unreduced section 415(e) limit is used) defined benefit minimum for all its participants. The defined contribution plan must provide the defined contribution minimum for participants in the defined contribution plan who are not participants in the paired defined benefit plan, or

2 The defined contribution plan must provide a contribution not less than 5% (7 1/2% if the unreduced section 415(e) limit is used) with respect to any participant who is a participant in a paired defined benefit plan and a contribution not less than 3% (4% if the unreduced section 415(e) limit is used) for any participant who is not a participant in the paired defined benefit plan. The defined benefit plan must provide the 2% minimum (3% if the unreduced section 415(e) limit is used) with respect to any participant who is not in the defined contribution plan or who does not receive the entire defined contribution allocation.

.04 Pairing Provisions Must be in the Basic Plan Document — In the case of paired plans, all provisions necessary to coordinate the plans (other than the reliance statement required under section 5.08 of this revenue procedure) must be set forth in the basic plan document and not in the adoption agreement.

.05 Paired Plans Limited to Two Different Basic Plan Documents — While the sponsoring organization is not limited in the number of sets of paired plans it may adopt, each set must be limited to two different basic plan documents: one for defined benefit plans and one for defined contribution plans. The pairing of defined contribution plans requires only one basic plan document such as a profit-sharing plan and a money purchase plan containing the identical basic plan document and two different adoption agreements. A sponsoring organization may provide a pairing of defined benefit and defined contribution plans in such a manner that with two different basic plan documents and three adoption agreements, an adopting employer may adopt a profit-sharing plan, a money purchase plan, and a defined benefit plan.

SEC. 8. SPECIAL REQUIREMENTS FOR PLANS THAT INCLUDE A CASH OR DEFERRED ARRANGEMENT

.01 Required Provisions — In order to receive a favorable opinion letter, a master or prototype plan which includes a cash or deferred arrangement (CODA) must be a profit-sharing plan or a rural electric cooperative plan, as defined in section 401(k)(7) of the Internal Revenue Code, and must include provisions which comply with the following list:

1 The CODA must include a mechanism whereby an eligible employee may make a cash or deferred election with respect to employer contributions, within the meaning of section 401(k).

2 The minimum number of years of service required for participation in the cash or deferred arrangement cannot exceed 1.

3 Separate accounts must be maintained for each participant's

(a) elective deferrals, as described in section 402(g)(3)(A) of the Code;

(b) qualified nonelective contributions, as described in section 401(m)(4)(C), and qualified matching contributions used to satisfy the test provided in section 401(k)(3);

(c) employee contributions; and

(d) matching contributions, as described in section 401(m)(4)(A) of the Code, that are not used to satisfy the test provided in section 401(k)(3).

4 Elective deferrals, employee contributions, qualified nonelective contributions, and qualified matching contributions must be nonforfeitable at all times.

5 Amounts attributable to elective deferrals (other than excess deferrals or excess contributions), qualified nonelective contributions, and qualified matching contributions used to satisfy the test provided in section 401(k)(3), may not be withdrawn prior to the occurrence of one of the events specified in section 401(k)(2)(B).

6 If the plan provides for hardship distributions, then for plan years beginning after December 31, 1988, amounts attributable to qualified nonelective contributions and qualified matching contributions may not be distributed merely

on account of hardship. Also, income allocated to elective deferrals after December 31, 1988 may not be distributed on account of hardship.

7 If the plan provides for hardship distributions of amounts attributable to elective deferrals, then, for the purpose of determining the existence of an immediate and heavy financial need and the amount necessary to meet that need, the plan must adopt the safe-harbor standards set forth in sections 1.401(k)-1(d)(2)(ii)(B) and (iii)(B) of the regulations.

8 The CODA provisions may not be integrated with social security.

9 Elective deferrals under the plan may not exceed $7000 (or such greater amount as subsequently determined in accordance with increases provided under section 415(d)) for any taxable year.

10 A mechanism must be provided by which a participant may notify the plan administrator of an allocation of excess elective deferrals, and upon which notice such excess elective deferrals, and the applicable earnings, will be distributed to the participant by April 15 of the year following the taxable year of deferral.

11 The Actual Deferral Percentage (ADP) test set forth in section 401(k)(3) of the Code must be contained in the plan.

12 Definitions of highly compensated employee and family member, as described in section 414(q) of the Code, and compensation as described in section 414(s), must be contained in the plan.

13 The method or methods by which the plan may correct contributions in excess of those allowed under the ADP test must be described in the plan. The plan must provide that the employer will maintain records to demonstrate compliance with the nondiscrimination requirements of 401(k), including the extent to which qualified nonelective contributions and qualified matching contributions are taken into account.

14 An explanation of the 10% excise tax imposed by section 4979 of the Code upon employers that have not distributed (within 2 1/2 months following the end of the plan year) or recharacterized contributions in excess of the amount allowed by the ADP test must be contained in the plan.

15 A mechanism must be provided to assure the proper ordering of tests as described in section 401(m)(6)(D) of the Code.

16 Provisions to satisfy the top-heavy requirements as set forth in section 416 must be contained in the plan. For plan years beginning on or after January 1, 1989, plans may not include elective deferrals or matching contributions as employer contributions for the purpose of satisfying the minimum contribution requirements.

17 The plan must provide that if contributions subject to section 401(m) are made pursuant to the plan containing the CODA or any other plan maintained by the same employer, such employer must designate the method of correction to be used and the plan to be corrected if a multiple use of the alternative limitation (within the meaning of section 401(m)(9) of the Code) occurs.

.02 Optional Provisions — Master or prototype plans that include CODA provisions may also include some or all of the following items:

1 Matching employer contributions or employee contributions. If such contributions are made, the plan must contain the Actual Contribution Percentage (ACP) non-discrimination test set forth in section 401(m)(2) of the Code, and must describe the method or methods by which the plan will correct contributions made in excess of the section 401(m)(2) limits. The plan must provide that the employer will maintain records to demonstrate compliance with the nondiscrimination requirements under section 401(m), including the extent to which qualified nonelective contributions and elective contributions are taken into account. The plan must also contain an explanation of the 10% excise tax imposed by section 4979 of the Code upon employers that have not corrected contributions in excess of the amount allowed by the ACP test within 2½ months following the end of the plan year;

2 qualified nonelective contributions (QNECs);

3 recharacterization of elective contributions in excess of the ADP test as voluntary employee contributions subject to section 401(m);

4 employer contributions, including elective deferrals, to be made regardless of profits;

5 use of QNECs to satisfy the ADP test;

6 use of qualified matching contributions to satisfy the test set forth in section 401(k); and

7 distributions on account of participant hardship (but see sections 8.016 and 8.017).

.03 Additional Requirements for Standardized Form Plans —

1 A standardized form plan that includes a CODA must, in addition to satisfying the requirements listed in section .02 above, provide a minimum qualified nonelective contribution of 3% of compensation.

2 The requirement that contributions be a uniform percentage of each participant's compensation does not apply to elective deferrals, QNECs or matching contributions (if any) under the CODA. However, all other requirements of sections 3.08 and 6 of this revenue procedure apply to a standardized form plan that contains a CODA.

SEC. 9. OPINION LETTERS — SCOPE

.01 Issuance Only to Appropriate Sponsors — Opinion letters will be issued only to sponsoring organizations or mass submitters (as provided in section 18.01) and do not constitute rulings or determinations as to either the qualification of the plans as adopted by particular employers, or, in the case of prototype plans, the exempt status of related trusts or custodial accounts.

.02 Nonapplicability of the Procedure to IRAs and SEPs — Opinion letters will not be issued under this revenue procedure for prototype plans intended to meet the requirements for individual savings programs or simplified employee pension programs under section 408 of the Code (see Rev. Proc. 87-50, 1987-2 C.B. 647).

.03 Areas Not Covered by Opinion Letters — Opinion letters will not be issued for:

1 Any plan under which the rules of section 401(a), 410 or 411 are applied by treating the employees of more than one employer as employed by a single employer, and any plan which has been negotiated pursuant to a collective bargaining agreement and submitted to the Service as a plan maintained pursuant to a collective bargaining agreement. For this purpose, the term "one employer" includes all employers aggregated under section 414(b), (c), (m) or (o). This does not preclude a master or prototype plan, by its terms, from covering employees of the employer who are included in a unit covered by a collectively bargained agreement or the adoption of a master or prototype plan pursuant to such agreement as a single employer plan which covers only employees of the employer. However, the Service will not issue an opinion letter with respect to an M&P plan if any provision therein would cause a plan

that is not described in section 413(b) of the Code to fail to be qualified. Furthermore, an opinion letter may not be relied on with respect to whether a plan satisfies any requirement that is applicable to a plan described in section 413(b) but inapplicable to other plans;

2 Stock bonus plans;

3 Bond purchase plans;

4 Employee stock ownership plans (see Rev. Proc. 75-48, 1975-2 C.B. 583);

5 Pooled fund arrangements contemplated by Rev. Rul. 81-100, 1981-1 C.B. 326;

6 Annuity contracts under section 403(b) of the Code;

7 Uniform plans (see Rev. Proc. 84-86, 1984-2 C.B. 787);

8 Defined contribution plans (except for target benefit plans) under which the test for prohibited discrimination under section 401(a)(4) of the Code is made by reference to benefits rather than contributions;

9 Plans that involve integration with Social Security benefits or contributions other than plans that, in form, meet the permitted disparity limitations of section 401(l) or that satisfy the requirements of section 401(a)(5)(D).

10 Plans described in section 414(k) of the Code (relating to a defined benefit plan which provides a benefit derived from employer contributions which is based partly on the balance of the separate account of a participant);

11 Defined contribution plans (other than any CODA portion of such a plan) that allocate contributions or forfeitures to the account of any participant in any manner other than on the basis of total compensation within the meaning of section 414(s);

12 Target benefit and defined benefit plans that provide benefits on the basis of compensation where compensation is not defined as total compensation within the meaning of section 414(s);

13 Governmental plans described in section 414(d) of the Code;

14 Church plans described in section 414(e) of the Code that have not made the election provided by section 410(d);

15 Plans, other than master plans (i.e., plans with a single master trust for all adopting employers) that designate the M&P sponsoring organization as plan administrator and plans which include a qualified CODA under section 401(k) of the Code, which permit contributions which are subject to the special nondiscrimination requirements of section 401(m). However, this does not prohibit mandatory employee contributions in a defined benefit plan. In the case of a plan which includes a qualified CODA, such plan may provide for after-tax employee contributions and matching contributions in addition to elective deferrals.

16 Plans which contain or may contain a multi-tiered benefit structure (other than an integrated benefit formula). Thus, a plan may not provide different benefit formulas for different employees, such as two percent of compensation for salaried employees and one percent for hourly employees.

17 Any plan under which the section 415 limitations are incorporated by reference.

18 Any plan under which the ADP test under section 401(k)(3) or the ACP test under section 401(m)(2) is incorporated by reference. However, a plan which prohibits contributions subject to the requirements of section 401(m) pursuant to subsection .0315, but which allowed such contributions in a plan year to which section 401(m) applies, may incorporate the section 401(m)(2) test by reference for such prior year's contributions.

.04 Nontransferability of Opinion Letters — An opinion letter issued to a sponsoring organization is not transferable to any other entity. For this purpose, a change of employer identification number is deemed to be a change of entity.

SEC. 10. OPINION LETTERS — INSTRUCTIONS TO SPONSORING ORGANIZATIONS

.01 National Office Issues Opinion Letters — The National Office will, upon the request of a sponsoring organization, issue an opinion letter as to the acceptability under section 401 of the Code of the form of a master or prototype plan and any related trust or custodial account.

.02 Forms and Address for Requesting Opinion Letters — A request for an opinion letter relating to a master or prototype plan must be submitted on the current version of Form 4461, Application for Approval of Master or Prototype Defined Contribution Plan, Form 4461-A, Application for Approval of Master or Prototype Defined Benefit Plan, or Form 4461-B, Application for Approval of Master or Prototype Plan Mass Submitter Adopting Sponsor, as appropriate. All information on the first page of the application must be typed and no photocopies of the first page will be accepted. The request is to be sent to the Internal Revenue Service, Assistant Commissioner (Employee Plans and Exempt Organizations), Attention: E:EP:Q, P.O. Box 14073, Ben Franklin Station, Washington, D.C. 20044. The Service reserves the right to review applications in any order which will expedite the processing of such opinion letter applications. To expedite the review of substantially identical plans which are not described in section 18, relating to mass submitter plans, the Service encourages plan drafters and sponsoring organizations to include in each opinion letter application where it is appropriate a covering letter setting forth the following information:

1 The name and file folder number (if available) of the plan which, for review purposes, the plan drafter designates as the "lead plan" (including the name and EIN of the sponsoring organization);

2 A list of all plans written by the plan drafter which are substantially identical to the lead plan (including the information described in paragraph 1);

3 A description of each place where the plan for which the application is being submitted is not word-for-word identical to the language of the lead plan, including an explanation of the purpose and effect of each such difference;

4 A certification, made under penalty of perjury by the plan drafter, that the information described in paragraph 3 is true and complete. If the sponsoring organization or plan drafter is aware that a lead plan or any substantially identical plan has been assigned for review to a specific tax law specialist, the covering letter should also indicate the name of the tax law specialist. To the extent feasible, lead plans and substantially identical plans should be submitted together. The Service will regard the information and certification described in paragraphs 3 and 4 above as a material representation for purposes of issuing an opinion letter.

.03 Replacement of plans — If the plan is intended to be a replacement plan, as defined in section 3.10 of this revenue procedure, the sponsoring organization must identify the replaced plan(s) by the file folder number(s). After October 31, 1989, the Service will issue a list of all replacement plans which have been submitted on or before such date (see section 13.042). A sponsoring organization will then have 60 days from the date such list is published to identify any replacement plan which was properly submitted but which does not appear on the list. Failure to identify a proper replacement plan within the 60 day period will preclude the sponsoring organization from later claiming that the TEFRA approved plan was in fact properly replaced.

.04 Separate Applications Required for Different Categories of Master or Prototype Plans — An application for a master or prototype plan shall not contain any combination of profit-sharing, money purchase (other than target benefit), target benefit, non-integrated defined benefit, or integrated defined benefit plan features. However, separate defined contribution plans may have the same basic plan document but the provisions of such basic plan document must be identical for both plans (i.e. no elective or optional features).

.05 Sample Language — A Listing of Required Modifications (LRM) containing sample language to be used in drafting master or prototype plans is available from the Employee Plans Technical & Actuarial Division of the Internal Revenue Service. Such language is not automatically required in master or prototype plans but should be used as a guide in drafting such plans. An LRM may be obtained by writing to the Internal Revenue Service, Employee Plans Technical & Actuarial Division, Washington, D.C. 20224, Attention E:EP:Q. To expedite the review of their plans, sponsoring organizations are encouraged to use LRM language and to identify where such language is being used in their plan documents.

.06 Additional Information May Be Requested — The Service may, at its discretion, require any additional information that it deems necessary. If a letter, requesting changes to plan documents, is sent to the plan's sponsoring organization or authorized representative, the changes must be received no later than 30 days from the date of the letter. If the changes are not received within 30 days, the application may be considered withdrawn. An extension of the 30 day time limit will only be granted for good cause. Any request for an extension is to be made in writing prior to the expiration of the 30 day period and must be approved by the Chief of the Qualifications Branch, Employee Plans Technical & Actuarial Division.

.07 Inadequate Submissions — The Service will return, without further action, plans which are not in substantial compliance with the qualification requirements or plans that are so deficient that they cannot be reviewed in a reasonable amount of time. A plan may be considered not to be in substantial compliance if, for example, it omits any of the requirements set forth below, or merely incorporates these requirements by reference to the applicable Code section. The Service will not consider these plans until after they are revised, and they will be treated as new requests as of the date they are resubmitted. No additional user fee will be charged under Rev. Proc. 89-4 if an inadequate submission is amended to be in substantial compliance and is resubmitted to the Service within 30 days following the date the sponsor is notified of such inadequacy. The following are some examples of qualification requirements, the omission of which may cause a plan to be regarded as not being in substantial compliance:

1 Section 401(a)(9) of the Code, as amended by section 1121 of TRA '86, relating to required distributions from qualified plans (see section 1.401(a)-(9)-1 and 2 of the proposed regulations);

2 Section 401(a)(11) of the Code, as amended by section 1898 of TRA '86, and section 417 of the Code, as amended by sections 1139 and 1898 of TRA '86, and the regulations thereunder, relating to minimum survivor annuity requirements;

3 Section 415 of the Code, as amended by sections 1106, 1108, 1114, 1852, 1875, and 1898 of TRA '86, relating to contribution and benefit limits for qualified plans (see Notice 87-21, 1987-1 C.B. 458);

4 Section 416 of the Code, as amended by sections 1106, 1118, and 1852 of TRA '86, containing special rules for top-heavy plans;

5 If the plan provides for disparity in contributions or benefits, section 401(l) of the Code, as amended by section 1111 of TRA '86, relating to nondiscriminatory coordination with Social Security benefits (see sections 1.401(l)-1 through 1.401(l)-4 of the proposed regulations);

6 Section 414(m) of the Code, as amended by section 1114 of TRA '86, relating to employees of affiliated service groups;

7 Section 414(n) of the Code, as amended by sections 1146 and 1151 of TRA '86, relating to leased employees;

8 Section 414(o) of the Code, as added by section 1146 of TRA '86, and the regulations thereunder;

9 Sections 401(c) and (d) of the Code, unless the plan precludes participation by self-employed individuals;

10 Section 411(a)(2) of the Code, as amended by section 1113 of TRA '86, and the temporary regulations thereunder, relating to vesting of employer contributions;

11 If the plan contains a cash or deferred arrangement, section 401(k) of the Code, as amended by sections 1116 and 1879(g) of TRA '86, and the regulations thereunder (see section 1.401(k)-1 of the final and proposed regulations);

12 If the plan permits, or permitted in any plan year beginning after 1986, employee or matching contributions (other than mandatory contributions under a defined benefit plan), section 401(m) of the Code, as added by section 1117(a) of TRA '86, relating to the nondiscrimination test for employee and matching contributions (see section 1.401(m)-1 and 2 of the proposed regulations, and also see section 9.0315 of this revenue procedure for rules as to which plans may permit such contributions);

13 Section 410(a) of the Code, as amended by section 1113 of TRA '86 and section 9203 of OBRA '86, relating to minimum participation standards (see section 1.410(a)-4A of the proposed regulations);

14 Sections 411(b)(1)(H) and 411(b)(2) of the Code, as added by section 9202 of OBRA '86, relating to accruals and allocations after a specified age (see section 1.411(b)-2 of the proposed regulations);

15 If the plan is a contributory defined benefit plan, section 411(c)(2) of the Code, as amended by section 9346(b) of OBRA '87, relating to an employee's accrued benefit derived from employee contributions;

16 Section 401(a)(17) of the Code, as added by section 1106 of TRA '86, relating to the limitation on annual compensation that may be taken into account; and

17 Section 401(a)(26) of the Code, as added by section 1112 of TRA '86, relating to additional participation requirements (see the proposed regulations under section 401(a)(26)).

.08 Material Furnished to Adopting Employers — A sponsoring organization must furnish each adopting employer with a copy of the approved plan, copies of any subsequent amendments, and the most recently issued Internal Revenue Service opinion letter.

.09 Nonidentification of Questionable Issues May Cause Delay — If the plan document submitted as part of an opinion letter request contains a provision that gives rise to an issue for which contrary published authorities exist, failure to disclose and address significant contrary authorities may result in requests for additional information, which will delay action on the request (see section 7.06 of Rev. Proc. 83-36).

.10 Material Furnished to Key District Offices — Each mass submitter and sponsoring organization of a non-mass submitter plan must furnish a copy of the approved master or prototype plan and the Internal Revenue Service opinion letter to each Internal Revenue Service key district office in whose jurisdiction there are employers who adopt the plan. In addition, each mass submitter must submit a list to the appropriate key district office of all sponsoring organizations that have adopted a word-for-word identical plan of the mass submitter and a copy of any plan which contains minor modifications. Each mass submitter and sponsoring organization of a non-mass submitter plan must also furnish key district offices with a copy of all amendments subsequently approved as to form by the National Office. Copies of word-for-word identical plans of mass submitters, as described in section 18.01 of this revenue procedure, need not be submitted to the key district offices.

SEC. 11. AMENDMENTS

.01 Opinion Letters for Sponsor Amendments — A sponsoring organization may amend or restate its previously approved plan (including any related trust or custodial account) and the National Office will entertain a request for a written opinion as to the acceptability, for purposes of sections 401, 403, and 501(a) of the Code, of the form of the plan as amended. If the sponsoring organization is amending its plan, it must, except as provided in section 18.02 and 18.04, submit a Form 4461 or Form 4461-A, as applicable, to the National Office, together with a copy of the amendment(s), a cover letter summarizing the changes to the plan effected by such amendment(s), and a copy of the plan which is being amended. If the sponsoring organization is restating its plan, it must, except as provided in sections 18.02 and 18.04, submit the restated plan, with the changes highlighted, along with a Form 4461 or 4461-A, as applicable. No more than four consecutive amendments may be submitted without restating the plan. In addition, the Service may, at its discretion, require plan restatement at any time that it deems necessary to adequately review a plan. Opinion letters issued by the Service with respect to the restatement or amendment of plans to comply with TRA '86 will not distinguish between restated or amended plans.

.02 No Opinion Letters for Certain Amendments — A master or prototype plan will not lose its qualified status and, except as provided in section .024 below, no opinion letter will be issued merely because amendments are made which solely cover the following:

1 Amendments to conform a plan to the requirements of section 402(a) of Title I of the Employee Retirement Income Security Act of 1974 (ERISA), Pub. L. 93-406, 1974-3 C.B. 1, relating to named fiduciaries.

2 Amendments to conform a plan to requirements of section 503 of ERISA, relating to claims procedures.

3 Amendments that merely adjust the maximum limitations under section 415, 402(g), and 401(a)(17) to reflect annual cost-of-living increases, other than amendments that add an automatic cost-of-living adjustment provision to the plan.

4 Amendments that merely reflect a change of a sponsoring organization's name. However, a sponsoring organization must notify the Service, in writing, of the change in name and must certify that it is still a proper sponsoring organization under this revenue procedure. No opinion letter will be issued and no user fee will be required for a mere change in name. However, if the sponsoring organization wants a new opinion letter, it will have to submit a new Form 4461, 4461-A or 4461-B and pay the appropriate user fee. (Also see section 9.04 regarding changes in employer identification numbers.)

SEC. 12. DETERMINATION LETTER PROCEDURES

Except as provided in section 6, approval by the Service of the form of a master or prototype plan under this revenue procedure does not constitute a determination that an employer who adopts the plan will have a qualified plan. Therefore, such an adopting employer should request a determination letter in accordance with the procedures set forth in Rev. Proc. 80-30. For this purpose, a master or prototype plan sponsored by a trade or professional organization which is adopted by an employer that is not a bona fide member of such organization will be considered an individually designed plan.

SEC. 13. CONTINUED AND INTERIM RELIANCE

.01 Continued Reliance for Pre-Effective Date M&P Plan Adopters — An employer who has adopted a master or prototype plan with a favorable TEFRA opinion letter prior to the effective date of this revenue procedure, and who either was entitled to rely on such opinion letter pursuant to the procedures in effect before such date or receives a favorable determination letter, may continue to rely on such opinion or determination letter for plan years beginning after December 31, 1988 only if the conditions described in section 13.03 are satisfied.

.02 Interim Reliance for Post-Effective Date M&P Plan Adopters — An employer who adopts a master or prototype plan with a favorable TEFRA opinion letter or a replacement plan (as described in section 3.10) on or after the effective date of this revenue procedure, will have reliance, beginning with the first plan year for which such plan is timely adopted, only if:

1 the conditions described in section 13.03 are satisfied;

2 in the case of a replacement plan, the plan's sponsoring organization submits it to the Service in accordance with the requirements of sections 5 and 10 on or before the earlier of the date of the employer's adoption of the plan or March 31, 1990; and

3 in the case of a master or prototype or replacement plan which amends or restates a plan of the employer, the employer is entitled to rely on a favorable opinion or determination letter issued with respect to the plan that is amended or restated at the time of adoption of such master or prototype or replacement plan.

For this purpose, a master or prototype or replacement plan is timely adopted for a plan year if it is adopted on or before the last day of the remedial amendment period provided by regulations under section 401(b) of the Code that includes such year. However, this does not permit a plan to be made retroactively effective for a taxable year prior to the taxable year of the employer in which the plan was first adopted by the employer.

.03 Conditions for Continued or Interim Reliance / Proper Amendment by Sponsoring Organization — Except as provided in section 13.05, the following conditions must be satisfied in order for the employer to obtain the continued or interim reliance described in this section:

1 The employer must operate its plan in accordance with those requirements

of TRA '86, OBRA '86, OBRA '87, and the regulations and revenue ruling described in section 5.11 that are effective for plan years beginning before 1989 as of the effective dates of such requirements.

2 The sponsoring organization of the TEFRA approved plan described in section 13.01 or 13.02 must submit a replacement plan to the Service in accordance with the requirements of sections 5 and 10 on or before March 31, 1990. (However, also see section 13.05.)

3 Unless section 13.05 applies, the employer must adopt the Service approved version of such replacement plan and, except as provided in section 6, request a determination letter on or before the later of the last day of the twelfth calendar month beginning after the date the Service issues a favorable opinion letter under this procedure with respect to such replacement plan or the end of any remedial amendment period under section 401(b) of the Code applicable to the employer's plan. Plan provisions necessary to comply with the requirements of sections 5 and 10 must be made retroactively effective to the extent required by the relevant legislation, regulations, revenue rulings and notices.

.04 Lists of Plans to be Published by the Service — The Service will publish in the Internal Revenue Bulletin

1 After March 31, 1990, a cumulative list of all sponsoring organizations and their related replacement plans which have been submitted in accordance with this revenue procedure on or before such date. If a sponsoring organization believes that a replacement plan has been omitted from the cumulative list, it may, within 60 days of publication of such list, notify the Service by writing to the address in section 10.02, including in its notification the file folder numbers of the replacement plan and the plan(s) it replaces. Thereafter, the Service will publish an addendum to the cumulative list, if necessary. A plan that is not listed on the cumulative list or addendum will in no event be considered a replacement plan for purposes of this revenue procedure.

2 Periodically, a list of sponsoring organizations and their related replacement plans which have been submitted to the Service on or before March 31, 1990 and which

(a) receive favorable opinion letters (and the respective date issued),

(b) receive unfavorable opinion letters, or

(c) withdraw their requests for opinion letters.

.05 Conditions for Continued or Interim Reliance / No Proper Amendment by Sponsor — This subsection applies if the sponsoring organization of the TEFRA approved plan described in section 13.01 or 13.02 fails to submit a proper replacement plan by March 31, 1990, or if it subsequently withdraws its application or receives an unfavorable opinion letter. In order to obtain the continued or interim reliance described in this section, an employer whose master or prototype plan is not included in the list described in subsection .041 or whose master or prototype plan is included in one of the lists described in subsection .042(b) or (c) must operate its plan in compliance with those requirements described in sections 5 and 10 that are effective before 1989 as of the relevant effective dates, adopt all required amendments retroactive to their effective dates, and satisfy either of the following conditions:

1 By the last day of the twelfth calendar month beginning after publication of the relevant list, the employer must adopt another master or prototype plan with a favorable TEFRA opinion letter, or a replacement plan, that is included in the lists described in subsection .041. The employer must then satisfy section 13.033 with respect to the Service approved version of this plan. For this purpose, the twelve month period described in section 13.033 will start with the first month beginning after the later of the date of the favorable opinion letter issued under this procedure or the date of publication of the relevant list showing that the employer's original master or prototype plan was not properly amended.

2 By the later of the last day of the twelfth calendar month beginning after publication of the relevant list or the end of any applicable remedial amendment period, the employer must amend its plan to satisfy the requirements of section 5.11 and section 10 (in which case the plan will be treated as individually designed) and request a determination letter.

.06 Adoption of Another Master or Prototype Plan — An employer will not be treated as having failed to satisfy the conditions set forth in section 13.03 merely because, instead of adopting the Service approved version of the replacement plan described therein, it adopts another master or prototype plan with a favorable TEFRA opinion letter or its replacement plan (a "substitute plan"), provided such plan has been submitted to the Service in accordance with the requirements of sections 5 and 10 on or before March 31, 1990. If the employer's initial adoption of the substitute plan precedes the date of issuance of a favorable opinion letter under this procedure with respect to the replacement plan described in section 13.03, then the twelve month period provided therein will begin with the first month after the date of the favorable opinion letter issued under this procedure with respect to the substitute plan. Furthermore, an employer will not be treated as having failed to satisfy section 13.03 merely because, instead of adopting the Service approved version of the replacement plan described therein, it adopts individually designed amendments intended to comply with the requirements of section 5.11 and section 10, provided such amendments are adopted and a determination letter application is filed within the time set forth in section 13.033.

.07 Adopters of Plans Without Favorable TEFRA Opinion Letters — Any employer who adopts a master or prototype plan which has no favorable TEFRA opinion letter (other than a master or prototype plan which amends or replaces a plan with a favorable TEFRA opinion letter), will not receive the reliance provided by this section.

.08 Reliance for Plan Years Beginning Before 1989 — Notwithstanding any other provision of this section, whether an employer may rely on a favorable TEFRA opinion letter for plan years beginning after December 31, 1986 and before January 1, 1989 will be determined in accordance with Notice 87-28, 1987-1 C.B. 472, and, if the sponsoring organization has adopted model amendments issued by the Service, Notice 8733, 1987-1 C.B. 480, and, if applicable, Notice 87-34, 1987-1 C.B. 490. (Also see section 1140 of TRA '86.)

.09 Examples —

1 Employer X adopted Plan A, a nonstandardized master or prototype profit-sharing plan with a favorable TEFRA opinion letter, in July 1988, and received a favorable determination letter in December 1988. The sponsoring organization of Plan A properly submits a replacement plan to the Service by March 31, 1990. In 1990, before Plan A receives its TRA opinion letter, X amends its plan by adopting Plan B, a standardized profit-sharing plan which replaces a prototype plan with a favorable TEFRA opinion letter and which

has also received a favorable TRA opinion letter when it is adopted by X.

(a) X will be entitled to continued reliance under this revenue procedure if it adopts the Service approved version of replacement Plan B not later than the later of the end of the twelfth month beginning after Plan B receives its TRA '86 opinion letter or the end of any section 401(b) remedial amendment period applicable to X's plan provided the other requirements of section 13.03 have been complied with. X is not required to request a determination letter with respect to Plan B unless it has maintained another plan in addition to this profit-sharing plan.

(b) If replacement Plan A receives its favorable TRA '86 opinion letter before X adopts Plan B, X would be required to adopt a replacement plan with a favorable TRA '86 opinion letter by the later of the end of the twelfth month beginning after Plan A receives its favorable TRA '86 opinion letter or the end of the remedial amendment period.

2 Employer Y, a calendar year taxpayer, establishes a new calendar year plan with a January 1, 1990 effective date in December 1990 by adopting a non-standardized prototype plan which replaces a prototype plan with a favorable TEFRA opinion letter and which has been properly submitted to the Service by March 31, 1990. This replacement plan receives a favorable TRA '86 opinion letter on January 1, 1991. Y will have reliance beginning with the 1990 plan year if it adopts the Service approved version of the replacement plan and requests a determination letter by January 31, 1992, or the end of any applicable remedial amendment period, if later, provided the other requirements of section 13.03 are satisfied.

3 Employer Z adopted an individually designed plan which received a favorable determination letter in 1983 but was not amended as required to comply with the Retirement Equity Act of 1984 (REA). Z amends its plan by adopting a standardized plan with a favorable TEFRA opinion letter in 1989. The sponsoring organization of the prototype plan properly submits a replacement plan to the Service by March 31, 1990. Z is not entitled to continued reliance under this section because Z was not entitled to rely on a favorable determination letter with respect to its individually designed plan at the time it was replaced by the prototype plan.

4 Employer X adopted Plan A, a standardized plan with a favorable TEFRA opinion letter, in 1986. The sponsoring organization of Plan A fails to submit a replacement plan to the Service by March 31, 1990. On June 30, 1990, the Service publishes a final cumulative list of all replacement plans that have been submitted to the Service by March 31, 1990. On June 30, 1991, X amends its plan by adopting Plan B, another standardized replacement plan which has been properly submitted to the Service by March 31, 1990. Plan B receives a favorable TRA '86 opinion letter on July 15, 1991. X will be entitled to continued reliance under this section if it adopts the Service approved version of replacement Plan B by July 31, 1992 or the end of any applicable remedial amendment period, if later, and the other requirements of section 13.03 are satisfied.

5 Employer Y establishes a new plan in 1990 by adopting Plan C, a standardized plan which was submitted to the Service for approval under this revenue procedure by March 31, 1990. Plan C does not have a favorable TEFRA opinion letter and does not replace a plan with such a letter. Employer Y is not entitled to continued or interim reliance under this section.

6 Employer Z adopts an individually designed plan in 1986 and requests and receives a favorable determination letter. Employer Z retroactively amends its plan to comply with TRA '86, OBRA '86, and OBRA '87 by adopting a prototype plan which has received a favorable opinion letter under this revenue procedure. Employer Z's adoption of the prototype plan occurs within 12 months after the prototype plan receives its opinion letter under this procedure but after the last date on which the employer could timely adopt individually designed amendments intended to comply with TRA '86, OBRA '86, and OBRA '87. Employer Z is not entitled to continued or interim reliance under this section because it is not entitled to rely on a favorable determination letter with respect to its individually designed plan at the time it is amended through adoption of the prototype plan.

SEC. 14. APPROVED PLANS — MAINTENANCE OF APPROVED STATUS

.01 Revocation of Opinion Letter by the Service — An opinion letter found to be in error or not in accord with the current views of the Service may be revoked. However, except in rare or unusual circumstances, such revocation letter will not be applied retroactively if the conditions set forth in section 14.05 of Rev. Proc. 83-36 are met. For this purpose, such opinion letters will be given the same effect as rulings. Revocation may be effected by a notice to the sponsoring organization to which the letter was originally issued, or by a regulation, revenue ruling or other statement published in the Internal Revenue Bulletin. The sponsor should then notify each adopting employer of the revocation.

.02 Subsequent Required Amendments — Except as provided in section 17.03, an approved master or prototype plan must be amended by the sponsoring organization and, if necessary, the employer, to retain its approved status if any provisions therein fail to meet the requirements of law, regulations, or other rules and guidelines affecting qualification that become effective subsequent to the issuance of an opinion letter.

.03 Amendments Following Revenue Rulings — If an approved master or prototype plan is required to be amended to retain its approved status as a result of publication by the Service of a revenue ruling, notice or similar statement in the Internal Revenue Bulletin (I.R.B.), then, unless section 17.03 is applicable or unless specifically stated otherwise in this revenue ruling, etc., the time by which the sponsoring organization must amend its master or prototype plan to conform to the requirements of the revenue ruling, etc. and request a new opinion letter shall be the end of the one-year period after its publication in the I.R.B., and with respect to any adopting employer's plan the effective date of such amendment shall be the first day of the first plan year beginning within such one-year period.

SEC. 15. WITHDRAWAL OF REQUESTS

.01 Notification and Effect — A sponsoring organization may withdraw its request for an opinion letter at any time prior to the issuance of such letter by notifying the National Office in writing of such withdrawal. The sponsoring organization must also notify each employer who adopted the plan that the request has been withdrawn. Such an employer will be deemed to have an individually designed plan to which Rev. Proc. 80-30 applies.

.02 Service Retains Information — Even though a request is withdrawn, the National Office will retain all correspondence and documents associated with that request and will not return them to the sponsoring organization. The National Office may furnish its views concerning the qualified status of the plan to District Directors who have or will have audit jurisdiction of the returns of any employers who have adopted the plan.

SEC. 16. ABANDONED PLANS

.01 Notification to the Service — A sponsoring organization should notify the National Office in writing of an approved master or prototype plan that is no longer used by any employer and that the sponsoring organization no longer intends to offer for adoption. Such written notification should be filed with the Commissioner of Internal Revenue, Washington, D.C. 20224, Attention: E:EP:Q: and should refer to the file folder number appearing on the latest opinion letter issued.

.02 Notification to Employers — A sponsoring organization that intends to abandon an approved master or prototype plan that is in use by any adopting employer must inform each adopting employer that the form of the plan has been terminated, that the employer's plan will become an individually designed plan (unless the employer adopts another approved M&P plan), and that any employer with a determination letter may continue to rely on such letter (or if the plan is standardized, may continue to rely as if it had received a determination letter) on the date the form of the plan is terminated but only until a change in law or other change in the qualification requirements. After so informing all adopting employers, the sponsoring organization should notify the National Office in accordance with subsection .01 above.

SEC. 17. SPECIAL PROVISIONS RELATED TO TRA

.01 Delayed Submissions — Effective immediately, no applications for the approval of master and prototype plans (other than those plans submitted pursuant to section 17.02 of this revenue procedure) may be submitted after the effective date of this revenue procedure and prior to July 7, 1989. Any application received more than 10 days after the effective date of this revenue procedure and prior to July 7, 1989, will be returned. The National Office will continue to process all master and prototype applications received not later than 10 days after the effective date of this revenue procedure in accordance with the provisions of Rev. Proc. 84-23, and any opinion letter issued to such a plan will not consider the effect of TRA '86.

.02 Early Submission Period for Mass Submitters and National Sponsoring Organizations — Mass submitters (as defined in section 18.01) and national sponsoring organizations (as defined in section 3.11) may submit applications for approval of master or prototype plans at any time on or after April 10, 1989, and will not be subject to the delayed submission requirement of section 17.01. In the case of a national sponsoring organization, each application submitted during this early submission period must be accompanied by the sponsoring organization's certification, made under penalty of perjury, that it maintains a list of adopting employers which establishes that it is a national sponsoring organization as described in section 3.11. The Service reserves the right to request a copy of such list in order to verify that these requirements have been met.

.03 Extended Reliance —

1 A sponsoring organization that submits a master or prototype plan which has been amended in accordance with the requirements specified in sections 5 and 10 of this revenue procedure (and other requirements that are in effect on the date the application is submitted) on or before March 31, 1990, and receives a favorable opinion letter under this revenue procedure, will not be required to amend its plan for subsequent regulations under TRA '86, OBRA '86, OBRA '87, or for revenue rulings, revenue procedures, or other Service releases issued after the date of the application, before the earlier of:

(a) December 31, 1994, or

(b) the date the plan is otherwise required to be amended by subsequent legislation.

2 Solely for purposes of this subsection, a master or prototype plan which is submitted to the Service after March 31, 1990 as a word-for-word identical adoption of a mass submitter plan that has been amended in accordance with the requirements specified in sections 5 and 10 of this revenue procedure (and all other requirements in effect on the date of the mass submitter's application) and that has been submitted to the Service on or before March 31, 1990, will be deemed to have been submitted to the Service on the date of the mass submitter's application.

3 Any employer which adopts a plan described in paragraph 1 or 2 above, and is otherwise entitled to reliance, may continue to rely on the opinion letter, or determination letter, if applicable, until the earlier of:

(a) the last day of the last plan year commencing prior to January 1, 1995, or

(b) the date established for plan amendment by any subsequent legislation.

4 In unusual circumstances, the Service may require M&P plans to be amended for, or operationally comply with, qualification requirements issued by the Service after a request for an opinion letter or determination letter is submitted but prior to the end of this extended reliance period. The Service will require this action only in cases where it is necessary to correct a fundamental error or omission that is likely to affect participants' rights or tax revenues in a significant number of plans. Any rule or regulation remedying an omission or correcting an error will generally be made effective prospectively, for plans which have met the requirements for extended reliance. However, the Service reserves the right to make such a rule or regulation applicable to such plan during the entire extended reliance period. Upon termination of an employer's master or prototype plan prior to the end of the extended reliance period, the plan must be amended retroactively to the effective date of any intervening change with respect to which operational compliance was required in order to correct a fundamental error or omission. This extended reliance period will not prevent the Service from requiring a plan to be amended to correct any defect in the plan which was not discovered upon prior review by the Service.

SEC. 18. MASS SUBMITTERS

.01 Opinion Letters Issued to Mass Submitters — Notwithstanding anything to the contrary, opinion letters will be issued to any person, whether or not such person is a sponsoring organization, that submits applications for at least 10 sponsoring organizations which will sponsor the identical master or prototype plan. Any such mass submitter that meets the requirements for a sponsoring organization may submit an application on its own behalf as one of the 10 adopting sponsoring organizations. Each sponsoring organization must sponsor a plan that is word-for-word identical to the mass submitter plan. For purposes of this revenue procedure a flexible plan (as defined in section 18.031) which is adopted by a sponsoring organization will be considered a word-for-word identical plan. After the initial submission (with applications for at least 10 identical adopters), the mass submitter may submit additional applications on behalf of sponsoring organizations that wish to adopt a word-for-word identical plan or a plan which contains minor modifications from the mass submitter plan, as provided in section 18.032. With respect to its plan, the mass submitter must submit a completed Form 4461 or 4461-A, as applicable, to the National Office. The first page of the Form 4461 or 4461-A must be typed and no photocopies of the first page will be accepted. Opinion letters issued to a mass submitter will apply only to the mass submitter and may be made available by the mass submitter to an adopting employer only if the mass submitter is also a sponsoring organization defined in section 3.07. All other sponsoring organizations must obtain an opinion letter.

.02 Reduced Procedural Requirements for Sponsoring Organizations Which Use Mass Submitter Plans — A sponsoring organization of a master or prototype plan of a mass submitter must obtain an opinion letter. For initial qualification, or where the sponsoring organization's plan includes minor modifications, the mass submitter on behalf of the sponsoring organization must submit a completed Form 4461-B to the Service which contains a declaration by the mass submitter under penalty of perjury that the sponsoring organization has adopted a master or prototype plan that is word-for-word identical, within the meaning of this section, to a plan of the mass submitter, or plan that is a minor modification of the mass submitter's plan. Such form must be typed and no photocopies will be accepted. If the mass submitter's plan has been approved by the Service, the sponsoring organization's request for an opinion letter must identify the letter serial number and date of the opinion letter issued to the mass submitter with respect to that plan. If the sponsoring organization has previously received an opinion letter with respect to a plan that is identical to the mass submitter's plan, the procedures described in sections 4.044 and 18.04, as applicable, should be followed. If the sponsoring organization is sponsoring a word-for-word identical plan (including a flexible plan), a copy of the plan need not be submitted. If the mass submitter submits a plan with minor modifications, it must comply with the requirements of section 18.032. Upon receipt of the request for an opinion letter, described above, the Service will, as soon as clerically feasible, issue an opinion letter to the sponsoring organization.

.03 Special Definitions —

1 Flexible Plan —

(a) In general — A "flexible plan" is a plan submitted by a mass submitter which contains optional provisions (as defined in subsection (b) below). Sponsoring organizations that adopt the flexible plan may include or delete any optional provision which is designated as such in the mass submitter's plan, provided the inclusion or deletion of specific optional provisions conforms to the mass submitter's written representation to the Service concerning the choices available to sponsoring organizations and the coordination of optional provisions. A mass submitter must bracket and identify the optional provisions when submitting such plan to the National Office and must also provide the Service a written representation describing the choices available to sponsoring organizations and the coordination of optional provisions. Thus, such a representation must indicate whether a sponsoring organization's plan may contain only one of a certain group of optional provisions, may contain only a specific combination of provisions, or may exclude the provisions entirely. Similarly, if the inclusion (or deletion) of a specific optional provision in a sponsoring organization's plan will automatically result in the inclusion (or deletion) of any other optional provision, this must be set forth in the mass submitter's representation. A flexible plan may contain only optional provisions which meet the requirements of subsection (b) and must be drafted so that the qualification of any sponsoring organization's plan will not be affected by the inclusion or deletion of optional provisions. For example, if a sponsoring organization's defined contribution plan contains an optional provision which allows a portion of a participant's account to be invested in life insurance, then under the terms of the sponsoring organization's plan, the application of the proceeds must meet the requirements of sections 401(a)(11) and 417 of the Code. A flexible plan adopted by a sponsoring organization which differs from the mass submitter plan only because the sponsoring organization has deleted certain optional provisions from its plan in conformance with the mass submitter's representation described above will be treated as a word-for-word identical plan to the mass submitter plan. The Service encourages mass submitters to limit the number of optional provisions described in subparagraph (b)(i) and (ii) below which they provide under a flexible plan to six investment provisions and six administrative provisions.

(b) Optional Provisions — A flexible plan may contain only optional provisions which comply with the requirements set forth below. The optional provisions may be arranged as separate optional articles or as separate optional provisions within a single article. A flexible plan may also contain optional provisions in the adoption agreement. For example, if a mass submitter flexible plan basic plan document contains an optional provision which would allow for loans under a sponsoring organization's master or prototype plan, the adoption agreement could also include an optional provision which would enable an adopting employer to elect whether loans will be available under the plan it adopts. If the sponsoring organization does not wish to enable adopting employers to make loans available under their plans, both the basic plan document optional provision and the adoption agreement optional provision would be deleted from the sponsoring organization's master or prototype plan. Sponsoring organizations may include or delete optional provisions of mass submitter plans, but once the sponsoring organization has decided to include an optional provision, it must offer that provision to all adopting employers. Any optional provision which the Service determines does not meet the requirements for a proper optional provision will have to be changed to a non-optional provision or deleted from the mass submitter's plan. The following is an exclusive list of the allowable optional provisions which a flexible plan may contain:

(i) Investment Provisions — A mass submitter may offer a variety of investment provisions in its plan for sponsoring organizations to include or delete from their version of the plan. However, the plan as adopted by the sponsoring organization must provide some method for investing trust assets. Investment provisions are those provisions which describe the plan's methods of investing the trust or custodial funds, including provisions such as the availability of loans and investments in insurance contracts or other funding media, and self-directed investments.

(ii) Administrative Provisions — A mass submitter may offer a variety of administrative provisions in its plan for sponsoring organizations to include or delete from their version of the plan. However, the plan as adopted by the sponsoring organization must describe how the plan will be administered. Administrative provisions are those provisions which describe the administration of the plan, including the powers, duties, and responsibilities of a plan's custodian, trustee, administrator, employer, and other fiduciaries. Administrative provisions include the allocation of responsibilities among fiduciaries, the resignation or replacement of fiduciaries, claims procedures under the plan, and record-keeping requirements. However, procedural provisions which are required for plan qualification are not administrative provisions under this section. For example, provisions which provide for the notice to participants required by section 417 of the Code and record-keeping required by regulations under sections 401(k) and (m) are not administrative provisions for purposes of this revenue procedure, and may not be optional provisions.

(iii) Cash or Deferred Arrangement — A mass submitter may include a self-contained cash or deferred arrangement (as defined in section 401(k) of the Code) which meets the requirements of section 8 for sponsors to include or delete.

(c) Addition of Optional Provisions by the Mass Submitter — A mass submitter may add additional optional provisions to its plan after a favorable opinion letter is issued. Generally, the addition of such optional provisions will not be treated as a plan amendment for purposes of this revenue procedure, Rev. Proc. 80-30, and Rev. Proc. 89-4, and sponsoring organizations and adopting employers will not be required to obtain new opinion and determination letters in order to preserve reliance. (However, the addition of a cash or deferred arrangement or any change to the language of the adoption agreement subsequent to the issuance of an opinion letter will be treated as a plan amendment to the mass submitter's plan and the requirements of subsection .04 will then apply.) The mass submitter must submit such additional optional provisions to the Service, along with a completed Form 4461 or 4461-A, as applicable, and a check or money order payable to the Internal Revenue Service in the amount specified in Rev. Proc. 89-4, as modified by section 19.04 of this revenue procedure. No opinion letter will be issued to the mass submitter or any adopting sponsoring organization with respect to the addition of these optional provisions. Instead, an advisory letter will be issued to the mass submitter notifying it that the addition of such optional provisions will not affect the status of favorable opinion and determination letters issued to sponsoring organizations and adopting employers.

(d) Notification to Employer — If a mass submitter adds optional provisions, as described in subsection (c) above, all adopting sponsors who wish to include the additional optional provisions must furnish each adopting employer with a copy of the plan which includes such additional provisions in accordance with section 10.08. If a sponsoring organization decides to include or delete an optional provision after it initially adopted the plan, it must also furnish each adopting employer with a copy of the new plan in accordance with section 10.08. However, if such inclusion or deletion results in a change to the language of the adoption agreement, such change will be treated as a plan amendment and the sponsoring organization and its adopting employers may not continue to rely on previously issued opinion or determination letters.

2 Minor Modification — A "minor modification" is a minor change to an otherwise word-for-word identical plan of the mass submitter which does not require an in-depth technical review. For example, a change from 5 year 100% vesting to 3 year 100% vesting is a minor modification. On the other hand, a plan which is modified to change the method of accrual of benefits would not be considered a minor modification. A minor modification must be submitted by the mass submitter on behalf of the sponsoring organization which will adopt the modified plan. Such submissions will be reviewed on an expedited basis and opinion letters will be issued to the sponsoring organization as soon as possible. However, the Service reserves the right to determine if such changes are actually minor. If it is determined that the changes are extensive or require an in-depth technical review, the plan will not be entitled to expedited review but will be treated as a non-mass submitter plan. (In such event, the Service will notify the mass submitter in writing of its determination. Within 30 days following the date of such communication, either the mass submitter may revise the plan so that the modifications are minor and resubmit the revised plan, or the sponsoring organization may submit an additional user fee in an amount equal to the difference between a non-mass submitter plan application user fee and a minor modifier application user fee. If, after such 30 day period neither action has been taken, the application may be considered withdrawn.) To qualify for the expeditious review, the mass submitter must submit a completed Form 4461-B. Such form must be typed and no photocopies will be accepted. In addition, the mass submitter must submit a copy of the mass submitter's plan with the minor modifications highlighted, as well as a statement indicating the location and effect of each change. The mass submitter must certify under penalty of perjury that the plan of the sponsoring organization except for the delineated changes is word-for-word identical, within the meaning of this section, to the plan for which the mass submitter received a favorable opinion letter. If a mass submitter fails to identify each modification, such failure will be considered a material misrepresentation and an employer may not rely on any opinion or determination letter that may be issued with respect to the plan. If a mass submitter repeatedly fails to identify such modifications, the Service may deny permission to that mass submitter to submit additional minor modifications.

.04 Amendments of Mass Submitter Plans — Any plan submitted by a mass submitter must include language designating the mass submitter as agent for the sponsoring organization for purposes of making plan amendments (see section 14.02). Any sponsoring organization which does not wish to make the amendments made by a mass submitter may switch to another mass submitter or may submit an application for an opinion letter on its own behalf. If the mass submitter makes any change to the plan, other than the addition of optional provisions pursuant to section 18.031(c) or an amendment described in section 11.02, it must comply with the requirements of section 11.01 of this revenue procedure. In addition, prior to submitting an amendment to the National Office, the mass submitter must notify the Service of its intention to amend the plan. Such notification should be submitted, in writing, to the Commissioner of Internal Revenue, Washington, D.C. 20224, Attention: E:EP:Q. The Service will then mail a list to the mass submitter showing all sponsoring organizations which have adopted plans that are identical to the mass submitter's plans, as well as the specific plans adopted by each sponsoring organization. The mass submitter must then submit the amended plan to the National Office for approval, along with a list identifying all adopting sponsoring organizations' plans which will be amended, a user fee form for each such sponsoring organization, and the appropriate user fee required under Rev. Proc. 89-4. All sponsoring organizations which have adopted the mass submitter's plan, are identified on the list submitted to the Service, and for which a user fee has been submitted, will be considered to have made such amendments and will be issued opinion letters. In the case of minor modifier plans, separate Form 4461-B applications must be filed along with copies of the plans as amended, user fee forms, and the user fee required by Rev. Proc. 89-4 for minor modifier applications. Copies of the amended plan must be sent to adopting employers and key district offices in accordance with section 10. Any adopting sponsor which is not included on the list submitted to the Service (or in the case of a minor modifier, for which a Form 4461-B application has not been filed) or which notifies the Service of its desire not to adopt such amendment will no longer participate as a mass submitter plan but must apply for an opinion letter on its own behalf to retain its status as a master or prototype plan.

.05 Expeditious Processing Accorded Mass Submitter Plans — All mass submitter plans, including the adoption of approved mass submitter plans by sponsoring organizations, will be accorded more expeditious processing than master and prototype plans submitted by non-mass submitters, to the extent administratively feasible.

.06 Substitution of Mass Submitter Plans for Non-Mass Submitter Plans — A sponsoring organization which has submitted to the Service a non-mass submitter replacement plan (as defined in section 3.10) may substitute a word-for-word identical plan of a mass submitter which is of the same type as the non-mass submitter plan at any time prior to receiving its favorable TRA '86 opinion letter, and such plan will be considered a replacement plan for purposes of section 13. However, if a sponsoring organization which has submitted a non-mass submitter replacement plan substitutes a minor modifier plan after the Service has begun reviewing the non-mass submitter plan, then the minor modifier will not be considered a replacement plan under section 13. A non-mass submitter that intends to switch to a minor modifier should contact the Inventory Control Unit of the Employee Plans Technical and Actuarial Division (Qualifications Branch) by calling (202) 566-4576 (not a toll-free call) to determine whether review of the non-mass submitter plan has begun.

SEC. 19. EFFECT ON OTHER DOCUMENTS

.01 Rev. Proc. 84-23 and Rev. Proc. 84-83 are hereby superseded.

.02 Rev. Proc. 87-18 is hereby superseded.

.03 Section 15.01 of Rev. Proc. 80-30 is modified by renumbering paragraph 4 as 2 after replacing paragraphs 1, 2, and 3 with the following:

1 A standardized form plan or paired plans as defined in sections 3.08 and 3.09 of Rev. Proc. 89-9 provided that:

(a) the sponsoring organization of such plan or plans has a currently valid favorable opinion letter from the National Office,

(b) the employer has followed the terms of the plan(s), and the coverage and contributions or benefits under the plan(s) are not more favorable for highly compensated employees (as defined in Code section 414(q)),

(c) the employer has properly notified all interested parties of the adoption of the plan(s) in accordance with sections 7 and 8, above, and

(d) the employer has not received, within 120 days after the date of adoption of the plan(s), notice from the Service that the plan(s) will not be treated as qualified pursuant to this subsection. (In this regard, see section 4.145, above).

.04 Section 6.032 of Rev. Proc. 89-4 is hereby modified by amending the title of subparagraph (b) to read "Opinion and Advisory Letters on Master and Prototype Plans" and adding at the end of such subparagraph the following: Mass submitter's addition of optional provisions following issuance of a favorable opinion letter, per basic document (regardless of the number of adoption agreements). $400

SEC. 20. EFFECTIVE DATE

This revenue procedure is effective February 6, 1989, the date it is published in the Internal Revenue Bulletin.

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26 CFR 601.204: Changes in accounting periods and in methods of accounting.
(Also Part I, Section 472; 1.472-2; 1.472-3.)

Rev. Proc. 89-10

SECTION 1. PURPOSE

This revenue procedure sets forth the application of section 472(c) and section 472(e)(2) of the Internal Revenue Code in the examination of federal income tax returns when a taxpayer, with the consent of the Commissioner, changes from the last-in, first-out (LIFO) inventory method of accounting to another inventory method and is required by Accounting Principles Board Opinion No. 20 (APB 20) to restate financial statements for prior years under the new inventory method.

SEC. 2. BACKGROUND

.01 Section 472(c) of the Code requires a taxpayer using the LIFO method to use no procedure other than the LIFO method specified in section 472(b)(1) and (3) in inventorying its goods to ascertain the income, profit, or loss of the first tax year for which the LIFO method is to be used, for the purpose of a report or statement covering such tax year to shareholders, partners, or other proprietors, or to beneficiaries, or for credit purposes.

Section 472(e)(2) of the Code imposes a requirement similar to that set forth in section 472(c) for tax years subsequent to the year of the LIFO election. Under section 472(e), the Secretary may require a taxpayer to discontinue the use of the LIFO method if the taxpayer violates this requirement.

Collectively, the provisions of section 472(c) and section 472(e)(2) of the Code are called the "LIFO conformity requirement."

.02 Section 1.472-3(d) of the Income Tax Regulations provides that whether or not the taxpayer's use of the LIFO method, once adopted, may be continued, will be determined by the Commissioner in connection with the examination of the taxpayer's income tax returns.

.03 APB 20 was issued by the Accounting Principles Board of the American Institute of Certified Public Accountants in July 1971. For financial reportinq purposes, any change in accounting principle must be reported in accordance with the requirements of APB 20. Paragraph 27 of APB 20 provides that, if there is a change from the LIFO inventory method to any other inventory method, financial statements of all prior periods presented in current reports should be restated under the new inventory method.

SEC. 3. SCOPE

This revenue procedure applies to taxpayers that change from the LIFO method to another method with the consent of the Commissioner and are required by APB 20 to restate prior years' financial statements under the new inventory method.

SEC. 4. APPLICATION

The restatement of financial statements for prior years on a non-LIFO inventory method in the current year's annual financial statement is a violation of the LIFO conformity requirement. However, in the examination of returns, the Service, under the discretionary authority contained in section 472, will not disallow a taxpayer's LIFO election or require a change from the taxpayer's LIFO method for the prior years solely because of the application of paragraph 27 of APB 20.

SEC. 5. INQUIRIES

Inquiries in regard to this revenue procedure should refer to its number and be addressed to the Commissioner of Internal Revenue, Attention CC:IT&A, 1111 Constitution Avenue, N.W., Washington, D.C. 20224.

SEC. 6. EFFECTIVE DATE

This revenue procedure applies to all tax years beginning after July 31, 1971.

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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, Section 6661; 1.6661-4.)

Rev. Proc. 89-11

SECTION 1. PURPOSE

.01 This revenue procedure updates Rev. Proc. 88-37, 1988-2 C.B. 560, and identifies circumstances under which the disclosure on a taxpayer's return of an item or a position taken is adequate disclosure for the purpose of reducing the understatement under section 6661 of the Internal Revenue Code.

.02 This procedure applies to 1988 tax forms filed for all taxable years beginning in 1988. It also applies to 1988 forms filed in 1989 for short taxable years beginning in 1989.

SEC. 2. CHANGES FROM PREVIOUS YEAR

.01 Section 4(b) has been revised to include certain expenses related to the rental of property as trade or business expenses for purposes of this revenue procedure.

.02 Section 4(d)(1) reflects the change in the name of Form 2119 from Sale or Exchange of Principal Residence to Sale of Your Home.

.03 Section 4(d)(4) reflects the change in the name of Form 4136 from Computation of Credit for Federal Tax on Gasoline and Special Fuels to Computation of Credit for Federal Tax on Fuels.

.04 Section 4(e)(2), relating to subpart F income shown on Form 5471, Information Return with Respect to a Foreign Corporation, has been deleted.

.05 Section 4(e)(3), relating to intercompany transactions shown on Form 5471, Schedule M, has been deleted.

.06 Section 4(e)(4), relating to Form 1116, Computation of Foreign Tax Credit, in the case of individuals, and Form 1118, Computation of Foreign Tax Credit, Corporations, has been deleted.

SEC. 3. BACKGROUND

.01 Section 6661(a) of the Code imposes a penalty in situations in which there is a substantial understatement of income tax. The rate is 25 percent for penalties assessed after October 21, 1986. Section 6661(b)(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 required to be shown on the return or $5,000 ($10,000 in the case of a corporation other than an S corporation or a personal holding company). Section 6661(b)(2) defines an understatement as the difference between the amount of tax required to be shown on the return for the taxable year and the amount of the tax that is actually shown on the return (reduced by any rebate within the meaning of section 6211(b)(2)).

.02 In the case of an item not attributable to a tax shelter, section 6661(b)(2)(B) of the Code provides that the amount of the understatement is reduced by the amount of the understatement attributable to any item if the taxpayer discloses, in the return or in an attachment, the identity and amount of the item as well as the specific facts or the position taken relevant to the tax treatment of the item. Disclosure on a return of items attributable to a tax shelter does not reduce an understatement.

.03 Section 6661(c) of the Code allows the Secretary to waive all or part of the penalty provided by section 6661(a) if the taxpayer shows that there was reasonable cause for all or part of the understatement and that the taxpayer acted in good faith.

.04 In general, rules providing guidance on the adequacy of disclosure for purposes of reducing an understatement under section 6661 of the Code are set forth in the regulations under section 6661. Section 1.6661-4(c) of the Income Tax Regulations gives the Commissioner authority to prescribe by revenue procedure the circumstances under which information provided on the return, in accordance with the applicable forms and instructions, is adequate disclosure for purposes of section 6661. 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. This revenue procedure provides guidance in determining when such disclosure is adequate. Guidance for returns filed in 1983, 1984, 1985, 1986, 1987, and 1988 is provided in Rev. Proc. 83-21, 1983-1 C.B. 680, Rev. Proc. 84-19, 1984-1 C.B. 433, Rev. Proc. 85-19, 1985-1 C.B. 520, Rev. Proc. 86-22, 1986-1 C.B. 562, Rev. Proc. 87-48, 1987-2 C.B. 645, and Rev. Proc. 88-37, respectively.

SEC. 4. PROCEDURE

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 tax under section 6661 of the Code, provided, however, that the forms and attachments are completed in a clear manner and in accordance with the instructions. Pursuant to the forms and instructions, items must not be combined but must be separately stated on the appropriate line. 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.

(a) Form 1040, Schedule A, Itemized Deductions:

(1) Medical and Dental Expenses: Complete lines 1-4 supplying all required information. Line 1b must list each item and the amount paid.

(2) Taxes: Complete lines 5-8 supplying all required information. Line 7 must list each type of tax and the amount paid.

(3) Interest Expense: Complete lines 9-13 supplying all required information. This section of the procedure does not apply to (i) amounts disallowed under section 163(d) of the Code unless Form 4952, Investment Interest Expense Deduction, is completed, or (ii) any amounts disallowed under section 265 of the Code.

(4) Contributions: Complete lines 14-17 supplying all required information. Merely entering the name of an organization to which the taxpayer makes a donation and the amount of the donation on Schedule A, however, will not constitute adequate disclosure for purposes of section 6661 of the Code 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.

(5) Casualty and Theft Losses: Form 4684, Casualties and Thefts, must be completed and attached to the return. Each item or article for which a casualty or theft loss is claimed must be listed on Form 4684.

(6) Moving Expenses: Complete Form 3903, Moving Expenses, or Form 3903F, Foreign Moving Expenses, and attach to the return.

(b) Certain Trade or Business Expenses (which, for purposes of this revenue procedure, include the following six expenses as they relate to the rental of property):

(1) Casualty and Theft Losses: The procedure outlined in (a)(5) above must be followed.

(2) Legal Fees: The amount paid must be stated.

(3) Specific Bad Debt Charge-off: The amount written off must be stated.

(4) Reasonableness of Officers' Compensation: Form 1120, Schedule E, must be completed when required by instructions. The time devoted to business must be expressed as a percentage as opposed to "part" or "as needed." This does not apply to "golden parachute" compensation prohibited by section 280G of the Code.

(5) Repair as Opposed to Capital Expenditure: The amount of repairs must be stated.

(6) Taxes (other than foreign taxes): The amount of taxes must be stated.

(c) Form 1120, Schedule M-1, Reconciliation of Income Per Books With Income Per Return:

An item clearly identified on Form 1120, Schedule M-1, but only if—

(1) 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

(2) The information provided reasonably may be expected to apprise the Service of the nature of the potential controversy concerning the tax treatment of the item.

(d) Other:

(1) Sale or Exchange of Your Main Home: Complete Form 2119, Sale of Your Home, and attach to the return.

(2) Employee Business Expenses: Complete Form 2106, Employee Business Expenses, and attach to the return.

(3) General Business Credit Carryforwards: Amounts shown on Line 7, Form 3800, General Business Credit.

(4) Fuels Credit: Amounts shown on Form 4136, Computation of Credit for Federal Tax on Fuels.

(5) Investment Credit: Complete Form 3468, Computation of Investment Credit, and attach to the return.

(e) Foreign Tax Items:

(1) International Boycott Transactions: Transactions disclosed on Form 5713, International Boycott Report.

(2) Intercompany Transactions: Transactions and amounts shown on Form 5471, Schedule G.

SEC. 5. EFFECTIVE DATE

This revenue procedure is effective for returns filed on 1988 tax forms for all taxable years beginning in 1988, and 1988 forms filed in 1989 for short taxable years beginning in 1989.

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26 CFR 601.201: Rulings and determination letters. (Also Part I, Section 7701; 301.7701-2, 301.7701-3.)

Rev. Proc. 89-12

SECTION 1. PURPOSE

.01 This revenue procedure specifies the conditions under which the Internal Revenue Service will consider a ruling request that relates to classification of an organization, for federal tax purposes, as a partnership. The following revenue procedures are hereby modified and superseded: Rev. Proc. 72-13, 1972-1 C.B. 735 (limited partnership with a corporation as the sole general partner); Rev. Proc. 74-17, 1974-1 C.B. 438 (limited partnerships that raise factual questions as to whether their principal purpose is the reduction of federal taxes); and Rev. Proc. 75-16, 1975-1 C.B. 676 (frequently omitted required information). Rev. Proc. 89-1, page 740, this Bulletin, is modified by deleting the reference in section 8.06 to Rev. Proc. 72-13, Rev. Proc. 74-17, and Rev. Proc. 75-16. Rev. Proc. 89-3, page 761, this Bulletin, is modified by deleting section 3.0136 (continuity of life for removal of a general partner); section 3.0137 (1-percent general partner interest in each material item); and section 3.0138 (general partner contributions).

.02 Organizations covered by this revenue procedure include both those formed as partnerships and other organizations seeking partnership classification. In the case of an organization not formed as a partnership, references to "partnership" documents, including the "partnership agreement," apply to the organization's comparable documents, however designated. Any reference to a "limited partnership" includes an organization formed as a limited partnership under applicable state law and any other organization formed under a law that limits the liability of any member for the organization's debts and other obligations to a determinable fixed amount. References to "general partners" and "limited partners" appply also to comparable members of an organization not designated as a partnership under controlling law and documents; the "general partners" of such an organization will ordinarily be those with significant management authority relative to the other members. In the case of a foreign organization, "state" and "federal" references in the information requirements of section 3 apply to any relevant foreign jurisdictions. This revenue procedure does not apply to a publicly traded partnership treated as a corporation under section 7704 of the Internal Revenue Code.

.03 The provisions of this revenue procedure are not intended to be substantive rules for the determination of partner and partnership status and are not to be applied upon audit of taxpayers' returns.

.04 The Service may decline to issue a ruling under this revenue procedure whenever warranted by the facts and circumstances of a particular case and whenever appropriate in the interest of sound tax administration.

SEC. 2. BACKGROUND

.01 Section 7701(a)(2) of the Code defines the term "partnership" to include a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of the Code, a trust or estate or a corporation. Sections 301.7701-2 and 301.7701-3 of the Procedure and Administration Regulations set forth rules for determining whether an organization is classified, for federal tax purposes, as a partnership or as an association taxable as a corporation.

.02 Rev. Proc. 89-1, page 740, this Bulletin, as updated annually, sets forth procedures for the taxpayer request and Service issuance of advance rulings. The Service generally issues rulings on prospective transactions and on completed transactions for which the applicable return has not been filed. Section 5.01 of Rev. Proc. 89-1, however, provides that the Service will also consider ruling requests concerning the classification of an existing organization as a partnership. A ruling issued in response to such a request will be effective prospectively. *See* Rev. Proc. 86-12, 1986-1 C.B. 534. Rev. Proc. 89-3, page 761, this Bulletin, as updated annually, lists areas in which the Service will not issue, or will not ordinarily issue, advance rulings. Additional ruling guidelines, on the classification of partnerships, have been contained in Rev. Proc. 72-13, 1972-1 C.B. 735; Rev. Proc. 74-17, 1974-1 C.B. 438; and Rev. Proc. 75-16, 1975-1 C.B. 676.

SEC. 3. INFORMATION TO BE SUBMITTED

.01 Section 8 of Rev. Proc. 89-1 outlines general requirements concerning the information to be submitted as part of a ruling request, including a classification ruling request. For example, a partnership classification ruling request must contain a complete statement of all the facts relating to the classification issue. Among those facts are the items of information specified in this revenue procedure. The ruling request must therefore provide all items of information specified below, or at least account for all such items. As an example of accounting for an item, if no registration statement is required to be filed with the Securities and Exchange Commission (section 3.04(3)), the ruling request should so state.

.02 Submission of the documents and supplementary materials required by section 3.04 herein does not satisfy the information requirements contained in section 3.03 herein or in section 8 of Rev. Proc. 89-1. Thus, all material facts in documents, including those items required by section 3.03, must be included in the letter requesting a ruling and not merely incorporated by reference. All submitted documents and supplementary materials must contain applicable exhibits, attachments, and amendments.

.03 Required General Information.

(1) The name and identification number of the organization.

(2) The business of the organization.

(3) The date and place of filing the partnership certificate, or the anticipated date and place.

(4) The state whose law controls the formation and operation of the organization, and whether or not the controlling law is a statute corresponding to, as applicable, the Uniform Partnership Act, the Uniform Limited Partnership Act (1916), or the Revised Uniform Limited Partnership Act (1976) with or without amendments.

(5) If the Service has not determined that the controlling state statute corresponds to the applicable Uniform Act for purposes of section 301.7701-2 of the regulations, a list of all substantial differences.

(6) A representation that the organization has been, and will be at all times, in conformance with the controlling state statute.

(7) The nature, amount, and timing of the capital contributions made and to be made by both the general partners and the limited partners.

(8) The extent of participation of the general partners and the limited partners in profits and losses, including any possible shift in the profit and loss sharing ratios over time.

(9) A description of the relationships, direct and indirect, between the limited partners and the general partners that suggest that the general partners, individually or in the aggregate, may not at all times act independently (because of individual or aggregate limited partner influence or control). Such relationships include: (a) ownership by limited partners of 5 percent or more of the stock or other beneficial interests in a general partner; (b) control by limited partners of 5 percent or more of the voting power in a general partner; (c) ownership of 5 percent or more of the stock or other beneficial interests in any general partner and in any limited partner by the same person or persons acting as a group; and (d) control of 5 percent or more of the voting power in any general partner and in any limited partner by the same person or persons acting as a group. For purposes of the preceding sentence, a person shall be considered to own any beneficial interest owned by a related person and shall be considered to control any voting power controlled by a related person; a person shall be treated as related to another person if they bear a relationship specified in section 267(b) or section 707(b)(1) of the Code. The relationships defined in the first sentence of this section 3.03(9) may also include a debtor-creditor relationship and an employer-employee relationship.

(10) A representation of the net worth (based on assets at current fair market value) of each general partner, excluding interests in the partnership, a description of all general partner assets and liabilities arising from transactions with the partnership or with a person related to any general partner under section 267(b) or section

707(b)(1) of the Code, and a description of all other partnerships in which any of the general partners has an interest.

(11) If, and to the extent that, section 4 of this revenue procedure applies to the organization, a detailed description of how each of the applicable provisions therein is satisfied.

.04 Required Copies of Documents and Supplementary Materials.

(1) The partnership agreement.

(2) The partnership certificate filed or to be filed with the state in which the organization is formed.

(3) The registration statement filed or to be filed with the Securities and Exchange Commission. (A draft is acceptable.)

(4) If a registration statement is not required to be filed with the Securities and Exchange Commission, then documents filed or to be filed with any federal or state agency engaged in the regulation of securities and any private offering memorandum. (Drafts are acceptable.)

(5) A copy of the applicable state statutes, and amendments, under which the organization was or will be formed.

(6) An outline or copies of all promotional material used to sell interests in the organization, highlighting statements about probable tax consequences and the effect of the requested ruling upon the tax consequences.

SEC. 4. PROVISIONS APPLICABLE TO LIMITED PARTNERSHIPS

The Service will ordinarily consider a ruling request that relates to classification of a limited partnership as a partnership, for federal tax purposes, only if the conditions in this section 4 are satisfied. Section 4.05, however, relates solely to the corporate characteristic of continuity of life described in section 301.7701-2(b) of the regulations. Similarly, section 4.06 relates solely to the corporate characteristic of centralization of management described in section 301.7701-2(c). Therefore, failure to satisfy section 4.05 or section 4.06 will preclude a specific ruling that continuity of life or centralized management is lacking, but will not necessarily preclude the issuance of a partnership classification ruling. Section 4.07 provides a safe harbor, generally applicable to a limited partnership with at least one corporate general partner, that relates to the corporate characteristic of limited liability described in section 301.7701-2(d).

.01 Unless exempted by section 4.02 below or the provisions of this section 4.01, the interests (including limited partnership interests) of all the general partners, taken together, in each material item of partnership income, gain, loss, deduction, or credit must be equal to at least 1 percent of each such item at all times during the existence of the partnership, and the partnership agreement must expressly so provide. If the 1-percent standard will not be satisfied because of a temporary allocation required under section 704(b) of the Code, section 704(c), or corresponding Income Tax Regulations (a qualified income offset or minimum gain chargeback, for example), this will generally not be considered a violation of this section 4.01, but the ruling request must describe any such allocation and explain why the allocation is required under section 704(b) or (c), as appropriate. Any other temporary nonconformance with the 1-percent standard will be considered a violation of this section 4.01 unless it is demonstrated that the general partners' interest in net profits and losses over the anticipated life of the partnership is material. For this purpose, a profits interest generally will not be considered material unless it is substantially in excess of 1 percent and will be in effect for a substantial period of time during which it is reasonably expected that the partnership will generate profits. For example, a 20-percent interest in profits that begins 4 years after partnership formation and continues for the life of the partnership would generally be considered material if the partnership is expected to generate profits for a substantial period beyond the 4 years.

.02 If the limited partnership has total contributions exceeding $50 million, the general partners need not meet the 1-percent standard in section 4.01. However, except for a temporary allocation or nonconformance specified in section 4.01, the general partners' aggregate interest at all times in each material item must be at least 1 percent divided by the ratio of total contributions to $50 million, and the partnership agreement must expressly incorporate at least the computed percentage. For example, if total contributions are $125 million, the interest in each material item must be at least .4 percent, that is, 1 percent divided by 125/50. In no event, however, other than as a result of a temporary allocation or nonconformance specified in section 4.01, may the general partners' aggregate interest at any time in any material item be less than .2 percent.

.03 Unless section 4.04 applies, the general partners, taken together, must maintain a minimum capital account balance equal to either 1 percent of total positive capital account balances for the partnership or $500,000, whichever is less. Whenever a limited partner makes a capital contribution, the general partners must be obligated to contribute immediately capital equal to 1.01 percent of the limited partner's capital contribution or a lesser amount (including zero) that causes the sum of the general partners' capital account balances to equal the lesser of 1 percent of total positive capital account balances for the partnership or $500,000. If no limited partner capital account has a positive balance, the general partners, taken together, need not have a positive capital account balance to satisfy this section 4.03. Capital accounts and the value of contributions are determined by application of the capital accounting rules in section 1.704-1(b)(2)(iv) of the regulations.

.04 If at least one general partner has contributed or will contribute substantial services in its capacity as a partner, apart from services for which guaranteed payments under section 707(c) of the Code are made, then the general partners need not meet the capital account standard in section 4.03. However, the partnership agreement must expressly provide that, upon the dissolution and termination of the partnership, the general partners will contribute to the partnership an amount equal to: (a) the deficit balances, if any, in their capital accounts; or (b) the excess of 1.01 percent of the total capital contributions of the limited partners over the capital previously contributed by the general partners; or (c) the lesser of (a) or (b). Those services that do not relate to day-to-day operations in the partnership's primary business activity, such as services relating to organization and syndication of the partnership, accounting, financial planning, and general business planning, and those that are in the nature of investment management will be closely scrutinized to determine if they are in fact substantial services. In making this determination, the Service will consider the nature of the partnership and its activities.

.05 For a limited partnership formed in a state with a statute corresponding to the Uniform Limited Partnership Act or the Revised Uniform Limited Partnership Act, in the case of the removal of a general partner, the partnership agreement may not permit less than a majority in interest of limited partners to elect a new general partner to continue the partnership, or the Service will not rule that the partnership lacks continuity of life.

.06 Limited partner interests, excluding those held by general partners, may not exceed 80 percent of the total interests in the partnership, or the Service will not rule that the partnership lacks centralized management. In addition, the Service will consider all the facts and circumstances, including limited partner control of the general partners (whether direct or indirect), in determining whether the partnership lacks centralized management.

.07 If the net worth of corporate general partners at the time of the ruling request equals at least 10 percent of the total contributions to the limited partnership and is expected to continue to equal at least 10 percent of the total contributions throughout the life of the partnership, then, for advance ruling purposes, the partnership will generally be deemed to lack limited liability. In the case of a limited partnership in which the only general partners are corporations that do not satisfy the safe harbor described in the preceding sentence, close scrutiny will be applied to determine whether the partnership lacks limited liability. In that connection, it must be demonstrated either that a general partner has (or the general partners collectively have) substantial assets (other than the partner's interest in the partnership) that could be reached by a creditor of the partnership or that the general partners individually and collectively will act independently of the limited partners.

SEC. 5. EFFECT ON OTHER REVENUE PROCEDURES

The following revenue procedures are modified and superseded: Rev. Proc. 72-13, 1972-1 C.B. 735; Rev. Proc. 74-17, 1974-1 C.B. 438; and Rev. Proc. 75-16, 1975-1 C.B. 676. Rev. Proc. 89-1, page 740, this Bulletin, is modified by deleting the reference in section 8.06 to Rev. Proc. 72-13, Rev. Proc. 74-17, and Rev. Proc. 75-16. Rev. Proc. 89-3, page 761, this Bulletin, is modified by deleting sections 3.0136, 3.0137, and 3.0138.

SEC. 6. EFFECTIVE DATE

This revenue procedure applies to all ruling requests received in the National Office after February 13, 1989, the date of publication of this revenue procedure in the Internal Revenue Bulletin.

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26 CFR 601.201: Rulings and determination letters.

Rev. Proc. 89-13

Table of Contents

SECTION 1. PURPOSE

This revenue procedure sets forth the procedures of the Internal Revenue Service for issuing notification letters relating to the qualification, as to form, of certain regional prototype defined contribution plans and defined benefit plans, and provides guidance with respect to the issuance of determination letters to employers adopting such plans as to whether the plans as adopted qualify under sections 401 and 403(a) of the Internal Revenue Code and as to whether any related trusts or custodial accounts are exempt under section 501(a).

SEC. 2. BACKGROUND AND GENERAL INFORMATION

.01 Rev. Proc. 83-36, 1983-1 C.B. 763, as modified by Rev. Proc. 87-40, 1987-2 C.B. 514, sets forth the general procedures of the Service relating to the issuance of rulings, determination letters, opinion letters, and notification letters on employee plans and exempt organization matters.

.02 Rev. Proc. 80-30, 1980-1 C.B. 685, sets forth general procedures for the issuance of determination letters by key district directors on the qualification of pension, profit-sharing, stock bonus, and annuity plans involving sections 401 and 403(a) of the Code, and the status for exemption of any related trusts or custodial accounts under section 501(a).

.03 Rev. Proc. 84-86, 1984-2 C.B. 787, sets forth procedures whereby certain "sponsors" may submit "uniform plans" to key district directors for approval as to form.

.04 Rev. Proc. 88-42 , 1988-2 C.B. 613, sets forth procedures of the Service relating to the issuance of determination letters and notification letters that consider provisions of the Tax Reform Act of 1986 (TRA 86), Pub. L. 99-514, 1986-3 (Vol. 1) C.B. 1, the Omnibus Budget Reconciliation Act of 1986 (OBRA 86), Pub. L. 99-509, and the Omnibus Budget Reconciliation Act of 1987 (OBRA 87), Pub. L. 100-203, that are effective for plan years beginning before 1989.

.05 Rev. Proc. 89-9, page 780, this Bulletin, updates Rev. Proc. 84-23, 1984-1 C.B. 457, to set forth the current procedures of the Service pertaining to the issuance of opinion letters relating to master or prototype (M & P) pension, annuity and profit-sharing plans involving sections 401(a) and 403(a) of the Code as amended by TRA 86, OBRA 86, OBRA 87, and the Technical and Miscellaneous Revenue Act of 1988 (TAMRA), Pub. L. 100-647, and to the status for exemption of related trusts or custodial accounts under section 501(a).

.06 Rev. Proc. 89-4, page 767, this Bulletin, sets forth procedures relating to the payment of user fees for requests to the Service for rulings, opinion letters, determination letters, and similar requests.

.07 TRA 86 substantially altered the requirements that a plan must meet in order to be qualified under section 401(a) of the Code. Many of the TRA 86 qualification changes are effective for plan years beginning after December 31, 1986. Other TRA 86 qualification requirements are not effective until plan years beginning after December 31, 1988. OBRA 86 and OBRA 87 also altered the requirements that a plan must meet in order to be qualified. The qualification requirements under OBRA 86 and OBRA 87 are generally effective for plan years beginning after December 31, 1987. TAMRA contains technical corrections to TRA 86, OBRA 86, and OBRA 87, as well as other changes affecting qualified plans.

.08 Section 1140 of TRA 86 provides that a qualified plan must be amended retroactively, not later than the end of the first plan year beginning on or after January 1, 1989, to comply with the requirements of TRA 86. Section 1.401(b)-1 of the Income Tax Regulations extends until the end of the remedial amendment period described therein the time by which plans must be amended to comply with provisions of TRA 86 that are effective before the first day of the first plan year beginning after December 31, 1989, provided certain conditions are satisfied. In general, the remedial amendment period described in section 1.401(b)-1 of the regulations also applies in the case of amendments necessary to conform to the requirements of OBRA 86, OBRA 87, and other changes to the qualification requirements described in section 5.11. The Service has issued substantive guidelines, including those cited later in this procedure, for conforming plans to the TRA 86, OBRA 86, and OBRA 87 requirements.

SEC. 3. OVERVIEW

.01 *In General.* This revenue procedure replaces the uniform plans procedure set forth in Rev. Proc. 84-86 with a regional prototype program which eliminates many of the restrictions that applied to uniform plans. For example, notification letters were not issued under Rev. Proc. 84-86 with respect to plans containing a cash or deferred arrangement but will be issued with respect to such plans under this revenue procedure; also, while uniform plans had to provide that the vesting requirements applicable to top-heavy plans described in section 416 of the Code applied at all times regardless of whether the plan was top-heavy, that requirement does not apply to regional prototype plans under this revenue procedure (other than standardized regional prototype plans described in section 4.11). In addition, this revenue procedure enables adopters of regional prototype plans to retain their prototype status and reliance subsequent to changes in law, provided certain requirements are met.

.02 *Effect on Sponsors of Uniform Plans.* Sponsors of uniform plans will meet the definition of regional prototype plan sponsor if they satisfy the requirement of this revenue procedure as to the number of expected adopters; if they do not have a sufficient number of expected adopters, they will be able to meet the definition by adopting a mass submitter regional prototype plan as defined in section 4.04 below.

.03 *Features of the Regional Prototype Program.* The principal features of the regional prototype program are:

(1) Greater flexibility in the elections available to adopting employers;

(2) Reciprocity (see section 5.04), so that a regional prototype plan approved in one region of the Service will be automatically accepted in other regions;

(3) A mass submitter program (see section 9), under which the National Office of the Service may approve plans of mass submitters and such plans may then be adopted by regional prototype plan sponsors;

(4) Provision for standardized regional prototype plans (see section 4.11 and section 11), with respect to which adopting employers generally do not need to request a determination letter in order to obtain reliance as to the qualified status of the plan as adopted, and paired standardized defined contribution regional prototype plans;

(5) A sponsor registration program (see section 14) that provides continued reliance to adopting employers in the event amendments are needed because of subsequent changes in plan qualification requirements; and

(6) Modification of the user fee schedule set forth in section 6.03 of Rev. Proc. 89-4 by adding new subcategories and related fees (see section 17).

.04 *Multiple Plans.* Under this revenue procedure, combinations of certain categories of plans are not permitted. See section 10.01. However, the sponsor may use one basic plan document for a combination of several defined contribution plans and one basic plan document for a combination of several defined benefit plans. The only differences will be in the adoption agreements and, if applicable, the trust or custodial account documents. See sections 4.09, 4.10, and 4.13 for definitions of "adoption agreement," "basic plan document" and "trust or custodial account document," respectively. A sponsor, for example, may use one basic plan document for a money purchase plan (other than a target benefit plan), a target benefit plan, and a profit-sharing plan. Similarly, a sponsor may use one basic plan document for several defined benefit plans (for example, an integrated standardized plan, a non-integrated standardized plan, an integrated non-standardized plan, and a non-integrated non-standardized plan. See section 4.11 for the definition of "standardized form plan." A separate adoption agreement and completed application form must be submitted with respect to each defined benefit plan and each defined contribution plan. Paired plans (as defined in section 4.12) must share one basic plan document and must be submitted simultaneously.

.05 *Special Requirements for Regional Prototype Plans.*

(1) Because of the nature of the regional prototype program, this revenue procedure requires that special provisions be included in every regional prototype

plan. Section 6 includes some of these requirements. Thus, for example, regional prototype plans must include language permitting the sponsor to amend the plan. Furthermore, provisions must be included to ensure compliance with section 411(a)(10) and (d)(6) of the Code, such as in the event an adopting employer amends the plan by revising the options selected in the adoption agreement. The plan language is required in order that the employer's plan may remain in the regional prototype program and still satisfy the requirements of section 411(a)(10)) and (d)(6).

(2) Under this revenue procedure, the Service will approve regional prototype plans that include a qualified cash or deferred arrangement (CODA) under section 401(k) of the Code. Section 7 sets forth some of the required provisions that must be included in such plans as well as optional provisions that may be included.

(3) The Service will not issue notification letters with respect to certain types of plans. Thus, for example, the Service will not issue a notification letter with respect to ESOPs or with respect to plans (other than plans that include a qualified CODA) that provide for contributions which are subject to the special nondiscrimination requirements of section 401(m).

(4) Regional prototype plans may be adopted by an employer that has other plans covering the same employees. Such plans must be aggregated for purposes of section 415 of the Code. Aggregation may also be required under section 416 of the Code. It is impossible for sponsors of regional prototype plans to include form language that properly aggregates such regional prototype plan with any other plan of an adopting employer. Therefore, provision is made to enable adopting employers to add additional language to a regional prototype plan.

.06 *Provisions Relating to TRA 86.*

(1) Generally, no applications for approval of regional prototype plans may be submitted prior to July 14, 1989. However, mass submitters (as defined in section 4.05) may submit applications to the National Office of the Service beginning April 17, 1989.

(2) This revenue procedure provides a period of extended reliance in the case of any regional prototype plan which is submitted in accordance with the requirements of this procedure by March 31, 1990 and is subsequently approved by the Service. An employer who adopts such a plan and is otherwise entitled to reliance under this procedure or under Rev. Proc. 80-30 may rely on the favorable notification letter issued under this procedure (or on a determination letter, if required) until the earlier of the date established for plan amendment by subsequent legislation or the last day of the last plan year beginning before January 1, 1995.

(3) This revenue procedure also provides a method for an employer to extend its remedial amendment period in the event such an extension is necessary because a regional prototype sponsor has not received a favorable notification letter by the time the employer is required to amend its plan to comply with TRA 86.

SEC. 4. DEFINITIONS

.01 *Regional Prototype Plan.* A "regional prototype plan" is a defined contribution plan or a defined benefit plan that is made available by a regional "sponsor," as defined in section 4.02 below, for adoption by employers. A regional prototype plan consists of an "adoption agreement," as defined in section 4.09 below, a "basic plan document," as defined in section 4.10, and, except in the case where the basic plan document incorporates a trust or custodial account agreement the provisions of which are applicable to all adopting employers, a "trust or custodial account document," as defined in section 4.13.

.02 *Sponsor.* The term "sponsor," for purposes of this revenue procedure, means a firm (other than a sponsoring organization as defined in section 3.07 of Rev. Proc. 89-9) which: (1) has an established place of business in the United States where it is accessible during every business day, and (2) either has at least 30 clients that have their principal place of business within the jurisdiction of not more than two regions of the Service and are expected to adopt the sponsor's regional prototype plan, or has at least three clients that are expected to adopt a "mass submitter regional prototype plan," as defined in section 4.04 below, with respect to which a favorable notification letter has been issued to its sponsor. A sponsor may submit any number of adoption agreements so long as each will be adopted by at least 10 clients and the total number of adopting clients is at least 30. The Service reserves the right at any time to request from the sponsor a list of the clients that the sponsor asserts are expected to adopt the plan, including their business addresses and employer identification numbers.

.03 *Firm.* As used in the definition of "sponsor" above, "firm" means a partnership or corporation at least one of whose members or employees is authorized to practice before the Internal Revenue Service with respect to employee plans matters, or an individual who is so authorized. The term "firm" also includes any other individual, partnership, or corporation, if such individual, or a member or employee of such partnership or corporation, certifies that he or she has read and understands Rev. Proc. 89-13, and agrees, on behalf of the firm, to comply with the requirements contained therein. Such certification must be submitted to the Key District Office along with the sponsor's application for a notification letter. The Service reserves the right to deny a firm the right to participate in the regional prototype program if it learns that the firm does not comply with the requirements contained therein. In such a case, any favorable notification letters issued to such firm may be revoked.

.04 *Mass Submitter Regional Prototype Plan.* A "mass submitter regional prototype plan" is a defined contribution plan or a defined benefit plan that is made available to sponsors by a "mass submitter," as defined in section 4.05 below, and that would otherwise meet all of the requirements applicable to regional prototype plans under this revenue procedure.

.05 *Mass Submitter.* A "mass submitter," for purposes of this revenue procedure, is any person, whether or not such person is a sponsor within the meaning of section 4.02 above, which can establish that, if it receives a favorable notification letter with respect to a regional prototype plan it has submitted to the Service, there are at least 50 unaffiliated sponsors that will adopt the plan on a word-for-word identical basis. To establish that this criterion is satisfied, the mass submitter must submit to the Service a list of the sponsors that, to the best of the mass submitter's knowledge, are unaffiliated. In general, corporations that are members of a controlled group under section 414(b) of the Code, and partnerships, proprietorships, etc. which are under common control under section 414(c) will be considered affiliated for this purpose. However, without regard to whether section 414(b) or section 414(c) applies, persons such as the following will be considered to be affiliated: each partner or associate of a law firm, accounting firm, or actuarial consulting firm, with such firm, and all branch offices of the firm. Each adoption agreement will be considered a separate plan with respect to which the numerical requirement must be separately satisfied.

.06 *Notification Letter.* A "notification letter," for purposes of this revenue procedure, is a letter issued by the Service to a sponsor or to a mass submitter informing the sponsor or mass submitter that the sponsor's or mass submitter's plan is acceptable as to form.

.07 *Defined Contribution Plan.* "Defined contribution plan" means a plan described in section 414(i) of the Code.

.08 *Defined Benefit Plan.* "Defined benefit plan" means a plan described in section 414(j) of the Code.

.09 *Adoption Agreement.* For purposes of this revenue procedure, with respect to an adopting employer, an "adoption agreement" is the portion of a regional prototype plan that contains all of the options that may be selected by such adopting employer. (Also, see section 4.13, below.)

.10 *Basic Plan Document.* A "basic plan document," for purposes of this revenue procedure, is the portion of a regional prototype plan that contains all of the nonelective provisions applicable to all adopting employers. No options (including blanks to be completed) may be provided in the basic plan document. The same basic plan document may be used for both standardized (including paired) and nonstandardized regional prototype plans (see subsections .11 and .12 below). Such plans may differ only by the different adoption agreements and, if applicable, different trust or custodial account agreements (see section 4.13).

.11 *Standardized Regional Prototype Plan.* A "standardized regional prototype plan," for purposes of this revenue procedure, is a regional prototype plan that meets the following requirements:

(1) The provisions governing eligibility and participation are such that the plan by its terms must cover all employees described in section 6.01(10) (regardless of whether any employer is treated as operating separate lines of business under section 414(r)) except those that may be excluded under section 410(a)(1) or (b)(3) of the Code. For example, a plan providing full and immediate vesting may exclude employees who do not have at least two years of service. However, the adoption agreement may provide options as to whether some or all of the employees described in section 410(a)(1) and (b)(3) are to be excluded.

(2) The eligibility requirements under the plan are not more favorable for highly compensated employees (as defined in section 414(q) of the Code) than for other employees.

(3) The vesting schedule in the plan provides vesting at a rate at least as favorable for every year as would be required by the schedules set forth in section 416(b)(1)(A) or (B) of the Code if the plan was top-heavy for every year after 1983.

(4) Except for contributions made under a qualified cash or deferred arrangement (CODA) as defined in section 401(k) of the Code and the regulations (including proposed) thereunder, the contributions (including forfeitures) provided under the plan (if a defined contribution plan other than a target benefit plan) or the benefits (if a defined benefit plan or a target benefit plan that complies with Rev. Rul. 76-464, 1976-2 C.B. 115) are a uniform percentage of total compensation within the meaning of section 414(s) of the Code, excluding compensation in excess of the limitation under section 401(a)(17). A plan will not be treated as failing to meet this requirement merely because it involves integration with Social Security benefits or contributions provided (a) the form of the plan meets the permitted disparity limitations of section 401(l), or (b) the plan is a defined benefit plan with a final pay limitation that satisfies the requirements of section 401(a)(5)(D). This paragraph does not preclude a sponsor from submitting a defined benefit plan or a target benefit plan that uses a unit benefit formula based on years of service. (See section 7 of this revenue procedure for rules governing contributions made under a CODA.)

.12 *Paired Regional Prototype Plans.* "Paired regional prototype plans," for purposes of this revenue procedure, are a combination of two or more defined contribution standardized regional prototype plans (for example, a money purchase pension plan and a profit-sharing plan), so designed that if any single plan, or combination of plans, is adopted by an employer, each plan by itself, or the plans together, will meet the nondiscrimination rules set forth in section 401(a)(4) of the Code, the contribution limitations set forth in section 415, and the top-heavy provisions set forth in section 416. In addition, paired regional prototype plans must meet the following requirements:

(1) Regional prototype plans can only be paired with plans of the same sponsor.

(2) Only one of the paired plans that an employer adopts may provide for disparity in contributions that is permitted under section 401(l).

(3) If the paired plans do not provide duplication of minimum contributions, then each plan must provide, in any year in which it is top-heavy, the top-heavy minimum contribution for all participants in the plan who do not participate in the other paired plan(s) and must also state which of the paired plans will provide the top-heavy minimum contribution for participants who also participate in one or more of the other paired plans.

(4) All of the provisions necessary to coordinate the plans (other than the reliance statement required under section 6.01(9)) must be set forth in the basic plan document and not in the adoption agreement.

.13 *Trust or Custodial Account Document.* (*Note: This definition is inapplicable if the basic plan document includes a trust or custodial account agreement the provisions of which apply to all adopting employers.*) A "trust or custodial account document," for purposes of this revenue procedure, is the portion of a regional prototype plan that contains the trust agreement or custodial account agreement and includes provisions covering such matters as the powers and duties of trustees, investment authority, and the kinds of investments that may be made. Except as provided in section 6.01(5) and below, all provisions of the trust or custodial account document must be applicable to all adopting employers and no options may be provided in the trust or custodial account document. A sponsor or mass submitter may provide up to five separate trust or custodial account documents that are intended for use with any single basic plan document. Thus, for example, several employers that adopt a sponsor's standardized regional prototype plan may have plans with different trust or custodial account documents. In addition, a sponsor or mass submitter may provide a trust or custodial account document, designated for use only by adopters of nonstandardized plans, which provides for blanks to be completed with respect to administrative provisions of the trust or custodial account agreement. Any trust or custodial account document (including one to be used by adopters of standardized regional prototype plans) may provide for blanks to be completed that merely enable the adopting employer to specify the names of the plan, employer, trustee or custodian, plan administrator and other fiduciaries, the trust year, and the name of any pooled trust in which the plan's trust will participate.

SEC. 5. NOTIFICATION LETTERS

.01 *Scope of Notification Letters.* Except as provided in section 11, a notification letter does not constitute a ruling or determination as to either the qualification of the plan as adopted by a particular employer, or the exempt status of its related trust or custodial account.

.02 *Matters Not Covered by Notification Letters.* Notification letters will not be issued for:

(1) Any plan under which the rules of section 401(a), 410 or 411 of the Code are applied by treating the employees of more than one employer as employed by a single employer, and any plan which has been negotiated pursuant to a collective bargaining agreement and submitted to the Service as a plan maintained pursuant to a collective bargaining agreement. For this purpose, the term "one employer" includes all employers aggregated under section 414(b), (c), (m) or (o). This does not preclude a regional prototype plan, by its terms, from covering employees of the employer who are included in a unit covered by a collectively bargained agreement or the adoption of a regional prototype plan pursuant to such agreement as a single employer plan which covers only employees of the employer. However, the Service will not issue a notification letter with respect to a regional prototype plan if any provision therein would cause a plan that is not described in section 413(b) of the Code to fail to be qualified. Furthermore, a notification letter may not be relied on with respect to whether a plan satisfies any requirement that is applicable to a plan described in section 413(b) but inapplicable to other plans;

(2) Stock bonus plans;

(3) Employee stock ownership plans;

(4) Pooled fund arrangements contemplated by Rev. Rul. 81-100, 1981-1 C.B 326;

(5) Annuity contracts under section 403(b) of the Code;

(6) Master and prototype plans (see Rev. Proc. 89-9, (page 780, this Bulletin).

(7) Defined contribution plans (except target benefit plans) under which the test for prohibited discrimination under section 401(a)(4) of the Code is made by reference to benefits rather than contributions;

(8) Plans that involve integration with social security benefits or contributions, other than plans that, in form, meet the permitted disparity limitations of section 401(l) or that satisfy the requirements of section 401(a)(5)(D);

(9) Plans described in section 414(k) of the Code (relating to a defined benefit plan that provides a benefit derived from employer contributions that is based partly on the balance of the separate account of a participant);

(10) Defined contribution plans (other than any CODA portion of such a plan) that allocate contributions or forfeitures to the account of any participant in any manner other than on the basis of total compensation within the meaning of section 414(s);

(11) Target benefit and defined benefit plans that provide benefits on the basis of compensation where compensation is not defined as total compensation within the meaning of section 414(s);

(12) Governmental plans described in section 414(d) of the Code;

(13) Church plans described in section 414(e) of the Code that have not made the election provided by section 410(d);

(14) Plans (other than plans including a qualified CODA under section 401(k)) that permit contributions subject to the special nondiscrimination requirements of section 401(m). However, this does not prohibit mandatory employee contributions in a defined benefit plan. In the case of a plan which includes a qualified CODA, such plan may provide for after-tax employee contributions and matching contributions in addition to elective deferrals;

(15) Plans which contain, or may contain, a multi-tiered benefit structure (other than an integrated benefit formula). Thus, a plan may not provide different benefit formulas for different employees, such as two percent of compensation for salaried employees and one percent for hourly employees;

(16) Any plan under which the section 415 limitations are incorporated by reference; and

(17) Any plan under which the ADP test under section 401(k)(3) or the ACP test under section 401(m)(2) is incorporated by reference. (However, also see section 10.04(12).)

.03 *Notification Letter Numbers.* The office issuing a notification letter will assign a number to each approved plan. This number will identify the Service's issuing office and provide a means of identifying the plan. All correspondence with the Service regarding a regional prototype plan must refer to the plan's latest notification letter number.

.04 *Reciprocity.* A favorable notification letter issued by a key district director with respect to a regional prototype plan will be accepted throughout the particular region of the Service and any other region within whose jurisdiction clients of the sponsor have their principal place of business. A notification letter issued by the National Office with respect to a mass submitter's regional prototype plan will be accepted throughout each region of the Service.

.05 *Nontransferability of Notification Letters.* A notification letter issued to a sponsor is not transferable to any other person. For this purpose, the sponsor is the person that has made the agreement described in section 14.05.

SEC. 6. REQUIREMENTS THAT APPLY TO EVERY REGIONAL PROTOTYPE PLAN

.01 *Required Provisions.* A regional prototype plan must include all of the provisions described in this subsection. The adoption agreement may not permit the employer to override any of such provisions.

(1) *Sponsor Amendments.* Regional prototype plans must provide a procedure for sponsor amendment, so that changes in the Code, regulations, revenue rulings, and other guidelines published by the Internal Revenue Service, or corrections of prior approved plans, may be applied to all employers that have adopted the plan.

(2) *Employer Amendments.* Except for amendments permitted under paragraph (4) and (5) below, an employer that amends any provision of an approved regional prototype plan, including its adoption agreement (other than to change the choice of options, if the plan permits or contemplates such a change), or an employer that chooses to discontinue participation in a plan as amended by its sponsor and does not substitute another approved regional prototype plan or an approved master or prototype plan is considered to have adopted an individually designed plan. An employer that amends a regional prototype plan because of a waiver of the minimum funding requirement under section 412(d) of the Code will also be considered to have an individually designed plan. The procedure stated in Rev. Proc. 80-30, relating to the issuance of determination letters for individually designed plans, will then apply to the plan as adopted by the employer.

(3) *Anti-cutback Provisions.* The plan must specifically provide for the protection of section 411(a)(10) and (d)(6) of the Code in the event that the employer amends the plan in any manner such as by revising the options selected

in the adoption agreement or by adopting a new regional prototype plan. A regional prototype sponsor may not amend its plan in a manner that could result in the elimination of a benefit protected under section 411(d)(6) with respect to the plan of any adopting employer, unless permitted to do so under regulation sections 1.401(a)-4 and 1.411(d)-4. In addition, a regional prototype plan that does not contain vesting for all years which is at least as favorable to participants as that provided in section 416(b) of the Code, must specifically provide that any vesting which occurs while the plan is top-heavy will not be cut back if the plan ceases to be top-heavy.)

(4) *Adopting Employer Modification to Satisfy Sections 415 and 416.* Regional prototype plans must provide that the plan provisions may be amended by overriding plan language completed by the employer in the adoption agreement, where such language is necessary to satisfy section 415 or 416 of the Code because of the required aggregation of multiple plans under those sections. In the event of such an amendment, the adopting employer must obtain a determination letter in order to continue reliance on the plan's qualified status. Generally, a space should be provided in the adoption agreement to enable the employer to add such language as necessary to satisfy sections 415 and 416. In addition, a space must be provided in the adoption agreement for the employer to specify the interest rate and mortality tables used for purposes of establishing the present value of accrued benefits in order to compute the top-heavy ratio under section 416. Such a space must be included in both defined contribution plans and defined benefit plans.

(5) *Adopting Employer Modification of Trust or Custodial Account Document.* An employer that has adopted a regional prototype plan other than a standardized plan (or paired plans) will not be considered to have an individually designed plan merely because the employer amends administrative provisions of the trust or custodial account document (such as provisions relating to investments and the duties of trustees), so long as the amended provisions are not in conflict with any other provision of the plan and do not cause the plan to fail to qualify under section 401(a) of the Code. For this purpose, an amendment includes modification of the language of the trust or custodial account document and the addition of overriding language. An employer that has adopted a standardized regional prototype plan may amend the trust or custodial account document provided such amendment merely involves the specification of the names of the plan, employer, trustee or custodian, plan administrator and other fiduciaries, the trust year, or the name of any pooled trust in which the plan's trust will participate.

(6) *Defined Contribution Section 415 Aggregation.* Plan language must be incorporated that aggregates all defined contribution regional prototype plans to satisfy section 415(c) and (f) of the Code. Sample language may be obtained by writing to the Internal Revenue Service, Employee Plans Technical and Actuarial Division, Washington, D.C. 20224, Attention: E:EP:Q.

(7) *Top-heavy Requirements.* Except to the extent described in section 4.12, relating to paired plans, each plan must provide that all the additional requirements applicable to top-heavy plans (described in section 416 of the Code) apply at all times, or must provide that such requirements apply automatically if the plan is top-heavy regardless of how the adoption agreement is completed. In any case where the latter option is chosen, all the requirements for determining whether the plan is top-heavy must be included in the plan. See section 1.416-1 of the Income Tax Regulations.

(8) *Additional Top-heavy Minimums to Satisfy Section 415(e).* Each plan must provide automatically or by optional provisions the additional minimums described in section 416(h)(2)(A) of the Code.

(9) *Provision in Adoption Agreement on Extent of Reliance.* In order to avoid unnecessary confusion as to the effect of a notification letter, sponsors must include in the adoption agreement of all regional prototype plans (other than standardized and paired regional prototype plans), in close proximity to the signature blank, a statement that adopting employers may not rely on the notification letter with respect to the qualification of that plan and must apply to the appropriate key district office for a determination letter in order to obtain reliance. Standardized and paired regional prototype plans must also include a similar statement in the adoption agreement, that the adopting employer may not rely on the notification letter and should apply for a determination letter if the employer maintains or later adopts another plan in addition to the standardized plan or paired plans. In the case of a standardized defined benefit plan, this statement must also advise the adopting employer that the notification letter may be relied on with respect to whether the plan meets the minimum participation requirements of section 401(a)(26) of the Code only if the plan satisfies one of the safe-harbors provided in regulations under section 401(a)(26) with respect to its prior benefit structure or is deemed to satisfy section 401(a)(26) under such regulations. However, in connection with the initial adoption or amendment by an employer of a standardized defined benefit plan, such employer may request a determination letter if the employer wishes to have reliance as to whether its plan satisfies section 401(a)(26) with respect to its prior benefit structure. For purposes of this paragraph, a plan that is properly replaced by the adoption of a standardized plan of the same type (for example, both are profit-sharing plans) is not considered another plan. The adoption agreement must state that it is to be used with one and only one specific basic plan document.

(10) *Definition of "Employee": Section 414(b), (c), (m), (n) and (o).* Each plan must include a definition of employee as any employee of the employer maintaining the plan or of any other employer aggregated under section 414(b), (c), (m) or (o) of the Code and the regulations thereunder. The definition of employee shall also include any individual deemed under section 414(n) or under regulations under section 414(o) to be an employee of any employer described in the previous sentence.

(11) *Definition of "Service": Section 414(b), (c), (m), (n) and (o).* Each plan must specifically credit all service with any employer aggregated under section 414(b), (c), (m) or (o) of the Code and the regulations thereunder as service with the employer maintaining the plan. In addition, in the case of an individual deemed under section 414(n) or under the regulations under section 414(o) to be the employee of any employer described in the preceding sentence, service with such employer must be credited to such individual.

.02 *Other Requirements.* In addition to the requirements listed in section 10.04 and any other substantive requirements, regional prototype plans must comply with the requirements of all revenue rulings, notices, legislation, and regulations including:

(1) Final regulations under the Retirement Equity Act of 1984 (REA), Pub. L. 98-397, 1984-2 C.B. 433;

(2) Final regulations under sections 401(a)(4) and 411(d)(6) of the Code, on limitations on availability of benefits;

(3) If the plan includes a cash or deferred arrangement, final regulations under section 401(k) of the Code; and

(4) If the plan is an integrated defined benefit plan, Rev. Rul. 86-74, 1986-1 C.B. 205 (modifications to guidelines for social security integration under Rev. Rul. 71-446) with respect to plan years beginning after the relevant effective date specified in section 6 of the revenue ruling and before January 1, 1989.

SEC. 7. SPECIAL REQUIREMENTS FOR REGIONAL PROTOTYPE PLANS THAT INCLUDE A CASH OR DEFERRED ARRANGEMENT

.01 *Required Provisions.* In order to receive a favorable notification letter, a regional prototype plan that includes a CODA must be a profit-sharing plan and must include provisions that comply with the following list:

(1) The CODA must include a mechanism whereby an eligible employee may make a cash or deferred election with respect to employer contributions, within the meaning of section 401(k);

(2) The minimum number of years of service required for participation in the CODA cannot exceed 1;

(3) Separate accounts must be maintained for each participant's —

- (a) elective deferrals, as described in section 402(g)(3)(A);
- (b) qualified nonelective contributions, as described in section 401(m)(4)(C), and qualified matching contributions used to satisfy the test provided in section 401(k)(3);
- (c) matching contributions, as described in section 401(m)(4)(A), that are not used to satisfy the test provided in section 401(k)(3); and
- (d) employee contributions.

(4) Elective deferrals, employee contributions, qualified nonelective contributions, and qualified matching contributions must be nonforfeitable at all times;

(5) Amounts attributable to elective deferrals, other than excess deferrals, and qualified nonelective contributions and qualified matching contributions used to satisfy the actual deferral percentage test under section 401(k)(3) may not be withdrawn prior to one of the events specified in section 401(k)(2)(B);

(6) If the plan provides for hardship distributions, then for plan years beginning after December 31, 1988, amounts attributable to qualified nonelective contributions and qualified matching contributions may not be distributed merely on account of hardship. Also, income allocated to elective deferrals after December 31, 1988 may not be distributed on account of hardship.

(7) If the plan provides for hardship distributions of amounts attributable to elective deferrals, then, for the purpose of determining the existence of an immediate and heavy financial need and the amount necessary to meet that need, the plan must adopt the safe-harbor standards set forth in sections 1.401(k)-1(d)(2)(ii)(B) and (iii)(B) of the regulations.

(8) The CODA provisions may not be integrated with social security;

(9) Elective deferrals under the plan may not exceed $7,000 (or such greater amount as subsequently determined in accordance with increases provided under section 415(d)) for any taxable year;

(10) A mechanism must be provided by which a participant may notify the plan administrator of an allocation of excess elective deferrals, upon which notice such excess elective deferrals, and the applicable earnings, will be distributed to the participant by April 15 of the year following the calendar year of deferral;

(11) The actual deferral percentage (ADP) test set forth in section 401(k)(3) of the Code must be contained in the plan;

(12) Definitions of "highly compensated employee" and "family member," as described in section 414(q) of the Code, and "compensation," as described in section 414(s), must be contained in the plan;

(13) The method or methods by which the plan may correct contributions in excess of those allowed under the ADP test must be described in the plan. The plan must provide that the employer will maintain records to demonstrate compliance with the nondiscrimination requirements of section 401(k), including the extent to which qualified nonelective contributions and qualified matching contributions are taken into account;

(14) The plan must contain an explanation of the 10% excise tax which section 4979 of the Code imposes on employers that have not, within $2\frac{1}{2}$ months following the end of the plan year, distributed contributions in excess of the amount allowed by the ADP test (see paragraph (8) above), or have not recharacterized such contributions;

(15) A mechanism must be provided to assure the proper ordering of tests described in section 401(m)(6)(D) of the Code and the regulations thereunder;

(16) The plan must contain provisions to satisfy the top-heavy requirements set forth in section 416; beginning January 1, 1989, plans may not include elective deferrals or matching contributions as employer contributions for the purpose of satisfying the minimum contribution requirement; and

(17) The plan must provide that if contributions subject to section 401(m) are made pursuant to the plan containing the CODA or any other plan maintained by the same employer, such employer must designate the method of correction to be used and the plan to be corrected if a multiple use of the alternative limitation (within the meaning of section 401(m)(9) of the Code) occurs.

.02 *Optional Provisions.* Regional prototype plans that include a CODA may also provide for some or all of the following items:

(1) Matching contributions or employee contributions. If such contributions are made, the plan must contain —

- (a) The average contribution percentage (ACP) nondiscrimination test described in section 401(m)(2) of the Code;
- (b) A description of the method or methods by which the plan will correct contributions made in excess of the section 401(m)(2) limits;
- (c) A provision that the employer will maintain records to demonstrate compliance with the nondiscrimination requirements under section 401(m), including the extent to which qualified nonelective contributions and elective contributions are taken into account; and
- (d) An explanation of the 10% excise tax imposed by section 4979 of the Code upon employers that have not corrected contributions in excess of amount allowed by the ACP test within $2\frac{1}{2}$ months

following the end of the plan year.

(2) Qualified nonelective contributions (QNECs);

(3) Recharacterization of excess contributions as voluntary employee contributions subject to section 401(m);

(4) Use of QNECs to satisfy the ADP test;

(5) Use of qualified matching contributions to satisfy the test set forth in section 401(k); and

(6) Distribution of amounts attributable to elective contributions on account of participant hardship (but see sections 7.016 and 7.017).

.03 *Additional Requirements for Standardized Regional Prototype Plans.*

(1) A standardized regional prototype plan that includes a CODA must, in addition to satisfying the requirements listed in section 7.01 above, provide a minimum qualified nonelective contribution of 3% of compensation.

(2) The requirement that contributions be a uniform percentage of each participant's compensation does not apply to elective deferrals, QNECs or matching contributions (if any) under the CODA. However, all other requirements of sections 7 and 11 of this revenue procedure apply to a standardized regional prototype plan that contains a CODA.

SEC. 8. INSTRUCTIONS TO SPONSORS REQUESTING NOTIFICATION LETTERS WITH RESPECT TO NONMASS SUBMITTER REGIONAL PROTOTYPE PLANS

.01 *Applicability of this Section.* The instructions in this section apply to regional sponsors that have at least 30 clients, located in not more than two regions of the Service, that are expected to adopt a regional prototype plan which is not a mass submitter plan. Regional sponsors that have the requisite number of such clients (and thus do not need to adopt a mass submitter's plan in order to qualify as sponsors under this revenue procedure) may nevertheless choose to adopt a mass submitter's regional prototype plan and make it available for adoption by their clients. In that case, the instructions contained in section 9 below are applicable, relating to notification letter applications by mass submitters and sponsors whose clients will adopt a mass submitter regional prototype plan.

.02 *Key District Office Issues Notification Letters.* The key district director will, upon a request by a plan sponsor that meets the requirements of this revenue procedure, issue a notification letter as to the acceptability of the form of the sponsor's plan and any related trust or custodial account under sections 401(a), 403(a) or 501(a).

.03 *Request for Notification Letter.* A sponsor's request for a notification letter under this revenue procedure must be submitted to the key district office within the region of the Service where the sponsor has its principal place of business. Such requests should be sent to the same address as that set forth in section 6.06(5) of Rev. Proc. 89-4, with reference to requests for notification letters submitted pursuant to Rev. Proc. 84-86. Sponsors may not file separate notification letter requests in more than one region. The request must include the application form, adoption agreement, basic plan document and trust or custodial account document(s), the written agreement relating to registration of regional prototype plans described in section 14.05, and a statement that the sponsor has not filed in any other region. Upon receipt of the notification letter, the sponsor must furnish a copy of the plan and notification letter to the key district office in each other region where the sponsor has clients that will adopt the plan.

.04 *Forms for Requesting Notification Letters.* A request for a notification letter as to the acceptability of a regional prototype plan should be submitted on Form 4461, Application for Approval of Master or Prototype Defined Contribution Plan, or Form 4461-A, Application for Approval of Master or Prototype Defined Benefit Plan, whichever is appropriate. The ''Regional Prototype Plan'' box on the form should be checked. Such requests must include a copy of the plan (the adoption agreement and basic plan document) and the trust or custodial account document(s). A sponsor's request for a notification letter must be accompanied by a covering letter requesting application of this revenue procedure and containing a representation that the sponsor can reasonably expect the submitted regional prototype plan (basic plan document) to be adopted by at least 30 employers (and each submitted adoption agreement to be adopted by no fewer than 10 employers) whose principal place of business is located within not more than two regions of the Service.

SEC. 9. INSTRUCTIONS TO MASS SUBMITTERS AND SPONSORS UTILIZING MASS SUBMITTER PLANS

.01 *Applicability of this Section.* The instructions in this section apply to mass submitters of regional prototype plans and to sponsors that have any clients that are expected to adopt a mass submitter regional prototype plan.

.02 *National Office Issues Notification Letter to Mass Submitter.* The National Office will, upon a request by a mass submitter as defined in section 4.05, issue a notification letter as to the acceptability of the form of the mass submitter's regional prototype plan and the form of any related trust or custodial account under sections 401(a), 403(a) or 501(a) of the Code.

.03 *Requirements for Mass Submitter's Notification Letter Request.* A mass submitter's request for a notification letter as to the acceptability of its regional prototype plan is to be submitted on Form 4461 or Form 4461-A, whichever is appropriate. The phrase ''Mass Submitter Regional Prototype Plan'' must be printed in bold letters in the upper right-hand corner of the first page of the application. The application form must be accompanied by a covering letter in which the mass submitter certifies that at least 50 sponsors are expected to sponsor the identical plan and which lists the names and addresses of such sponsors. For this purpose and as used throughout this revenue procedure, ''identical'' means the plan is word-for-word identical to another plan except for differences in the names of employers, sponsors, and trustees or custodians, and permitted differences in the trust or custodial account document(s). The request must include a copy of the plan (the adoption agreement and basic plan document) and the trust or custodial account document(s), and should be filed with the Internal Revenue Service, Assistant Commissioner (Employee Plans and Exempt Organizations), Attention: E:EP:Q, P.O. Box 14073, Ben Franklin Station, Washington, D.C. 20044.

.04 *Separate Notification Letters Required for Sponsors Utilizing Mass Submitter Regional Prototype Plans.* A sponsor that has adopted a mass submitter's regional prototype plan and intends to make it available to employers must obtain a notification letter from the key district office where the sponsor has its principal place of business. (A mass submitter which is also a sponsor must also apply for a notification letter from the key district office in order to make its plan available directly to adopting employers.) The sponsor's request for a notification letter must be filed by the mass submitter on behalf of the sponsor. Upon receiving the notification letter from the key district office, the sponsor must furnish a copy of the plan and notification letter to the key district office in each other region of the Service where the sponsor has clients that will adopt the plan. Because notification letter applications filed in the key district offices with respect to mass submitter plans will not require technical review, such applications will receive priority processing.

.05 *Requirements for Sponsor's Request for Notification Letter Relating to Mass Submitter's Regional Prototype Plan.* A request for a notification letter filed by a mass submitter on behalf of a sponsor that has adopted the mass submitter's regional prototype plan must contain a declaration by the mass submitter that the sponsor has adopted a particular word-for-word identical regional prototype plan of the mass submitter. The plan must be identified by the letter serial number and date of the notification letter issued by the National Office to the mass submitter with respect to the plan, and a copy of the plan and trust or custodial account document(s) must be submitted. (However, also see section 15.03.) The mass submitter on behalf of the sponsor must complete Part I of Form 4461 or Part I of Form 4461-A, whichever is appropriate. In addition, the request must include the written agreement (signed by the sponsor) relating to the registration of regional prototype plans described in section 14.05.

SEC. 10. INSTRUCTIONS THAT APPLY TO ALL MASS SUBMITTERS AND SPONSORS OF REGIONAL PROTOTYPE PLANS

.01 *Requests Involving Different Categories of Plans.* A plan will not be acceptable as a regional prototype plan if it combines features of plans in different categories, such as those of a profit-sharing plan, a money purchase pension plan (other than target benefit), a target benefit plan, a non-integrated defined benefit plan, or an integrated defined benefit plan. However, separate defined contribution plans may have the same basic plan document. Similarly, separate integrated and nonintegrated defined benefit plans may have the same basic plan document.

.02 *Multiple Plans Submitted by One Sponsor.* A sponsor of a regional prototype plan may receive separate notification letters for more than one defined contribution plan and more than one defined benefit plan. (See section 4.02 regarding the minimum number of clients which must adopt each plan in the event such plan is not identical to a mass submitter plan.) However, a separate application must be filed for each plan. The sponsor must assign a three-digit number to each plan, which may not be changed or used for any other plan of the sponsor. The three-digit number assigned to each plan should start with 001, and each additional plan should be numbered in sequence.

.03 *Additional Information May Be Requested.* The Service may, at its discretion, require any additional information that it considers necessary.

.04 *Inadequate Submissions.* The Service will return, without further processing, plans that are not in substantial compliance with the qualification requirements, or plans that are so deficient they cannot be reviewed in a reasonable amount of time. A plan may be considered not to be in substantial compliance if, for example, it omits or otherwise fails to comply with any of the requirements set forth below, or merely incorporates those requirements by reference to the applicable Code section. The Service will not consider these plans until after they are revised, and they will be treated as new requests as of the date they are resubmitted. The following are some examples of qualification requirements the omission of which may cause a plan to be regarded as not being in substantial compliance:

(1) Section 401(a)(9) of the Code, as amended by section 1121 of TRA 86, relating to required distributions from qualified plans (see section 1.401(a)(9)-1 and 2 of the proposed regulations).

(2) Section 401(a)(11) of the Code, as amended by section 1898 of TRA 86, and section 417 of the Code, as amended by sections 1139 and 1898 of TRA 86, and the regulations thereunder, relating to minimum survivor annuity requirements.

(3) Section 415 of the Code, as amended by sections 1108, 1114, 1852, 1875, and 1898 of TRA 86, relating to contribution and benefit limits for qualified plans (see Notice 87-21, 1987-1 C.B. 458).

(4) Section 416 of the Code, as amended by sections 1106, 1118, and 1852 of TRA 86, containing special rules for top-heavy plans.

(5) If the plan provides for disparity in contributions or benefits, section 401(l) of the Code, as amended by section 1111 of TRA 86, relating to nondiscriminatory coordination with Social Security benefits (see sections 1.401(l)-1 through 1.401(l)-4 of the proposed regulations).

(6) Section 414(m) of the Code, as amended by section 1114 of TRA 86, relating to employees of affiliated service groups.

(7) Section 414(n) of the Code, as amended by sections 1146 and 1151 of TRA 86, relating to leased employees.

(8) Section 414(o) of the Code, as amended by section 1146 of TRA 86, and the regulations thereunder.

(9) Section 401(c) and (d) of the Code, unless the plan precludes participation by self-employed individuals.

(10) Section 411(a)(2), as amended by section 1113 of TRA 86, and the temporary regulations thereunder, relating to vesting of employer contributions.

(11) If the plan contains a CODA, section 401(k) of the Code, as amended by sections 1116 and 1879(g) of TRA 86, and the regulations thereunder (see section 1.401(k)-1 of the final and proposed regulations).

(12) If the plan permits, or permitted in any plan year beginning after 1986, employee or matching contributions (other than mandatory contributions under a defined benefit plan), section 401(m) of the Code, as added by section 1117(a) of TRA 86, relating to the nondiscrimination test for employee and matching contributions (see section 1.401(m)-1 and 2 of the proposed regulations, and also see section 5.02(14) above as to which plans may permit such contributions). Since a regional prototype plan may be adopted as an amendment to a plan which permitted employee or matching contributions in a plan year beginning after December 31, 1986, all regional prototype plans must contain language which satisfies the requirements of section 401(m). However, if a regional prototype plan (other than one with a CODA that provides for employee or matching contributions) precludes such contributions after its adoption by an employer, this requirement may be satisfied by incorporating the rules of section 401(m) by reference.

(13) Section 410(a) of the Code, as amended by section 1113 of TRA 86 and

section 9203 of OBRA 86, relating to minimum participation standards (see section 1.410(a)-4A of the proposed regulations).

(14) Sections 411(b)(1)(H) and 411(b)(2) of the Code, as added by section 9202 of OBRA 86, relating to accruals and allocations after a specified age (see section 1.411(b)-2 of the proposed regulations).

(15) If the plan is a contributory defined benefit plan, section 411(c)(2) of the Code, as amended by section 9346(b) of OBRA 87, relating to an employee's accrued benefit derived from employee contributions.

(16) Section 401(a)(17) of the Code, as added by section 1106 of TRA 86, relating to the limitation on annual compensation that may be taken into account.

(17) Section 401(a)(26) of the Code, as added by section 1112 of TRA 86, relating to additional participation requirements (see the proposed regulations under section 401(a)(26)).

.05 *Material that Sponsor must Furnish to Adopting Employers.* A sponsor must furnish each adopting employer with a copy of the approved plan (including the trust or custodial account document) and notification letter.

.06 *Failure to Identify Questionable Issues May Cause Delay.* If the plan document submitted with the request for a notification letter contains a provision that gives rise to an issue for which contrary published authorities exist, failure to disclose and distinguish significant contrary authorities may result in requests for additional information, which will delay action on the request. (See section 7.06 of Rev. Proc. 83-36.)

.07 *Sample Language.* A Listing of Required Modifications (LRM) containing sample language to be used in drafting regional prototype plans is available from the Employee Plans Technical & Actuarial Division of the Internal Revenue Service. Such language is not automatically required in regional prototype plans but should be used as a guide in drafting such plans. An LRM may be obtained by writing to the Internal Revenue Service, Employee Plans Technical & Actuarial Division, Washington, D.C. 20224, Attention E:EP:Q. To expedite the review of their plans, sponsors are encouraged to use LRM language and to identify where such language is being used in their plan documents.

SEC. 11. EMPLOYER RELIANCE; STANDARDIZED REGIONAL PROTOTYPE PLANS

.01 *Reliance.* An employer adopting a standardized regional prototype plan may rely on its sponsor's notification letter, except as provided in subsections .02 and .03 below, if the following conditions are satisfied:

(1) The employer has followed the terms of the plan, and the coverage and contributions or benefits under the plan are not more favorable for highly compensated employees (as defined in section 414(q) of the Code) than for other employees;

(2) The employer has properly notified all interested parties of the adoption of the plan in accordance with rules similar to those set forth in section 8 of Rev. Proc. 80-30; and

(3) The employer has not received, within 120 days after the date the plan was adopted, notice from the Service that the plan will not be treated as qualified pursuant to this subsection. (In this regard, see section 4.14 of Rev. Proc. 80-30.)

.02 *Nonreliance by Employer Maintaining More than One Plan.* Except in the case of a combination of paired regional prototype plans, if an employer maintains at any time, or has maintained at any time, any other plan, including a regional prototype plan, that was qualified or determined to be qualified covering some of the same participants, the employer may not rely on a notification letter issued with respect to a standardized regional prototype plan but, in order to have reliance that the plan is qualified under section 401(a) of the Code, must obtain a favorable determination letter. However, if the plan is qualified under section 401(a) of the Code, an employer may rely on a notification letter issued with respect to a standardized regional prototype plan without obtaining a determination letter if the only other plan maintained by that employer was a plan that was replaced by the standardized regional prototype plan for which reliance is sought. Both such plans must be of the same type (for example, both money purchase plans) in order for such reliance to be available.

.03 *Reliance by Employer Adopting a Standardized Defined Benefit Plan.* An employer that has adopted a standardized defined benefit regional prototype plan may rely on a notification letter only if the plan satisfies one of the safe-harbors provided in regulations under section 401(a)(26) with respect to its prior benefit structure or is deemed to satisfy section 401(a)(26) under such regulations. However, in connection with the initial adoption or amendment by an employer of a standardized defined benefit plan, such employer may request a determination letter if the employer wishes to have reliance as to whether its plan satisfies section 401(a)(26) with respect to its prior benefit structure.

SEC. 12. DETERMINATION LETTERS AND INSTRUCTIONS TO ADOPTING EMPLOYERS

.01 *Determination Letters in General.* Except as provided in section 11, the issuance of a favorable notification letter does not imply that employers adopting the sponsor's plan have a qualified plan. In order to have reliance, such employers must obtain a favorable determination letter from the appropriate key district office. They should file a request in accordance with Rev. Proc. 80-30.

.02 *Submission of Determination Letter Requests.* An employer requesting a determination letter with respect to its adoption of a sponsor's regional prototype plan should file Form 5307, Short Form Application for Determination for Employee Benefit Plan. The application should be submitted to the key district director for the district in which the employer's principal place of business is located, as specified in section 6.06(5) of Rev. Proc. 89-4. The employer must include a copy of the notification letter that the sponsor received and a certification by the sponsor that the notification letter has not been withdrawn and is still in effect with respect to the plan being submitted. (However, also see section 15.03.) The submission must include an adoption agreement showing which elections the employer is making with respect to the elective provisions contained in the plan as well as a copy of the employer's trust or custodial account document.

SEC. 13. MAINTENANCE OF APPROVED STATUS

.01 *Revocation of Notification Letter by the Service.* A notification letter found to be in error or not in accord with the current views of the Service may be revoked. However, except in rare or unusual circumstances, such revocation will not be applied retroactively if the conditions set forth in section 14.05 of Rev. Proc. 83-36 are met. For this purpose, such notification letters will be given the same effect as rulings. Revocation may be effected by a notice to the sponsor of the plan to whom such letter was originally issued, or by regulation, revenue ruling or other statement published in the Internal Revenue Bulletin. The sponsor should then notify each adopting employer of the revocation.

.02 *Subsequent Required Amendments.* Approved regional prototype plans must be amended by the sponsor and, if necessary, the employer, to retain their approved status if any provisions therein fail to meet the requirements of law, regulations, or other issuances and guidelines affecting qualification that become effective subsequent to the issuance of a notification letter. See section 14 and section 15.02 below regarding the time by which such amendments must be adopted and other requirements relating to the amendment of regional prototype plans.

SEC. 14. REGISTRATION/RELIANCE

.01 *General Description of this Section.* The provisions of this section enable employers that have adopted approved regional prototype plans to continue to rely on favorable notification or determination letters subsequent to changes in law that affect plan qualification, provided certain conditions are satisfied. Among these conditions are requirements, set forth in subsection .05, that adoptions of regional prototype plans be registered with key district offices and that sponsors provide certain notices to adopting employers and key district offices. The key district offices will not issue a notification letter with respect to a regional prototype plan unless the sponsor has agreed to comply with these registration and notice requirements. If a sponsor subsequently fails to comply with these requirements, employers that have adopted the sponsor's regional prototype plan will be considered to have individually designed plans and will not be entitled to the reliance described in this section. A sponsor is not prohibited from including the substance of these requirements in its regional prototype plan.

.02 *Employer Reliance.* An employer that has received a favorable determination letter with respect to a regional prototype plan, or is entitled to rely on a notification letter pursuant to section 11, may not continue to rely on such determination letter or notification letter subsequent to the effective date with respect to its plan of a change in the Code or regulations or the publication by the Service of revenue rulings or other guidelines affecting the plan's qualified status unless the requirements of subsections .04 and .05 below are satisfied.

.03 *Issuance of Determination Letters during Interim Period.* Where an employer adopts an approved regional prototype plan subsequent to a change in law affecting plan qualification, key district offices will not, during the period described in subsection .04(1) below, refuse to issue a determination letter with respect to the plan unless the plan should not previously have been approved as to form because of an existing defect. However, the employer will not be entitled to rely on such determination letter or on a notification letter (if section 11 applies) unless the requirements of subsections .04 and .05 are satisfied.

.04 *Requirements for Reliance.* An employer will be entitled to the reliance described in subsections .01 and .02 only if the following requirements are satisfied:

(1) On or before the end of the 12-month period beginning with the earliest date on which the change in the qualification requirements becomes effective with respect to any plan (or such other date described in subsection .06 or section 15.02 or provided by notice in the Internal Revenue Bulletin), the sponsor amends the regional prototype plan and requests a notification letter with respect to such amendment.

(2) In the case of a mass submitter's regional prototype plan, this requirement will be satisfied if, by the end of the period described in paragraph (1), the mass submitter amends its regional prototype plan, requests a notification letter from the National Office with respect to such amendment, and, on behalf of each adopting sponsor, submits to the appropriate key district office an application for a notification letter along with a copy of the mass submitter's amendment and a covering letter certifying that the amendment has been submitted to the National Office for approval and that the sponsor intends to submit the approved amendment to the appropriate key district office within 60 days following the issuance of a notification letter by the National Office.

(3) The sponsor furnishes each adopting employer with a copy of the approved amendment and the key district office's notification letter within 60 days following the issuance of such notification letter.

(4) With regard to any adopting employer's plan, the amendment is effective as of the date the change in the qualification requirements became effective with respect to the plan. (In this regard, see subsection .07 and section 15.02 below.)

(5) If the amendment changes any provision of the adoption agreement or requires changes to any employer elections in the adoption agreement (or in the trust or custodial account document), the employer executes a new adoption agreement (and, if necessary, amends or modifies the trust or custodial account document) by the later of the end of the sixth calendar month beginning after issuance of the new notification letter or the end of any applicable remedial amendment period provided by regulations under section 401(b) of the Code.

(6) Except as provided in section 11, the employer requests a determination letter by the later of the two dates described in the preceding paragraph. Such a determination letter request may be made on Form 5307 and must include a copy of the new notification letter.

(7) To the extent that the employer's plan has not operationally complied with the change in the qualification requirements during the entire period for which the change has been effective with respect to the plan, the employer retroactively corrects such noncompliance (for example, through restoration of benefits) by the last day of the first plan year beginning after the latest of (a) the plan year in which the change first became effective with respect to the plan, (b) the plan year in which the new notification letter was issued, or (c) the plan year in which a new determination letter was issued.

(8) The sponsor complies with the registration requirements of subsection .05.

.05 *Registration Requirements.* A sponsor complies with the requirements of this subsection if, as part of its initial notification letter request, it agrees in writing, and subsequently abides by its agreement, to:

(1) Notify the key district office on each anniversary of the date of issuance of the initial notification letter as to whether the sponsor has made any changes to the plan and whether the sponsor intends to continue to make the plan available for adoption by employers;

(2) Provide the key district office on each such anniversary date with (a)

cumulative lists of the names, business addresses and taxpayer identification numbers of all employers (both in and outside the region): (i) that adopted the plan and are currently maintaining it (if the sponsor is continuing its sponsorship of the plan with respect to those employers), and (ii) that previously adopted the plan (if the sponsor has discontinued its sponsorship of the plan with respect to those employers during the prior 12-month period), and (b) a certification that it is in current compliance with the notification requirements in paragraphs (3) and (4) below.

(3) Notify each employer that had adopted the plan, but with respect to whom the sponsor has discontinued its sponsorship of the plan, by certified mail as soon as possible after such discontinuance (but not later than 60 days thereafter) that the employer's plan will be treated as an individually designed plan if the employer is continuing to maintain it and has not replaced it with another regional prototype plan (see Item 1 of the Appendix for a pattern notice that may be used);

(4) Notify each adopting employer annually, in writing, as to whether the sponsor continues to be a sponsor, whether any amendments have been made to the regional prototype plan, and, if amendments have been made, the requirements the employer must satisfy in order to be entitled to reliance (see pattern notice in Item 2 of the Appendix);

(5) Notify both the key district office and all adopting employers at the earliest possible date if the sponsor intends to discontinue its sponsorship of the regional prototype plan (see pattern notices in Item 3 of the Appendix); and

(6) Furnish to the key district office, upon request, copies of the notifications described in paragraphs (3), (4) and (5).

.06 *Amendments Following Publication of Revenue Rulings, etc.* If an approved regional prototype plan is required to be amended to retain its approved status as a result of publication by the Service of a revenue ruling, notice or similar statement in the Internal Revenue Bulletin (I.R.B.), then, unless section 15.02 is applicable or unless specifically stated otherwise in the revenue ruling, etc., for purposes of subsection .04 above, the time by which the sponsor must amend its regional prototype plan to conform to the requirements of the revenue ruling, etc. and request a new notification letter shall be the end of the one-year period after its publication in the I.R.B., and with respect to any adopting employer's plan the effective date of such amendment shall be the first day of the first plan year beginning within such one-year period.

SEC. 15. SPECIAL PROVISIONS RELATING TO TRA 86

.01 *Delayed Submissions.* Except with respect to applications that are filed with the National Office of the Service for notification letters relating to mass submitter regional prototype plans, applications for notification letters submitted under this revenue procedure will not be accepted prior to July 14, 1989. Applications filed with the National Office relating to mass submitter regional prototype plans will not be accepted prior to April 17, 1989.

.02 *Extended Reliance.* A sponsor which submits a regional prototype plan that has been amended in accordance with the requirements specified in sections 6 and 10 of this revenue procedure (and all other requirements that are in effect on the date the application is submitted) on or before March 31, 1990, and receives a favorable notification letter under this procedure, will not be required to amend its plan for subsequent regulations under TRA 86, OBRA 86, OBRA 87, or for revenue rulings, revenue procedures or other Service releases issued after the date of the application, before the earlier of December 31, 1994 or the date the plan is otherwise required to be amended by subsequent legislation. Solely for purposes of this subsection, a regional prototype plan which is submitted to the Service after March 31, 1990 as a word-for-word identical adoption of a mass submitter plan that has been amended in accordance with the requirements specified in sections 6 and 10 of this revenue procedure (and all other requirements in effect on the date of the mass submitter's application) and that has been submitted to the Service on or before March 31, 1990, will be deemed to have been submitted to the Service on the date of the mass submitter's application. Any employer that adopts a plan described above, and is otherwise entitled to reliance, may continue to rely on the determination letter (or notification letter, if applicable) until the earlier of the last day of the last plan year commencing before January 1, 1995 or the date established for plan amendment by any subsequent legislation. In unusual circumstances, the Service may require regional prototype plans to be amended for, or operationally comply with, qualification requirements issued by the Service after a request for a notification letter or determination letter is submitted but prior to the end of this extended reliance period. The Service will require this action only in cases where it is necessary to correct a fundamental error or omission that is likely to affect participants' rights or tax revenues in a significant number of plans. Any rule or regulation remedying an omission or correcting an error will generally be made effective prospectively for plans which have met the requirements for extended reliance. However, the Service reserves the right to make such a rule or regulation applicable to such plan during the entire extended reliance period. Upon termination of an employer's regional prototype plan prior to the end of the extended reliance period, the plan must be amended retroactively to the effective date of any intervening change with respect to which operational compliance was required in order to correct a fundamental error or omission. This extended reliance period will not prevent the Service from requiring a plan to be amended to correct any defect in the plan which was not discovered upon prior review by the Service.

.03 *Procedure for Extension of Remedial Amendment Period Pending Issuance of Notification Letter.* In the event that an employer establishing a new plan or amending an existing plan to comply with TRA 86 by adopting a regional prototype plan cannot file a determination letter request under this procedure prior to the expiration of its remedial amendment period under section 1.401(b)-1 of the regulations solely because the sponsor of the regional prototype plan has not as of such time received a favorable notification letter, then the end of such remedial amendment period under section 1.401(b)-1(c)(2) of the regulations shall be deemed to be the date on which the employer actually files a determination letter request under this procedure provided all of the following conditions are satisfied:

(1) In the case where the employer is adopting a nonmass submitter regional prototype plan, the sponsor's application for a notification letter was submitted to the Service on or before March 31, 1990, and was still pending with the Service as of the date 30 days preceding the date the employer's remedial amendment period would expire without regard to this section. In the case where the

employer is adopting a mass submitter regional prototype plan, the mass submitter's application was submitted to the Service on or before March 31, 1990, the sponsor's name was included on the mass submitter's list described in section 9.03 (or on a follow-up list submitted on or before March 31, 1990), and (a) the mass submitter's application was still pending with the National Office on the date 60 days preceding the end of the remedial amendment period , or (b) the sponsor's application was pending with the key district office on the date 30 days preceding the end of the remedial amendment period.

(2) The employer and the sponsor execute a written certification in the form set forth in Item 4 of the Appendix. Such written certification must be executed by both the employer and the sponsor by no later than the date on which the employer's remedial amendment period would expire without regard to this section.

(3) The employer files an application for a determination letter with respect to its adoption of the sponsor's approved regional prototype plan in accordance with this procedure by no later than the 60th day following the date of the favorable notification letter issued to the sponsor and attaches to its application the certification described in subsection .03(2), above. In the case of an employer not otherwise required to file a request for a determination letter pursuant to section 11, such employer may, under the circumstances described in subsection .03(1), above, extend its remedial amendment period until the 60th day after the date a favorable notification letter is issued to the sponsor provided the certification described above is timely executed and retained by the employer as evidence of extension of the remedial amendment period and the employer adopts the sponsor's approved regional prototype plan by no later than the 60th day after the date of the favorable notification letter. Sponsors and employers should note that nothing contained herein permits a plan to be made retroactively effective for a taxable year prior to the taxable year of the employer in which the plan was first adopted by the employer.

SEC. 16. WITHDRAWAL OF REQUESTS

.01 *Notification and Effect.* A sponsor may withdraw its request for a notification letter at any time prior to the issuance of such letter by giving written notice of such withdrawal to the office in which the request is pending.

.02 *Service Retains Information.* Even though a request is withdrawn, the Service will retain all correspondence and documents associated with the request and will not return them to the sponsor of the plan.

SEC. 17. USER FEES

Pursuant to section 10511 of OBRA 87, the following user fees have been established with respect to the notification letters and determination letters provided for in this revenue procedure:

Mass submission of regional prototype plan, per basic plan document (new or amended, regardless of number of adoption agreements)	$1,000
Sponsor's identical adoption of mass submitter's regional prototype plan basic plan document, per adoption agreement (mass submitters that are sponsors in their own right are liable for this fee)	$50
Nonmass submission by sponsor of regional prototype plan, per adoption agreement	$1,000
Adopters of regional prototype plans (Form 5307)	$100

SEC. 18. EFFECT ON OTHER DOCUMENTS

.01 Rev. Proc. 84-86 is superseded.

.02 Rev. Proc. 89-4 is modified by establishing the new subcategories and related fees described in section 17 above.

SEC. 19. EFFECTIVE DATE

This revenue procedure is effective February 13, 1989, the date of its publication in the Internal Revenue Bulletin.

APPENDIX

1. *Pattern notice that may be used to notify employer that its plan will be treated as an individually designed plan*

NOTICE

To: (Name of Employer)

On (date plan was adopted) you adopted the (name of plan) regional prototype plan. As of (date of discontinuance), we have discontinued our sponsorship of the plan as adopted by you. The purpose of this notice is to advise you that if you are continuing to maintain the plan and have not replaced it with another approved regional prototype plan or an approved master or prototype plan, the plan will be treated by the Internal Revenue Service as an individually designed plan. As a consequence, if it becomes necessary to amend the plan because of a change in the law or because of regulations or other guidelines issued by the Service, you will not be entitled to continue to rely on any determination letter you received from the Service as to the regional prototype plan's qualified status (or, in the case of a standardized plan, on the notification letter we received). In order to continue such reliance, you must obtain a favorable determination letter as to the qualified status of the individually designed plan.

(signature) date)

2. *Pattern notice that may be used to notify employer annually as to whether sponsor continues to be a sponsor, whether any amendments have been made, and, if amendments have been made, what requirements must be satisfied for reliance*

NOTICE

To: (Name of Employer)

On (date of adoption) you adopted the (name of plan) regional prototype plan sponsored by us. The purpose of this notice is to advise you that, as of December 31, 19 , we are continuing our sponsorship of the plan and that [the plan has not been amended in the year ending on that date.]/[the plan has been amended as follows in the year ending on that date: (describe amendment)]. The requirements that you must satisfy in order to be able to continue to rely on any favorable determination letter you received from the Internal Revenue Service as to the plan's qualified status (or, in the case of a standardized plan, on the notification letter issued to us) are set forth in section 14.04 of Rev. Proc. 89-13, page 801, this Bulletin.

(signature) (date)

3. *Pattern notices that may be used to notify key district office and all adopting employers that sponsor intends to discontinue sponsorship of plan*

NOTICE

To: Chief, EP/EO Division

____________ Key District

This is to inform you, in accordance with section 14.05(5) of Rev. Proc. 89-13, page 801, this Bulletin, that we intend to discontinue our sponsorship of the ________ regional prototype plan as of ______, 19__. The plan was approved by you on ______, 19__, by notification letter number ______.

(signature) (date)

NOTICE

To: (Name of Employer)

This is to inform you that, as of ______, 19__, we intend to discontinue our sponsorship of the (name of plan) regional prototype plan, which you adopted on (date of adoption). If you continue to maintain the plan and do not adopt another approved regional prototype plan or an approved master or prototype plan to replace it, the plan will be treated by the Internal Revenue Service as an individually designed plan. In that case, if it becomes necessary to amend the plan because of a change in the law or because of regulations or other guidelines issued by the Service, you must obtain a favorable determination letter from the appropriate key district office in order to have continued reliance as to the plan's qualified status.

(signature) (date)

4. *Certification to extend remedial amendment period in accordance with section 15.03*

(To be completed by employer)

I, (name of signatory), hereby certify under penalty of perjury that (name of adopting employer if different from name of signatory / I) intend(s) to adopt the regional prototype plan sponsored by (name of sponsor) once it has been approved by the Internal Revenue Service, and that I make this certification on the date set forth below for the purpose of extending the remedial amendment period under section 1.401(b)-1 of the Income Tax Regulations.

(Signature / Title) (Date signed)

(Name of employer)

(Business address)

(EIN)

(To be completed by sponsor)

I, (name of signatory), hereby certify under penalty of perjury that (name of sponsor if different from name of signatory / I)received the above certification on (date) in (its / my) capacity as a sponsor of a regional prototype plan, and that such certification was made under the circumstances described in section 15.03(1) of Rev. Proc. 89-13.

(Signature / Title) (Date signed)

(Name of sponsor)

(Business address) (EIN)

26 CFR 601.601: Rules and regulations.

Rev. Proc. 89-14

SECTION 1. PURPOSE

This revenue procedure supersedes Rev. Proc. 86-15, 1986-1 C.B. 544, and makes the changes described in section 2 below. The revenue procedure restates the objectives of, and sets forth the standards for, the publication of revenue rulings and revenue procedures in the Internal Revenue Bulletin.

SEC. 2. CHANGES

Section 7.01(5) of Rev. Proc. 86-15 provides that because each revenue ruling represents the conclusion of the Service as to the application of the law to the entire statement of facts involved, taxpayers, Service personnel, and others concerned are cautioned against reaching the same conclusion in other cases unless the facts and circumstances are substantially the same. This caution, which now appears in section 7.01(6) of this revenue procedure, has been clarified. It now explicitly warns that, if from the facts, legal analysis, or other discussion it is clear that the federal tax law conclusion of the revenue ruling or revenue procedure is predicated upon a certain provision or interpretation of law other than federal tax law, then those seeking to rely on that conclusion must check to see whether such relevant nontax law has changed materially from that used in the revenue ruling or revenue procedure.

Section 7.01(7) of the revenue procedure is revised to add a statement which encourages all interested parties to submit suggestions of generic issues that would be appropriately addressed in revenue rulings or revenue procedures.

Section 8.01 is revised to reflect the fact that the Assistant Commissioner (Taxpayer Service and Returns Processing) is now responsible for publishing the Internal Revenue Bulletin.

SEC. 3. DEFINITIONS

.01 A "revenue ruling" is an official interpretation by the Service of the internal revenue laws and related statutes, treaties, and regulations, that has been published in the Bulletin. Revenue rulings are issued only by the National Office and are published for the information and guidance of taxpayers, Service officials, and others concerned.

.02 A "revenue procedure" is an official statement of a procedure published in the Bulletin that either affects the rights or duties of taxpayers or other members of the public under the Internal Revenue Code and related statutes, treaties, and regulations or, although not necessarily affecting the rights and duties of the public, should be a matter of public knowledge.

SEC. 4. BACKGROUND

.01 The Bulletin is the authoritative instrument of the Commissioner of Internal Revenue for the publication of official rulings and procedures of the Service, including all rulings and statements of procedure that supersede, revoke, modify, amend, or affect any previously published ruling or procedure. The Service also announces in the Bulletin the Commissioner's acquiescence or nonacquiescence in decisions of the United States Tax Court (other than decisions in memorandum opinions), and publishes Treasury Decisions, Executive Orders, tax conventions, legislation, court decisions, and other items considered to be of general interest.

.02 The Bulletin is published weekly. In order to provide a permanent reference source, the contents of the Bulletin are consolidated semiannually into an indexed Cumulative Bulletin. These materials are sold by the Superintendent of Documents, U.S. Government Printing Office, Washington, D.C. 20402-9325.

SEC. 5. OBJECTIVES

The purpose of publication of revenue rulings and revenue procedures in the Bulletin is to promote uniform application of the tax laws by Service employees and to assist taxpayers in attaining maximum voluntary compliance by informing Service personnel and the public of National

Office interpretations of the internal revenue laws, related statutes, treaties, and regulations, and statements of Service procedures affecting the rights and duties of taxpayers.

SEC. 6. PUBLICATION STANDARDS

.01 It is the policy of the Service to publish in the Bulletin issues and answers involving substantive tax laws under the jurisdiction of the Service, except those involving—

(1) Issues answered by statute, treaties, or regulations;

(2) Issues answered by rulings, opinions, or court decisions previously published in the Bulletin;

(3) Issues that are of insufficient importance or interest to warrant publication;

(4) Determinations of fact rather than interpretations of law;

(5) Informers and informers' rewards; and

(6) Disclosure of secret formulas, processes, business practices, and similar information.

.02 It is the policy of the Service to publish in the Bulletin procedures affecting taxpayers' rights or duties that relate to matters under the jurisdiction of the Service.

SEC. 7. FORM AND EFFECT OF PUBLICATION

.01 *Revenue Rulings.*

(1) Rulings and other communications involving substantive tax law published in the Bulletin are published in the form of revenue rulings. The conclusions expressed in a revenue ruling will be directly responsive to, and limited in scope by, the pivotal facts stated in the revenue ruling. Revenue rulings arise from various sources, including rulings to taxpayers, technical advice to district offices, court decisions, suggestions from tax practitioner groups, publications, etc.

(2) If the revenue ruling arises from the circumstances of a particular taxpayer, the Service publishes as much as is necessary for an understanding of the position stated. However, identifying details, including the names and addresses of persons involved, and information of a confidential nature are not included, to prevent unwarranted invasions of personal privacy and to comply with statutory provisions, such as 18 U.S.C. section 1905 and 26 U.S.C. sections 6103 and 7213, dealing with disclosure of information obtained from members of the public.

(3) A revenue ruling, other than one relating to the qualification of pension, annuity, profit-sharing, stock bonus, and bond purchase plans, applies retroactively, unless it includes a specific statement indicating, under the authority of section 7805(b) of the Code, the extent to which it is to be applied without retroactive effect. When revenue rulings revoke or modify rulings previously published in the Bulletin, the authority of section 7805(b) ordinarily is invoked to provide that the new rulings will not be applied retroactively to the extent that the new rulings have adverse tax consequences to taxpayers. Section 7805(b) provides that the Secretary of the Treasury may prescribe the extent to which any ruling is to be applied without retroactive effect. That authority has been delegated to the Commissioner and has been redelegated to the Associate Chief Counsel (Technical), the Associate Chief Counsel (International), and the Assistant Commissioner (Employee Plans and Exempt Organizations) and to each of their deputies. The exercise of this authority requires an affirmative action. For the effect of revenue rulings on determination letters and opinion letters issued with respect to the qualification of pension, annuity, profit-sharing, stock bonus, and bond purchase plans, see section 13 of Rev. Proc. 80-30, 1980-1 C.B. 685.

(4) Revenue rulings published in the Bulletin do not have the force and effect of Treasury Department regulations (including Treasury Decisions), but are published to provide precedents to be used in the disposition of other cases, and may be cited and relied upon for that purpose. No unpublished ruling or decision will be relied on, used, or cited, by any officer or employee of the Service as a precedent in the disposition of other cases.

(5) Taxpayers generally may rely upon revenue rulings and revenue procedures published in the Bulletin in determining the tax treatment of their own transactions and need not request specific rulings applying the principles of a published revenue ruling or revenue procedure to the facts of their particular cases. However, taxpayers, Service personnel, and others concerned are also cautioned to determine whether a revenue ruling or revenue procedure on which they seek to rely has been revoked, modified, declared obsolete, distinguished, clarified, or otherwise affected by subsequent legislation, treaties, regulations, revenue rulings, revenue procedures or court decisions.

(6) Each revenue ruling represents the conclusion of the Service as to the application of the law to the entire statement of facts involved. Therefore, taxpayers, Service personnel, and others concerned are cautioned against reaching the same conclusion in other cases unless the facts and circumstances are substantially the same. For example, occasionally, from the facts, legal analysis, or other discussion it is clear that the federal tax law conclusion of the revenue ruling or revenue procedure is predicated upon a certain provision or interpretation of law other than federal tax law. If so, taxpayers, Service personnel, and others concerned are also cautioned to determine whether such relevant nontax law has changed materially from that used in the revenue ruling or revenue procedure on which they seek to rely. In some cases, if the conclusion of a revenue ruling or revenue procedure is so predicated on such nontax law, the ruling or procedure may caution taxpayers by referring to this paragraph of this revenue procedure. Any absence, however, of such a caution does not prevent the principles stated here from applying to that revenue ruling or revenue procedure.

(7) All interested parties, including teachers, professional associations, and trade or business groups are encouraged to submit suggestions of generic issues that would be appropriately addressed in revenue rulings or revenue procedures. Also, comments and suggestions from taxpayers, taxpayer groups, or other interested parties, on revenue rulings or revenue procedures being prepared for publication in the Bulletin may be solicited if justified by special circumstances. Conferences on revenue rulings or revenue procedures being prepared for publication will not be granted except when the Service determines that such action is justified by special circumstances.

.02 *Revenue Procedures.* When revenue procedures reflect the contents of internal management documents, it is Service practice to publish as much of the internal management document as is necessary for an understanding of the procedure. When publication of the substance of a revenue procedure in the Federal Register is required pursuant to 5 U.S.C. section 552, it will usually be accomplished by an amendment of the Statement of Procedural Rules (26 C.F.R. Part 601).

SEC. 8. RESPONSIBILITIES

.01 The Chief Counsel is responsible for administering the Service's revenue ruling and revenue procedure publication program including the standards for style and format of revenue rulings and revenue procedures. The Assistant Commissioner (Taxpayer Service and Returns Processing) is responsible for publishing the Internal Revenue Bulletin weekly and for consolidating the contents of the Bulletin semiannually into an indexed Cumulative Bulletin.

.02 In accordance with the standards set forth in section 6 of this revenue procedure, the Associate Chief Counsel (Technical), the Associate Chief Counsel (International), and the Assistant Commissioner (Employee Plans and Exempt Organizations) are responsible for the preparation and appropriate referral for publication of revenue rulings reflecting interpretations of substantive tax law made by their respective offices.

.03 In accordance with the standards set forth in section 6 of this revenue procedure, all Assistant Commissioners and the Chief Counsel are responsible for the determination of whether procedures established by any office under their jurisdiction should be published as revenue procedures and for the initiation, content, and appropriate referral for publication of such revenue procedures.

SEC. 9. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 86-15 is superseded.

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26 CFR 601.105: Examination of returns and claims for refund, credit, or abatement; determination of correct tax liability.

Rev. Proc. 89-15

SECTION 1. PURPOSE

This revenue procedure provides guidance for computing depreciation allowances for tangible property under section 168 of the Internal Revenue Code when (1) property is placed in service in a taxable year of less than 12 full months (a short taxable year), (2) property is disposed of prior to the end of the recovery period, or (3) the recovery period for the property includes all or part of a short taxable year other than the year property is placed in service.

SEC. 2. BACKGROUND

In general, section 168 of the Code determines the amount and timing of depreciation deductions for tangible property placed in service after December 31, 1986.

The applicable depreciation methods under section 168(b) of the Code are:

(1) for 3-year, 5-year, 7-year, and 10-year property (except any tree or vine bearing fruit or nuts), the 200 percent declining balance method, switching to the straight line method for the first taxable year for which using the straight line method with respect to the adjusted basis as of the beginning of such year will yield a larger allowance,

(2) for 15-year and 20-year property, any property used in a farming business (within the meaning of section 263A(e)(4)), and any property (other than property to which the straight line method applies) subject to an election under section 168(b)(2)(C) and (5), the 150 percent declining balance method, switching to the straight line method for the first taxable year for which using the straight line method with respect to the adjusted basis as of the beginning of such year will yield a larger allowance, and

(3) for residential rental property, nonresidential real property, any railroad grading or tunnel bore, property subject to an election under section 168(b)(3)(D) and (5), any tree or vine bearing fruit or nuts, and property subject to the alternative depreciation system of section 168(g), the straight line method.

The applicable recovery periods are determined under sections 168(c) and 168(g)(2)(C) of the Code.

Section 168(d) of the Code prescribes the conventions used to determine, for purposes of section 168, when property is treated as placed in service or disposed of. These conventions are used in computing depreciation allowances for the taxable year in which property is placed in service or disposed of.

Section 168(d)(1) of the Code provides that, in general, the applicable convention is the half-year convention. Section 168(d)(4)(A) defines the half-year convention as a convention that treats all property placed in service during any taxable year (or disposed of during any taxable year) as placed in service (or disposed of) on the mid-point of the taxable year.

Section 168(d)(2) of the Code provides that, for nonresidential real property, residential rental property, and any railroad grading or tunnel bore, the applicable convention is the mid-month convention. Section 168(d)(4)(B) defines the mid-month convention as a convention that treats all property placed in service during any month (or disposed of during any month) as placed in service (or disposed of) on the mid-point of the month.

Section 168(d)(3) of the Code generally provides that, if during a taxable year (i) the aggregate basis of property to which section 168 applies that is placed in service in the last 3 months of the taxable year exceeds (ii) 40 percent of the aggregate basis of property to which section 168 applies that is placed in service during such taxable year, then the applicable convention for all property to which section 168 applies that is placed in service during such taxable year is the mid-quarter convention.[1] Nonresidential real property and residential rental property are not taken into account for purposes of determining whether the mid-quarter convention applies, nor does that convention apply to such property even if the convention is otherwise applicable. Section 168(d)(4)(C) of the Code defines the mid-quarter convention as a convention that treats all property placed in service during any quarter of a taxable year (or disposed of during any quarter of a taxable year) as placed in service (or disposed of) on the mid-point of the quarter.

In determining whether section 168(d)(3) of the Code requires use of the mid-quarter convention, the taxpayer must look to the aggregate basis of property placed in service in the last 3 months of the taxable year, whatever the length of the taxable year. Thus, if a short taxable year consists of 3 months or less, the mid-quarter convention applies regardless of when the depreciable property is placed in service during the taxable year.

The half-year, mid-quarter, and mid-month conventions prescribed by section 168(d) of the Code establish deemed placed-in-service dates and deemed disposition dates. Depreciation is allowable only for the portion of a taxable year the property is treated as in service.[2] The

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[1]*See* section 203(d) of the Tax Reform Act of 1986, 1986-3 C.B. (Vol. 1) 63, as amended by section 1002(c) of the Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, 102 Stat. 3358, for the treatment of transition rule property under section 168(d)(3) of the Code.

[2]However, *see* section 168(i)(4) with respect to general asset accounts.

recovery period begins on the placed-in-service date prescribed by section 168(d). The remaining recovery period as of the beginning of the taxable year following the taxable year in which the property is placed in service is equal to the full applicable recovery period less the fraction of the first taxable year for which depreciation is allowable. Section 4.01 of this revenue procedure provides procedures for determining placed-in-service dates and disposition dates in short taxable years.

Depreciation allowances are determined on a taxable year basis. In contrast, the applicable recovery periods under section 168(c) of the Code are based on recovery years without regard to the taxpayer's underlying taxable year. The number of years in the recovery period determines the applicable depreciation rate under each of the methods provided in section 168(b). The product of (1) the annual applicable depreciation rate and (2) the adjusted basis of the property as of the beginning of the recovery year is the depreciation attributable to that recovery year.

Because of the applicable placed-in-service conventions, an asset's recovery year generally will not coincide with the taxpayer's taxable year. The depreciation attributable to a recovery year is consequently allocated to the taxable years that include the recovery year. For the taxable year in which the recovery period begins, the property is deemed in service for only a portion of the taxable year, and the depreciation allowance must be adjusted accordingly. The depreciation allowances for subsequent taxable years must account for the difference between recovery years and taxable years. Section 4.02 and section 4.03 of this revenue procedure provide rules for allocating depreciation allowances to taxable years when the recovery period includes a short taxable year or when the property is disposed of prior to the end of the recovery period.

Section 5 of Rev. Proc. 87-57, 1987-2 C.B. 687, describes the use of the applicable conventions when property is placed in service during a taxable year of 12 full months. The tables in section 8 of Rev. Proc. 87-57 take into account the applicable conventions and assume that the taxable year in which the property is placed in service and all subsequent taxable years in the recovery period are full taxable years. The tables further assume that the property is not disposed of during the recovery period. If at any time during the recovery period the taxpayer has a short taxable year or disposes of property, the tables in section 8 of Rev. Proc. 87-57 are inapplicable and this revenue procedure must be followed.

SEC. 3. SCOPE

.01 Except as provided in section 3.02, this revenue procedure applies in any taxable year in which property subject to section 168 of the Code is treated as in service for fewer than 12 full months or has been so treated for some prior taxable year in the recovery period. Thus, if, before the end of the recovery period, the taxpayer has a short taxable year or disposes of the property before the end of the recovery period, the procedures provided in section 4 of this revenue procedure apply in computing the depreciation allowances.

.02 If the taxable year in which property is placed in service is 12 full months, the fact that the applicable conventions treat such property as in service for less than 12 full months shall not be grounds for applying this revenue procedure. Rev. Proc. 87-57 provides rules for implementing the applicable conventions in taxable years of 12 full months.

SEC. 4. PROCEDURES

.01 *Property Placed in Service or Disposed of during a Short Taxable Year.*

(1) *Applicable Conventions.* Section 168(d)(4) of the Code applies both the half-year convention and the mid-quarter convention to the "taxable year." Consideration of the taxable year of the taxpayer is thus necessary in establishing the date property is treated as placed in service or disposed of. The mid-month convention, however, is applied without regard to the taxpayer's taxable year.

(a) *Half-year convention.* Property subject to the half-year convention is deemed placed in service or disposed of on the mid-point of the taxable year in which the property is placed in service or disposed of. For purposes of determining the date property subject to the half-year convention is deemed placed in service or disposed of, the following additional rules apply:

(i) For a short taxable year that begins on the first day of a month or ends on the last day of a month, the taxable year, for purposes of section 168 of the Code, shall consist of the number of months in the taxable year. (For this purpose, if the short taxable year includes part of a month, the entire month shall, in general, be included in the number of months in the taxable year.) The mid-point of the taxable year is then determined by dividing the number of months in the taxable year by 2. For example, a short taxable year that begins on June 20 and ends on December 31 consists of 7 months and the mid-point of the taxable year is the middle of September. Property is treated as placed in service or disposed on this mid-point.

However, no month shall be taken into account more than once. Thus, if a taxpayer has successive short taxable years, with one taxable year ending and the following taxable year beginning in the same calendar month, the first short taxable year shall be treated, for this purpose, as not including the month in which the first short taxable year terminates. For example, if a taxpayer had a short taxable year beginning on June first and ending on October 15 followed by a short taxable year beginning on October 16 and ending on May 31, the first short taxable year would thus consist of four months and its mid-point would be the end of July. The second short taxable year would consist of eight months and its mid-point would be the end of January.

(ii) For a short taxable year that begins on a day other than the first day of a month and ends on a day other than the last day of a month, the taxable year shall be measured by the number of days in the short taxable year. The arithmetical mid-point of the taxable year is then determined by dividing the number of days in the taxable year by 2. If the arithmetical mid-point of the taxable year is a day other than the first or the mid-point of a month, property is treated as placed in service or disposed of on the nearest preceding first or mid-point of the month.

Thus, under these rules, property subject to the half-year convention is always treated as placed in service or disposed of on either the first day or the mid-point of a month.

(b) *Mid-quarter convention.* Property subject to the mid-quarter convention is deemed placed in service or disposed of on the mid-point of the quarter of the taxable year in which the property is placed in service or disposed of. The taxpayer must divide a short taxable year into four quarters and then determine the mid-point of each quarter. For purposes of determining the date property subject to the mid-quarter convention is deemed placed in service or disposed of, the following additional rules apply:

(i) For a short taxable year that consists of four or eight full calendar months, the taxpayer determines quarter's on the basis of whole months. Thus, the mid-point of each quarter is either the first or the mid-point of a month, and property is treated as placed in service or disposed of on the mid-point.

(ii) For a short taxable year that consists of anything other than four or eight full calendar months, the taxpayer determines the number of days in the taxable year, divides by 4 to determine the length of each quarter, and determines the arithmetical mid-point by dividing the number of days in each quarter by 2. If the arithmetical mid-point of a quarter is a day other than the first or the mid-point of a month, property is treated as placed in service or disposed of on the nearest preceding first or mid-point of the month.

Thus, under these rules, property subject to the mid-quarter convention is always treated as placed in service or disposed of on either the first or the mid-point of a month.

(c) *Mid-month Convention.* Property subject to the mid-month convention is deemed placed in service or disposed of on the mid-point of the calendar month in which the property is placed in service or disposed of.

.02 *Depreciation Allowance for First Taxable Year in the Recovery Period.* To determine the depreciation allowance for the first taxable year in the recovery period, the taxpayer must initially determine the depreciation attributable to the first recovery year. The depreciation attributable to the first recovery year is obtained by multiplying the taxpayer's basis in the property by the applicable depreciation rate. The depreciation allowance allocable to the first taxable year is then obtained by multiplying the depreciation attributable to the first recovery year by a fraction, the numerator of which is the number of months (including fractions of months) the property is deemed to be in service during the taxable year (taking into account the applicable convention) and the denominator of which is 12.

.03 *Depreciation Allowances for Subsequent Taxable Years in the Recovery Period.* Taxpayers may use either the allocation method or the simplified method in computing depreciation allowances for subsequent years in the recovery period. The method adopted must be consistently applied until the year of switch to the straight line method.

(1) *Allocation Method.* The depreciation allowance for each subsequent taxable year is calculated by allocating to the taxable year the depreciation attributable to each recovery year, or portion thereof, that falls within the taxable year. Thus, whether the taxable year is a 12-month or a short taxable year, the depreciation allowance is calculated by determining which recovery years are included in the taxable year. For each recovery year included, the depreciation attributable to each recovery year is multiplied by a fraction, the numerator of which is the number of months (including fractions of months) that are in both the taxable year and the recovery year and the denominator of which is 12.

In the case of property disposed of before the end of the recovery period, the applicable conventions, as described in section 4.01, determine when the property is treated as disposed of.

(2) *Simplified Method.* In lieu of the allocation method described above, the taxpayer may calculate depreciation allowances for subsequent taxable years by multiplying the unrecovered basis of the property as of the beginning of the taxable year by the applicable depreciation rate. If a subsequent taxable year during the recovery period is a short taxable year or is a year in which the taxpayer disposes of the property, the depreciation allowance for the taxable year must be adjusted in a manner similar to that described in section 4.02, above. Thus, in the case of a subsequent short taxable year, the depreciation allowance is obtained by multiplying the unrecovered basis of the property as of the beginning of the taxable year by the applicable depreciation rate, and then multiplying the product by a fraction, the numerator of which is the number of months (including fractions of months) in the taxable year and the denominator of which is 12. In the case of a disposition before the end of the recovery period, the applicable convention determines when property is treated as disposed of for purposes of section 168 of the Code. The depreciation allowance for such property is obtained by multiplying the unrecovered basis of the property as of the beginning of the taxable year by the applicable depreciation rate, and then multiplying the product by a fraction, the numerator of which is the number of months (including fractions of months) the property is deemed in service during the taxable year and the denominator of which is 12. This simplified approach is consistent with section 6.06 of Rev. Proc. 87-57.

(3) *Declining Balance Method with Switch to Straight Line Method.* If the taxpayer depreciates property by use of the applicable depreciation method provided by section 168(b)(1) or (2) of the Code, the taxpayer must switch to the straight line method for the first taxable year that the straight line method produces a larger allowance. Therefore, for each taxable year, the taxpayer must compare the depreciation allowance calculated under the declining balance method with the depreciation allowance calculated under the straight line method. Under the straight line method, the applicable depreciation rate for each taxable year, except the last taxable year in the recovery period, is determined by dividing 1 by the number of years (including fractions of years) in the applicable recovery period remaining as of the beginning of such taxable year. For the taxable year in which the recovery period ends, the applicable depreciation rate under the straight line method is 100 percent. The applicable depreciation rate is then applied to the unrecovered basis of the property as of the beginning of that taxable year.

.04 *Alternative Minimum Tax.* In calculating the adjustment to taxable income under section 56 of the Code, depreciation allowances should reflect short taxable years in a manner consistent with that described above.

.05 *Depreciation Deductions for Short Taxable Years for which a Return has been Filed.* In the case of property subject to the half-year or mid-quarter convention that was placed in service or disposed of during a short taxable year for which a return was filed before the publication of this revenue procedure, taxpayers should file amended returns in a timely manner. However, if the depreciation deduction(s) claimed reflect placed-in-service dates and disposition dates on a more exact basis than this revenue procedure, the Service will not disturb this treatment on examination. Taxpayers not filing amended returns should compute depreciation deductions for subsequent taxable years in the recovery period consistent with the placed-in-service dates adopted on the return for the year the property was placed in service.

SEC. 5. EXAMPLES

.01 *Half-year convention.*

Example

FACTS. Corporation *X*, a calendar year taxpayer, was incorporated and began business on March 15, 1988. During its 1988 taxable year, *X* placed in service tangible personal property subject to an allowance for depreciation determined under section 168 of the Code. Assume that the applicable convention is the half-year convention.

ANALYSIS. *X* has a short taxable year that begins March 15, 1988, and ends

December 31, 1988, and thus is treated as having a 10-month taxable year under section 4.01(1)(a)(i), above. The property placed in service during the short taxable year is therefore treated as placed in service on the first day after the 5th month in the taxable year, that is, on August 1, 1988.

.02 *Mid-quarter convention.*

Example (1)

FACTS. Assume the same facts as in section 5.01, except that the applicable convention is the mid-quarter convention.

ANALYSIS Section 4.01(1)(b)(ii), above, applies to the property. *X*'s short taxable year consists of 292 days. Each quarter is 73 days, and the arithmetic mid-point of each quarter is the 37th day of the quarter. The arithmetic mid-point of the first quarter is thus April 20, 1988. Under section 4.01(1)(b)(ii), the mid-point of the first quarter is the middle of April. Table 1 illustrates the application of section 4.01(1)(b)(ii) under these facts.

Rev. Proc. 89-15, Table 1
Example of application of the mid-quarter convention in a short taxable year beginning March 15, 1988 and ending December 31. 1988.

	Quarter	*Arithmetic Mid-point of the Quarter*	*Deemed Placed-in-Service Date*
1.	March 15 to May 26, 1988	April 20, 1988	Middle of April
2.	May 27 to August 7, 1988	July 2, 1988	Beginning of July
3.	August 8 to October 19, 1988	September 13, 1988	Beginning of September
4.	October 20 to December 31, 1988	November 25, 1988	Middle of November

Example (2)

FACTS. Corporation *Z*, a calendar year taxpayer, was incorporated and began business on December 1, 1988. During its 1988 taxable year, *Z* placed in service tangible personal property subject to an allowance for depreciation under section 168 of the Code. *Z* has a short taxable year that begins December 1, 1988, and ends December 31, 1988. The applicable convention is the mid-quarter convention.

ANALYSIS. *X* has a 31-day short taxable year. Table 2 illustrates the application of section 4.01(1)(b)(ii) of this revenue procedure under these facts.

Rev. Proc. 89-15, Table 2
Example of application of the mid-quarter convention in a short taxable year of 1 month.

	Quarter	*Arithmetic Mid-point of the Quarter*	*Deemed Placed-in-Service Date*
1.	December 1 to December 8, 1988	December 5, 1988	Beginning of December
2.	December 9 to December 15, 1988	December 12, 1988	Beginning of December
3.	December 16 to December 23, 1988	December 20, 1988	Middle of December
4.	December 24 to December 31, 1988	December 28, 1988	Middle of December

.03 *Computation—Allocation Method.*

Example (1)—Initial Short Taxable Year.

FACTS. Assume the same facts as in section 5.01, above. In addition, assume that the property *X* placed in service during the taxable year was 5-year property with a cost basis of $100 and that *X* made no elections under section 168 of the Code.

ANALYSIS.

(1) *Applicable recovery period*. Under section 168(c) of the Code, the applicable recovery period for 5-year property is 5 years. The recovery period begins August 1, 1988, the date the property is deemed placed in service under section 168(d). Assuming that *X* does not retire the property before January 1, 1994, the recovery period ends July 31, 1993.

(2) *Applicable depreciation method*. Under section 168(b)(1) of the Code, the applicable depreciation method for *X*'s 5-year property is the 200 percent declining balance method, switching to the straight line method for the first taxable year in which using the straight line method produces a larger depreciation allowance. The applicable depreciation rate for the property is 40 percent, that

is, 200 percent divided by 5, the number of years in the recovery period. *See* section 6.04 of Rev. Proc. 87-57.

(3) *First taxable year in the recovery period.* For its taxable year ending December 31, 1988, *X* is entitled to 5 months of depreciation. The depreciation allowance is calculated by applying the applicable depreciation rate (40 percent) to the basis of the property ($100) and then multiplying the product by a fraction, the numerator of which is the number of months the property is deemed in service during the taxable year (5) and the denominator of which is 12. Thus, the depreciation allowance for the 1988 short taxable year is $16.67.

(4) *Depreciation allowances for subsequent taxable years.* Assume that *X* has no other short taxable years during the recovery period. For the taxable year beginning January 1, 1989, and ending December 31, 1989, *X* is entitled to 12 months of depreciation for the property. A recovery year for the property extends from August 1 to July 31. Seven months of the first recovery year and 5 months of the second recovery year fall within *X*'s 1989 taxable year. The depreciation allowance for *X*'s 1989 taxable year is the sum of (1) the depreciation attributable to the first recovery year times 7/12 and (2) the depreciation attributable to the second recovery year times 5/12; that is, 40 percent times $100 times 7/12, plus 40 percent times $60 times 5/12, equals $33.33. For the remaining portion of the applicable recovery period, *X* calculates its depreciation allowances under the declining balance method as shown in Table 3.

(5) *Switch to straight line method.* To determine the taxable year to switch to the straight line method, for each taxable year *X* must compare the depreciation allowance calculated under the declining balance method with the depreciation allowance calculated under the straight line method. *See* section 6.06 of Rev. Proc. 87-57.

For the taxable year beginning August 1, 1988, and ending December 31, 1988, the applicable depreciation rate under the straight line method, taking into account the 5 year recovery period, is 20 percent (1 divided by 5). This results in a depreciation allowance of $8.33 (20 percent times $100 times 5/12). Because the depreciation allowance calculated under the declining balance method produces a larger allowance ($16.67), *X* does not use the straight line method for taxable year 1988.

For the taxable year beginning January 1, 1989, and ending December 31, 1989, the applicable depreciation rate under the straight line method, taking into account the 4 years and 7 months remaining in the recovery period, is 21.82 percent [1 divided by (4 plus 7/12)]. This results in a depreciation allowance of $18.18 (21.82 percent times $83.33). Because the depreciation allowance calculated under the declining balance method produces a larger allowance ($33.33), *X* does not switch to the straight line method for taxable year 1989.

Table 3 shows, for comparison purposes, the depreciation allowances calculated under the straight line method if *X* switches from the 200 percent declining balance method to the straight line method in the taxable year identified.

The taxable year beginning January 1, 1992, and ending December 31, 1992, is the first taxable year in which the straight line method produces a depreciation allowance larger than the declining balance method. Thus, *X* switches to the straight line method for taxable year 1992. For that taxable year, *X* is entitled to a depreciation deduction of $11.37. Under the straight line method, the applicable depreciation rate for the taxable year in which the recovery period ends is 100 percent. Thus, for the taxable year ending December 31, 1993, *X* is entitled to a depreciation deduction of $6.63; this represents the remaining unrecovered basis in the property as of the beginning of the taxable year.

Rev. Proc. 89-15, Table 3
Computation of the Depreciation Allowance

Allocation Method—Declining Balance

Taxable Year	*Depreciation Allowance*
1988	[40% × $100.00 × 5/12] = $16.67
1989	[40% × $100.00 × 7/12] + [40% × $60.00 × 5/12] = $33.33
1990	[40% × $60.00 × 7/12] + [40% × $36.00 × 5/12] = $20.00
1991	[40% × $36.00 × 7/12] + [40% × $21.60 × 5/12] = $12.00
1992	[40% × $21.60 × 7/12] + [40% × $12.96 × 5/12] = $ 7.20
1993	[40% × $12.96 × 7/12] = $ 3.02

Determination of the Year of Switch
to the Straight Line Method
(compare depreciation allowances)

Taxable Year	*Basis Adjusted for Depreciation Allowable*	*Straight × Line Rate*	*Short year × adjustment =*	*Depreciation Allowance*
1988	$100.00	1/5	5/12	$ 8.33
1989	$ 83.33	1/(4 + 7/12)	12/12	$18.18
1990	$ 50.00	1/(3 + 7/12)	12/12	$13.95
1991	$ 30.00	1/(2 + 7/12)	12/12	$11.61
1992	$ 18.00	1/(1 + 7/12)	12/12	$11.37
1993	$ 6.63	1	12/12	$ 6.63

Example (2)—Subsequent short taxable years.

FACTS. Corporation *Y*, a calendar year taxpayer, incorporated and began business on May 1, 1987. On that date *Y* placed in service 5-year property acquired for $100. At the close of business on June 30, 1988, all of the stock of *Y* was acquired by Corporation *Z*, a fiscal year taxpayer with a June 30 year end. *Y* and *Z* elected in accordance with section 1501 of the Code to file a consolidated return.

ANALYSIS. When a taxpayer has a short taxable year other than the first taxable year in the recovery period, the depreciation allowance for that short taxable year must account for the difference between recovery years and taxable years.

Y has a short taxable year from May 1, 1987, to December 31, 1987. The property is treated as placed in service on September 1, 1987, the mid-point of *Y*'s first taxable year. For the first taxable year in the recovery period, *Y* calculates its depreciation allowance in the manner described in section 5.03(3) above. Thus, for the taxable year ending December 31, 1987, *Y* is entitled to 4 months of depreciation. The depreciation allowance is calculated under the declining balance method by determining the amount of depreciation attributable to the first recovery year that is allocable to *Y*'s first taxable year. Because the first recovery year runs from September 1, 1987 to August 31, 1988, 4 months of depreciation attributable to the first recovery year is allocable to the taxable year ending December 31, 1987. Thus, *Y*'s depreciation allowance for the taxable year is $13.33 (40 percent times $100 times 4/12).

Because of *Y*'s acquisition by *Z*, and *Y* and *Z*'s election to file a consolidated return, *Y*'s second taxable year ending June 30, 1988, is also a short taxable year. For the taxable year beginning January 1, 1988, and ending June 30, 1988, *Y* is entitled to 6 months of depreciation. Thus, *Y*'s depreciation allowance for the taxable year ending June 1988, is $20 (40 percent times $100 times 6/12). Two months of depreciation attributable to the first recovery year is allocable to the 12-month taxable year beginning July 1, 1989. In addition, 10 months of depreciation attributable to the second recovery year is allocable to that taxable year. Thus, *Y*'s depreciation allowance for the taxable year beginning July 1, 1989, is $26.67 [(40 percent times $100 times 2/12) plus (40 percent times $60 times 10/12)].

Example (3)—Disposition before the end of the recovery period.

FACTS. Assume the same facts as in section 5.01 above, except that *X* disposes of the property on December 28, 1989.

ANALYSIS. When a taxpayer disposes of depreciable property before the end of the recovery period, the depreciation allowance for the taxable year of disposition must reflect the premature end of the recovery period. Because the half-year convention applies to this property, the property is deemed disposed of on July 1, 1989, the mid-point of *X*'s second taxable year. For this taxable year, *X* is entitled to 6 months of depreciation for the property. Because the first recovery year extends from August 1, 1988, to July 31, 1989, 6 months of depreciation attributable to the first recovery year is allocable to the period during the second taxable year that the property was deemed in service. Thus, *X*'s depreciation allowance for the second taxable year is $20 (40 percent times $100 times 6/12).

.04 *Computation—Simplified Method*. The simplified method for calculating depreciation allowances is illustrated below. In most cases, the allocation method and the simplified method result in the same depreciation allowances. However, if prior to the switch to the straight line method (but after the first taxable year) the taxpayer has a short taxable year or disposes of the property, the depreciation allowance under the simplified method for that year will be less than under the allocation method.

Example (1)—Initial Short Taxable Year.

FACTS. Assume the same facts as in section 5.03 Example (1) above.

ANALYSIS.

(1) *First taxable year in the recovery period*. Under the simplified method, the depreciation allowance for the first taxable year in the recovery period is calculated in the same manner as under the allocation method. *See* section 5.03 Example (1) above.

(2) *Depreciation allowances for subsequent taxable years*. In lieu of allocating a portion of the depreciation attributable to the first recovery year and a portion of the depreciation attributable to the second recovery year to the taxable year beginning January 1, 1989, and ending December 31, 1989 (*see* section 5.03-(4)), *X* may calculate its depreciation allowance under the declining balance method by applying the applicable depreciation rate (40 percent) to the unrecovered basis of the property as of the beginning of the taxable year ($83.33). Thus, *X*'s depreciation allowance for its 1989 taxable year is $33.33. For the remaining portion of the applicable recovery period, *X* may calculate its depreciation allowances under the declining balance method as shown in Table 4.

Rev. Proc. 89-15, Table 4

Computation of Depreciation Allowances
under the Simplified Method-Declining Balance

Taxable Year	*Depreciation Allowance*
1988	[40% × $100.00 × 5/12] = $16.67
1989	40% × $83.33 = $33.33
1990	40% × $50.00 = $20.00
1991	40% × $30.00 = $12.00
1992	40% × $18.00 = $ 7.20
1993	[40% × $10.80 × 7/12] = $ 2.52

Determination of the Year of Switch
to the Straight Line Method
(compare depreciation allowances)

Taxable Year	*Basis Adjusted for Depreciation Allowable*	*Straight × Line Rate*	*Short year × adjustment =*	*Depreciation Allowance*
1988	$100.00	1/5	5/12	$ 8.33
1989	$ 83.33	1/(4 + 7/12)	12/12	$18.18
1990	$ 50.00	1/(3 + 7/12)	12/12	$13.95
1991	$ 30.00	1/(2 + 7/12)	12/12	$11.61
1992	$ 18.00	1/(1 + 7/12)	12/12	$11.37
1993	$ 6.63	1	12/12	$ 6.63

(3) *Switch to straight line method.* The taxable year *X* switches to the straight line method is determined as provided in section 5.03 Example (1) above.

Example (2)—Subsequent short taxable years.

FACTS. Assume the same facts as in section 5.03 Example (2) above, except that *Y* uses the simplified method described in section 4.03(2), above.

ANALYSIS. For the first taxable year in the recovery period, *Y* calculates its depreciation allowance in the manner described in section 5.03. Thus, its depreciation allowance for the taxable year ending December 31, 1987, is $13.33.

Because of *Y*'S acquisition by *Z*, and *Y* and *Z*'s election to file a consolidated return, *Y*'s second taxable year ending June 30, 1988, is also a short taxable year. For this short taxable year, *Y* calculates its depreciation allowance by multiplying the unrecovered basis of the property as of the beginning of the taxable year ($86.67) by the applicable depreciation rate (40 percent), and then multiplying the product by a fraction, the numerator of which is the number of months and fractions of months in the taxable year (6) and the denominator of which is 12. Thus, under the simplified method, *Y*'s depreciation allowance for the second short taxable year in the recovery period is $17.34; that is, $86.67 times 40 percent times (6/12).

Example (3)—Disposition before the end of the recovery period.

FACTS. Assume the same facts as in sections 5.01 and 5.03 Example (3) above, except that *X* uses the simplified method described in section 4.03(2), above.

ANALYSIS. For the first taxable year in the recovery period, *X* calculates its depreciation allowance in the manner described in section 5.03 Example (1); thus, its depreciation allowance for the taxable year ending December 31, 1988, is $16.67. The half-year convention applies when *X* disposes of the property in the second taxable year. Under the simplified method, *X* calculates its depreciation allowance by multiplying the unrecovered basis of the property at the beginning of the taxable year ($83.33) by the applicable depreciation rate (40 percent), and then multiplying the product by 6/12. Thus, under the simplified method *X*'s depreciation allowance for the second taxable year in the recovery period is $16.67.

SEC. 6. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 87-57 is amplified and clarified.

SEC. 7. EFFECTIVE DATE

This revenue procedure is effective for property and taxable years subject to section 168 of the Code as amended by section 201 of the Tax Reform Act of 1986, 1986-3 (Vol. 1) C.B. 38. However, for property subject to the half-year or mid-quarter convention that was placed in service or disposed of during a short taxable year for which a return has been filed, see section 4.05 above.

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26 CFR 601.204: Changes in accounting period and in methods of accounting.
(Also Part I, Sections 165, 167, 263, 263A, 446, 481; 1.165-2, 1.167(a)-3, 1.263(a)-2, 1.263A-1T, 1.446-1, 1.481-5.)

Rev. Proc. 89-16

SECTION 1. PURPOSE

This revenue procedure allows certain taxpayers to obtain expeditious consent from the Commissioner to change their method of accounting for package design costs (as defined in section 2 of this revenue procedure) to a capitalization method in accordance with Rev. Rul. 89-23, page 844, this Bulletin. The required method change is with respect to package design costs incurred prior to January 1, 1987 (change in method of accounting made pursuant to section 263 of the Internal Revenue Code) and package design costs incurred after December 31, 1986 (change in method of accounting made pursuant to section 263A), to the extent the amounts were previously deducted or amortized and the related package designs are still in use in the taxpayer's trade or business on the first day of the tax year of change (year of change). *See* Notice 88-78, 1988-2 C.B. 394, which provides guidance and procedural information to taxpayers that fail to change their method of accounting in order to conform to the uniform capitalization rules in accordance with the effective date provisions of section 263A.

SEC. 2. DEFINITIONS

For purposes of this revenue procedure, the term "package design" means an asset that is created by a specific graphic arrangement or design of shapes, colors, words, pictures, lettering, and so forth on a given product package, or the design of a container with respect to its shape or function.

The term "package design cost", as used in this revenue procedure, means the cost of package designs. If the taxpayer develops the package design, the term includes the cost of materials, labor, and overhead associated with the package design. If an independent contractor performs the work, the term includes all billings related to the development of the particular package design. Whether a package design is created in-house or is created by an independent contractor, the term includes all design exploration and study, 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. (*See also* section 1.263A-1T(a)(5)(ii) of the regulations that treats a taxpayer purchasing a package design as also producing such design to the extent the taxpayer incurs costs with respect to the design). The term, however, does not include costs associated with coupon inserts, refund offers, and other promotion-related changes, nor does it include costs that are unrelated to the package design itself, such as a change to the list of ingredients. Moreover, the term does not include costs that would have qualified as "trademark or trade name expenditures" under section 177 of the Internal Revenue Code of 1954 (the 1954 Code).

SEC. 3. BACKGROUND

.01 Section 263(a) of the Internal Revenue Code provides that no deduction shall be 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 provides in the examples of capital expenditures the costs of acquiring property having a useful life substantially beyond the taxable year.

.02 An expenditure generally must be capitalized under section 263 of the Code if the expenditure creates, enhances, or is part of the cost of acquiring a tangible or intangible asset with a useful life greater than one year. *See Commissioner v. Lincoln Savings and Loan Association v. Commissioner*, 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 section 263 because such costs create intangible assets with useful lives in excess of one year. See Rev. Rul. 89-23.

.03 Section 263A of the Code, as enacted by the Tax Reform Act of 1986, section 803(a), 1986-3 (Vol. 1) C.B. 267, provides, in part, for the nondeductibility of certain direct and indirect costs with respect to tangible property produced by the taxpayer. Section 1.263A-1T of the temporary Income Tax Regulations provides that all costs that are incurred with respect to real or tangible personal property that is produced are to be capitalized with respect to such property. Section 1.263A-1T(a)(5)(ii) of the temporary regulations provides that the term "produce" includes construct, build, install, manufacture, develop, improve, create, raise or grow. Although section 263A of the Code does not require the costs of producing intangible personal property to be capitalized, section 263A(b) defines tangible personal property to include a film, sound recording, video tape, book, or similar property. For this purpose, tangible personal property includes property embodying words, ideas, concepts, images, or sounds. See section 1.263A-1T(a)(5)(iii) of the temporary regulations; see also 2 H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. II-308 (1986), 1986-3 (Vol. 4) C.B. 308. Section 1.263A-1T(a)(5)(iii) applies to the production of tangible personal property within the meaning of paragraph (a)(5)(iii) without regard to whether such property is treated as tangible or intangible under other provisions of the Code. For example, the requirements of section 1.263A- 1T(a)(5)(iii) apply to the cost of the properties enumerated therein although such costs may consist of copyrights, licenses, manuscripts, and other items which may be treated as intangible for other purposes of the Code. The above-indicated provisions of section 263A and the temporary Income Tax Regulations thereunder require that expenses incurred after December 31, 1986, in connection with the development and design of product packages must be capitalized under section 263A for tax years ending after such date. See Rev. Rul. 89-23.

.04 As indicated in Rev. Rul. 89-23, package designs generally do not have an ascertainable useful life and, therefore, no depreciation or amortization is allowed under section 167 of the Code and the regulations thereunder. See section 1.167(a)-3 of the regulations. Only when such a package design is abandoned may the accumulated costs be deducted. See section 165 of the Code and section 1.165-2(a) of the regulations.

.05 Taxpayers currently deducting package design costs in a manner inconsistent with Rev. Rul. 89-23 are required to change their method of accounting, under sections 446 and 481 of the Code and the regulations thereunder, to a capitalization method consistent with Rev. Rul. 89-23. The required method change, pursuant to section 263 of the Code with respect to costs incurred prior to January 1, 1987, and pursuant to section 263A with respect to costs incurred after December 31, 1986, is for all amounts previously deducted or amortized with respect to all package designs still in use in the taxpayer's trade or business on the first day of the tax year of change. *See* sections 6.01 and 6.02 of this revenue procedure, which discuss the section 481(a) adjustment and the section 481(a) adjustment period, respectively, with respect to this method change.

.06 Section 446(e) of the Code provides that, except as otherwise provided, a taxpayer that changes the method of accounting on the basis of which it regularly computes its income in keeping its books shall, before computing its taxable income under the new method, secure the consent of the Secretary. Section 1.446-1(e)(2)(ii)(*a*) of the regulations provides that a change in the 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 used in such overall plan. Section 1.446-1(e)(ii)(*a*) defines a material item as any item that involves the proper time for the inclusion of the item in income or the taking of a deduction. Section 1.446-1(e)(3)(i) provides generally that in order to obtain the consent of the Commissioner for an accounting method change, a taxpayer must file an application on Form 3115, Application for Change in Method of Accounting, within 180 days after the beginning of the tax year for which the proposed change is to be made. 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 taxpayers to obtain consent to change their method of accounting in accordance with section 446(e).

.07 Section 481(a) of the Code provides that if a taxpayer's taxable income for any tax year is computed under a method of accounting different from the method used to compute taxable income in the preceding tax year, the taxpayer must take into account those adjustments necessary to prevent amounts from being duplicated or omitted by reason of such change in method. Section 481(c) and section 1.481-5 of the regulations provide that the adjustments required by section 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.

SEC. 4. SCOPE

.01 Except as provided in section 4.02 below, this revenue procedure applies to any taxpayer that has a method of accounting of currently deducting or amortizing package design costs (as defined in section 2 of this revenue procedure) in a manner inconsistent with Rev. Rul. 89-23 and, therefore, is required to change to a capitalization method consistent with Rev. Rul. 89-23. This required change is for all package design costs that (1) were currently deducted or amortized in tax years prior to the year of change, and (2) relate to package designs that were not abandoned prior to the year of change (whether or not the package design was placed in service prior to the start of the year of change). Any taxpayer to which this revenue procedure applies may not use Rev. Proc. 84-74, 1984-2 C.B. 736, but must use this revenue procedure for changing its method of accounting to a capitalization method in accordance with Rev. Rul. 89-23 and this revenue procedure.

.02 This revenue procedure does not apply to a taxpayer if, as of the date of filing Form 3115 with the National Office, as required by section 8.01, the taxpayer:

(1) Has been contacted in any manner by a representative of the Service for the purpose of scheduling an examination of the taxpayer's federal income tax return for any year and such examination has not been completed, unless the taxpayer has obtained an agreement (which must be attached to the Form 3115) from the Service's examining agent that there is no objection to the proposed change in method of accounting;

(2) Is before an appeals office of the Service with respect to an examination of the taxpayer's federal income tax return(s) for any year, unless the taxpayer has obtained an agreement (which must be attached to the Forms 3115) from the appeals officer that there is no objection to the proposed change in method of accounting;

(3) Is before any federal court with respect to an income tax issue arising in any tax year unless the taxpayer has obtained an agreement (which must be attached to the Form 3115) from counsel for the Government that there is no objection to the proposed change in method of accounting; or

(4) Is the subject of a criminal investigation or proceeding concerning, directly or indirectly, (i) the taxpayer's federal tax liability for any year, or (ii) the possibility of false or fraudulent statements made by the taxpayer with respect to any issue relating to its federal tax liability for any year.

.03 If a taxpayer desires to change its method of accounting for package design costs and this revenue procedure does not apply, the taxpayer must comply with the requirements of section 1.446-1(e)(3) of the regulations and Rev. Proc. 84-74, 1984-2 C.B. 736. *See*, however, Notice 88-78, 1988-2 C.B. 394, which modifies the provisions of Rev. Proc. 84-74 with respect to certain changes in method of accounting under section 263A.

SEC. 5. APPLICATION

.01 *The Capitalization Method.* The costs of developing a package design as defined in section 2 of this revenue procedure must be capitalized if the asset created by those costs has a useful life greater than one year. These costs may be deducted only upon the subsequent disposition (including abandonment) of the package design. *See* Rev. Rul. 89-23.

.02 *Method of Accounting.* The treatment of the costs of developing a package design, as defined in section 2 of this revenue procedure, in accordance with the capitalization method, as defined in section 5.01 of this revenue procedure, constitutes a method of accounting.

.03 *Consent.* In accordance with section 1.446-1(e)(3)(ii) of the regulations, the Commissioner hereby waives the 180-day rule, and, in accordance with section 1.446-1(e)(2)(i), hereby grants consent to a taxpayer to change its method of accounting for package design costs to the capitalization method defined in section 5.01 of this revenue procedure, provided the taxpayer complies with the provisions and conditions of this revenue procedure. *See* section 7 of this revenue procedure regarding compliance with the conditions of this revenue procedure. This consent is granted for the tax year (year of change) for which a taxpayer requests a change by filing a current Form 3115 in the manner described in section 8 of this revenue procedure.

.04 *Section 481(a) adjustment.* The section 481(a) adjustment shall be taken into account in the manner set forth in section 6 of this revenue procedure.

SEC. 6. SECTION 481(a) ADJUSTMENT.

.01 *Computation of section 481(a) adjustment.* Section 481(a) of the Code prescribes the rules to be followed in computing taxable income in cases in which the taxable income of a taxpayer is computed under a method of accounting different from the method used to compute the taxable income for the preceding tax year. An adjustment is required to prevent duplication or omission of items when a taxpayer changes its method of accounting. In the present situation, the section 481(a) adjustment, which will be positive, will restore to income (1) the total amounts previously deducted or amortized with respect to all package designs still in use in the taxpayer's trade or business on the first day of the tax year of change, and (2) the total amounts previously deducted or amortized with respect to all package designs not yet placed in service on the first day of the tax year of change, and not abandoned. The section 481(a) adjustment is the difference at the beginning of the tax year of change between the basis of such property determined under the taxpayer's present method and the basis redetermined by applying the provisions of section 263 and the regulations thereunder to costs incurred before January 1, 1987, and section 263A and the regulations thereunder to costs incurred after December 31, 1986 (regardless of the taxpayer's taxable year). The section 481(a) adjustment shall be taken into account in computing taxable income in the manner provided in section 6.02 below. For purposes of determining the amount of the section 481(a) adjustment, the approved change shall be considered a change in method of accounting initiated by the taxpayer; therefore, the section 481(a) adjustment is not to be reduced in any way by a pre-1954 amount.

.02 *Section 481(a) adjustment period.*

(1) With respect to taxpayers who have previously complied, on a timely basis, in accounting for package design costs under the provisions of section 263A of the Code or, alternatively, who comply in accounting for package design costs under the provisions of section 263A by filing an amended return as provided in Notice 88-78, 1988-2 C.B.

394, the appropriate period (adjustment period) for taking into account the positive adjustment (which will be attributable solely to costs incurred prior to January 1, 1987) referred to in section 6.01, is determined as follows:

(a) If the entire amount of the adjustment is attributable to the tax year immediately preceding the year of change (first preceding year), the total adjustment is to be taken into account in computing taxable income for the year of change. The amount attributable to the tax year immediately preceding the year of change is the amount of the adjustment determined under section 481(a) of the Code for the year of change less the amount of the adjustment that would have been required under section 481(a) if the same change in method of accounting had been made for such preceding year.

(b) If subparagraph (a) of this section 6.02(1) does not apply, the method of accounting that is being changed has been used for more than 4 tax years, and 67 percent or more of the adjustment is attributable to the 1-tax-year period, 2-tax-year period, or 3-tax-year period immediately preceding the year of change, the highest percent attributable to such 1-, 2-, or 3-tax year period is to be taken into account ratably over a 3-tax-year period beginning with the year of change. Any remaining balance is to be taken into account ratably over an additional period equal to the remainder of the number of tax years the taxpayer has used the method of accounting that is being changed. However, the total adjustment period shall not exceed 6 tax years. The amount attributable to the 1-, 2-, or 3-tax-year period immediately preceding the year of change is the amount of the adjustment determined under section 481(a) of the Code for the year of change less the amount that would have been required under section 481(a) if the same change had been made at the beginning of such preceding 1-, 2-, or 3-tax-year period. If the method of accounting being changed has been used for 4 tax years, 75 percent shall be substituted for 67 percent.

(c) In all other situations described in this section 6.02(1) to which subparagraphs (a) and (b) of this section 6.02(1) do not apply, the adjustment is to be taken into account ratably over the lesser of (1) the number of years the taxpayer has used the method of accounting that is being changed or (2) 6 tax years.

(2) With respect to taxpayers who have not previously complied, on a timely basis, in accounting for package design costs under the provisions of section 263A of the Code, and have not complied and will not comply in accounting for package design costs under the provisions of section 263A by filing an amended return as provided in Notice 88-78, 1988-2 C.B. 394, the positive adjustment will be attributable to costs incurred both before January 1, 1987, and after December 31, 1986. The portion of the section 481(a) adjustment referred to in section 6.01 that is attributable to costs incurred before January 1, 1987, shall be taken into account in accordance with the provisions of section 6.02(1)(a), (b) and (c), and the portion of the section 481(a) adjustment referred to in section 6.01 that is attributable to costs incurred after December 31, 1986 shall be taken into account in full in the tax year of change. See section II of Notice 88-78, 1988-2 C.B. 394.

(3) In applying section 6.02(1), if a taxpayer's books and records do not contain sufficient information to compute the section 481(a) adjustment that would have been required if the same change had been made at the beginning of such preceding 1-, 2-, or 3-tax-year period, the taxpayer may reasonably estimate these amounts, attach the computations upon which the estimates are based, and also sign the following statement and attach it to the Form 3115:

> Under penalties of perjury, I hereby certify that:
> (a) The books and records of [name of the taxpayer] do not contain sufficient information to permit a computation of the section 481(a) adjustment attributable to the 1-tax-year period, 2-tax-year period, or 3-tax-year period immediately preceding the year of change as required by section 6.02(1) of Rev. Proc. 89-16.
> (b) Based on the information that is contained in such records, to the best of my knowledge and belief, the entire amount of the section 481(a) adjustment for the year of change [indicate either "is" or "is not," as the case may be] attributable to the tax year immediately preceding the year of change, and 67 percent [or "75 percent," in applicable cases] or more of the section 481(a) adjustment for the year of change [indicate "is" or "is not," as the case may be] attributable to the 1-tax-year period, 2-tax-year period, or 3-tax-year period immediately preceding the year of change.

(4) For examples of the application of the rules prescribed in section 6.02(1) with respect to the appropriate period for taking into account the section 481(a) adjustment, see section 5.14 of Rev. Proc. 84-74.

.03 *Ceasing to engage in the trade or business.*

(1) With respect to a corporation:

If a corporation ceases to engage in the trade or business to which the adjustment described in section 6.01 relates at any time prior to the expiration of the adjustment period referred to in section 6.02, the taxpayer shall take into account in that year the balance of the adjustment not previously taken into account in computing taxable income. *See* Rev. Rul. 80-39, 1980-1 C.B. 112, which holds that, in the case of a corporation with a different division for each trade or business, if the corporation ceases to engage in the trade or business of a division that has been granted a change in method of accounting, the remaining portion of the section 481(a) adjustment applicable to that trade or business must be taken into account in computing income in the year the corporation ceases to engage in that trade or business. For purposes of section 6.03, the taxpayer is not considered to have ceased to engage in a trade or business if its assets have been acquired by another corporation in a transaction to which section 381 of the Code applies, but in that case the acquiring corporation shall continue to be subject to this revenue procedure as though it were the acquired corporation.

(2) With respect to a partnership:

In the event a partnership terminates (within the meaning of section 708(b) of the Code) or ceases to engage in the trade or business to which the adjustment described in section 6.01 relates at any time prior to the expiration of the adjustment period referred to in section 6.02, the balance of the adjustment not previously taken into account in computing ordinary income shall be taken into account in that year. A partnership is treated as ceasing to engage in a trade or business upon the incorporation of the trade or business in a transaction to which section 351 of the Code applies (see Rev. Rul. 85-134, 1985-2 C.B. 160).

(3) With respect to a sole proprietor:

If an individual (sole proprietor) ceases to engage in the trade or business to which the adjustment described in section 6.01 relates at any time prior to the expiration of the adjustment period referred to in section 6.02, the balance of the adjustment not previously taken into account in computing taxable income shall be taken into account in that year. A sole proprietor is treated as ceasing to engage in a trade or business upon the incorporation of the trade or business in a transaction to which section 351 of the Code applies (see Rev. Rul. 77-264, 1977-2 C.B. 187). A sole proprietorship is not treated as ceasing to engage in a trade or business upon the sale of a partial interest in the proprietorship if the individual who was the sole proprietor continues to be actively engaged in the management of the business and it is subsequently operated as a partnership. The section 481(a) adjustment remaining at the time the partnership is formed is taken into account by the sole proprietor in computing the sole proprietor's own taxable income as though there had been no change in ownership (see Rev. Rul. 66-206, 1966-2 C.B. 206).

.04 *Permanent reduction in account for package design costs.*

If, on the last day of any tax year of the adjustment period referred to in section 6.02, the balance of the taxpayer's account for capitalized and unamortized package design costs to which the adjustment described in section 6.01 relates is reduced by more than 33 1/3 percent of the account balance at the beginning of the first tax year of the adjustment period and is so reduced by at least such percentage at the end of the following tax year, the remaining balance of the adjustment must be taken into account in determining taxable income in the year succeeding the year of reduction. If the balance of the account for package design costs does not remain reduced for one year, the reduction is not considered permanent and the provisions of this paragraph do not apply.

.05 *Net operating loss carryovers and net operating losses.*

No part of any (consolidated or separate) net operating loss (NOL) carryover available at the beginning of the year of change may be used as an offset against the portion of the positive section 481(a) adjustment taken into account in the year of change. That is, the NOL carryover available at the beginning of the year of change may be offset only against income (other than the section 481(a) adjustment) generated in the year of change. This condition does not apply to years subsequent to the year of change. Any portion of the positive section 481(a) adjustment attributable to the year of change may be offset against any NOL otherwise incurred in the year of change as well as against any future NOL carryback under section 172(b) of the Code.

.06 *Credit carryover.*

No part of any (consolidated or separate) credit carryover available at the beginning of the year of change may be used to reduce the federal income tax liability resulting from, or attributable to, the inclusion in income of a portion of the section 481(a) adjustment in the year of change.

SEC. 7. COMPLIANCE WITH CONDITIONS

A taxpayer making a change in method of accounting from currently deducting package design costs to capitalizing such costs without complying with all the conditions of this revenue procedure has made a change in method of accounting without obtaining the consent of the Commissioner that is required under section 446(e) of the Code.

SEC. 8. MANNER OF EFFECTING THE CHANGE

.01 A taxpayer applying for a change in method of accounting pursuant to this revenue procedure must complete and file a current Form 3115 in duplicate.

(1) The original shall be attached to the taxpayer's timely filed (determined with regard to extensions) federal income tax return for the year of change.

(2) A copy of the Form 3115 shall be filed with the National Office addressed to the Commissioner of Internal Revenue, P.O. Box 7616, Benjamin Franklin Station, Washington, D.C. 20044, (a) within 270 days after the beginning of the tax year of change or (b) if later, on or before September 2, 1989, which is 180 days after the publication of this revenue procedure in the Internal Revenue Bulletin. If the taxpayer is described in section 4.02(1) through (3) of this revenue procedure (concerning taxpayers that must obtain special consent in order to use this revenue procedure), then "October 2, 1989" shall be substituted in the prior sentence in lieu of "September 2, 1989". No user fee is required for an application filed under this revenue procedure.

.02 In addition to including all of the information required on the Form 3115, the taxpayer must: (1) state that it agrees to all of the conditions of Rev. Proc. 89-16 and that it proposes to take the section 481(a) adjustment into account over the appropriate period required by section 6.02(1); and (2) indicate the period over which the section 481(a) adjustment will be taken into account and the basis for such conclusion. If the Service finds that the taxpayer does not qualify for the change in method of accounting under this revenue procedure, the National Office or the district director will so advise the taxpayer.

.03 In order to assist in the processing of these changes in method of accounting and to insure proper handling, reference to this revenue procedure shall be made a part of the Form 3115 by either typing or legibly printing the following statement at the top of page 1 of Form 3115: "FILED UNDER REV. PROC. 89-16."

.04 The signature of the person requesting the change in method of accounting and authorized to sign the Form 3115 must appear in the space provided for it on the Form 3115. For example, an officer must sign on behalf of a corporation, a general partner on behalf of a partnership, a trustee on behalf of a trust, or the individual taxpayer on behalf of a sole proprietorship. *See* the signature requirements set forth in the General Instructions attached to a current Form 3115 for those who are to sign.

.05 If the taxpayer is a member of an affiliated group that has elected to file a consolidated federal income tax return, a Form 3115 submitted on behalf of the taxpayer must be signed by a duly authorized officer of the common parent. *See* section 1.1502-77 of the regulations.

.06 If an agent is authorized to represent the taxpayer before the Service, to receive the original or copy of correspondence concerning the request, or to perform any other act(s) regarding the application 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 subsection will not be given any information regarding the application.

.07 For early applications, except as stated below, see section 5.03 of Rev. Proc. 84-74. The statement (described in section 8.02 of this revenue procedure) to be typed or legibly printed at the top of page 1 of the Form 3115 should read: "EARLY APPLICATION FILED UNDER REV. PROC. 89-16." Within the first 270 days after the beginning of the year of change, the taxpayer must file with the National Office a copy of a complete and perfected Form 3115. The original of the complete and perfected Form 3115 is to be attached to the taxpayer's timely filed (determined with regard to extensions) federal income tax return for the year of change. Unlike the early application procedure under Rev. Proc. 84-74, the taxpayer will not be notified during the 270-day period if the early application has not been perfected.

SEC. 9. INQUIRIES

Inquiries regarding this revenue procedure may be addressed to the Commissioner of Internal Revenue, CC:C:4, 1111 Constitution Avenue, N.W., Washington, D.C. 20224.

SEC. 10. EFFECTIVE DATE

This revenue procedure is effective March 6, 1989, the date of its publication. Any request for change in method of accounting filed under the provisions of Rev. Proc. 84-74 that qualifies under this revenue procedure and is received in the National Office after the effective date will be returned to the taxpayer. Any taxpayer that has timely filed a Form 3115 under Rev. Proc. 84-74 with the National Office prior to the effective date of this revenue procedure and that has not filed its federal income tax return for the year of change may use the automatic provisions of this revenue procedure if such taxpayer otherwise qualifies under this revenue procedure and will be notified to this effect by the National Office.

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26 CFR 601.204: Changes in accounting period and in methods of accounting.
(Also Part I, Sections 167, 263, 263A, 446, 481; 1.167(a)-3, 1.263(a)-2, 1.263A-1T, 1.446-1, 1.481-5.)

Rev. Proc. 89-17

SECTION 1. PURPOSE

This revenue procedure allows taxpayers that incur package design costs (as defined in section 2 of this revenue procedure) to deem the useful lives of certain package designs to be 60 months.

SEC. 2. DEFINITIONS

For purposes of this revenue procedure, the term "package design" means an asset that is created by a specific graphic arrangement or design of shapes, colors, words, pictures, lettering, and so forth on a given product package, or the design of a container with respect to its shape or function.

The term "package design cost", as used in this revenue procedure, means the cost of package designs. If the taxpayer develops the package design, the term includes the cost of materials, labor, and overhead associated with the design. If an independent contractor performs the work, the term includes all billings related to the development of the particular package design. Whether a package design is created in-house or is created by an independent contractor, the term includes all design exploration and study, 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. (*See also* section 1.263A-1T(a)(5)(ii) of the regulations that treats a taxpayer purchasing a package design as also producing such design to the extent the taxpayer incurs costs with respect to the design). the term, however, does not include costs associated with coupon inserts, refund offers,and other promotion-related changes, nor does it include costs that are unrelated to the package design itself, such as a change to the list of ingredients. Moreover, the term does not include costs that would have qualified as "trademark or trade name expenditures" under section 177 of the Internal Revenue Code of 1954 (the 1954 Code).

SEC. 3. BACKGROUND

.01 Because intangible assets created by package design costs generally have useful lives greater than one year, those costs generally must be capitalized, either under section 263A of the Code (for purchase costs and production costs incurred after December 31, 1986) or section 263 (for purchase costs and production costs incurred prior to January 1, 1987). See Rev. Rul. 89-23, page 85, this Bulletin. Rev. Rul. 89-23 also notes that, in general, the cost of package designs may not be amortized because their useful lives cannot be ascertained.

.02 To minimize disputes regarding the useful lives of individual package designs, the Service, as a matter of administrative convenience, will allow taxpayers to elect to deem the useful lives of certain package designs to be 60 months.

SEC. 4. SCOPE

This revenue procedure applies only to package designs (as defined in section 2 of this revenue procedure) placed in service in a tax year for which the taxpayer files its federal income tax return properly using a capitalization method of accounting with respect to its package design costs (as defined in section 2 of this revenue procedure). *See* Rev. Proc. 89-16, page 822, this Bulletin, which automatically grants the Commissioner's consent to certain taxpayers that are required to change to a capitalization method of accounting with respect to their package design costs, both with respect to package design costs incurred prior to January 1, 1987 (change in method of accounting made pursuant to section 263 of the Code) and package design costs incurred after December 31, 1986 (change made pursuant to section 263A). *See also* Notice 88-78, 1988-2 C.B 394, which provides guidance and procedural information to taxpayers that fail to change their method of accounting in order to conform to the uniform capitalization rules in accordance with the effective date provisions of section 263A.

SEC. 5 APPLICATION

.01 As a condition to a taxpayer electing pursuant to this revenue procedure to deem the useful lives of certain of its package designs to be 60 months, the taxpayer first must change its method of accounting for package design costs to a capitalization method (to the extent it is not already on a capitalization method). The required change in method of accounting is both with respect to package design costs incurred prior to January 1, 1987, and package design costs incurred after December 31, 1986. *See* Rev. Proc. 89-16.

.02 If an election has been made under this revenue procedure, with respect to a package design, the useful life of that package design is deemed to be 60 months. Thus, in computing taxable income, the cost of the package design would be allowed as a deduction ratably over a 60-month period, beginning with the month the design is placed in service. If the package design is disposed of or abandoned within the 60-month period, the taxpayer would be permitted to deduct the unamortized portion of the cost of the design in the taxable year of disposition or abandonment.

.03 With respect to one or more package designs described in section 4 that are placed in service in a tax year, a taxpayer makes an election under this revenue procedure as follows:

(1) The taxpayer must attach a statement to its timely filed (determined with regard to extensions) federal income tax return for the year in which the package designs are placed in service.

(2) The statement must indicate that, for specified package designs, the taxpayer is electing the 60-month deemed useful life provided in Rev. Proc. 89-17.

(3) The statement must provide a description of the particular package design(s) with respect to which the election is made, the date on which each was placed in service, and the cost basis of each.

.04 If no election is timely made for a package design, that package design remains subject to the federal income tax treatment described in Rev. Rul. 89-23.

SEC. 6. EFFECTIVE DATE

This revenue procedure is effective for package designs placed in service in tax years ending on or after March 6, 1989, the date of publication.

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26 CFR 601.201: Rulings and determination letters.

Rev. Proc. 89-18

SECTION 1. PURPOSE

.01 As of January 31, 1988, the Internal Revenue Service will begin to maintain an automated file of Reporting Agents Authorization (RAAs) for client/taxpayers whose returns can be filed on magnetic tape. The purpose of this file, known as the Reporting Agents File (RAF), is twofold:

1) to permit rapid verification of the identity of a reporting agent when the need to discuss a taxpayer's account arises.
2) to permit the issuance of duplicate copies of official notices to the authorized agent as well as the taxpayer.

.02 The purpose of this Revenue Procedure is to provide instructions for the preparation and submission of Form 8655, Reporting Agent Authorization.

.03 The Reporting Agent Authorization (RAA) is a multi-use form that allows taxpayers to designate reporting agents:

1) to file certain employment tax returns on magnetic tape,
2) to submit federal tax deposits on magnetic tape for certain employment tax returns

.04 If a taxpayer has designated a reporting agent to file certain employment tax returns on magnetic tape, then the taxpayer may authorize the agent to receive copies of notices and correspondence with respect to those employment tax returns.

.05 Currently, agents designated to submit federal tax deposits on behalf of a taxpayer are not authorized to receive notices and copies of correspondence, if they are not also authorized to file the tax return on magnetic tape.

SECTION 2. REPORTING AGENT AUTHORIZATION

.01 The RAA may be submitted on Form 8655 (see exhibit #1), which is available on request; or any other instrument which clearly states that the reporting agent is granted the authority to file and sign the return or submit federal tax deposits. The RAA filed under this revenue procedure is not subject to the rules contained in the Conference and Practice Requirements (Treasury Regulation 601.502). If desired, the RAA may cover both the filing of returns on magnetic tape and the submission of federal tax deposits on magnetic tape. It is the responsibility of the reporting agent to ensure that the requirements specified in this revenue procedure are met for those authorizations currently on file and those submitted in the future.

.02 The taxpayer, or his/her authorized representative, must sign the RAA. If, however, "authorized representative" includes the holder of a general power of attorney, additional precautions are needed to assure that the person executing the RAA has been specifically authorized, himself/herself, to sign returns on behalf of the taxpayer. If the taxpayer wishes to authorize the reporting agent to receive employment return notices, correspondence, and transcripts from the Internal Revenue Service, the authorized representative must be someone with authority both to receive, and to designate others to receive, return information of the taxpayer. The signed document will remain in effect until such time as it is revoked by written notification from the taxpayer, the reporting agent, or terminated by the Internal Revenue Service.

1. The following persons may execute an RAA on behalf of a corporation or other business taxpayer: .
   (a) The individual, if the person required to make the return is an individual;
   (b) The corporate president, chief executive officer or an officer authorized by law to bind the corporation, if the entity required to make the return is a corporation. These individuals may designate recipients of return information on behalf of a corporation. Additionally, with attestation by the corporation's secretary or other officer, any principal officer of the corporation may designate recipients of the corporation's return information;
   (c) A responsible and duly authorized member or officer having knowledge of its affairs, if the person required to make the return is a partnership or other unincorporated organization. A nonpartner officer of a partnership or other unincorporated organization may designate recipients of return information only if that officer has been granted authority to receive, and to re-delegate authority to receive, the return information of the partnership or organization;
   (d) The fiduciary, if the entity required to make the return is a trust or estate; or
   (e) An agent who is duly authorized in accordance with section 31.6011(a)-7 of the Employment Tax Regulations, provided the authorization explicitly states that the agent may both receive and designate recipients of the taxpayer's return information, if the form is used to designate the reporting agent as a recipient of return information.

.03 The scope of the RAA for magnetic tape filing of certain employment tax returns will be governed by the following instructions:

1. RAA will delegate to the reporting agent the power to sign and file appropriate federal tax returns.
2. The RAA becomes effective for the tax period designated by the agent/taxpayer and remains in effect for subsequent periods until revoked, or terminated. The RAA must be submitted timely and the Service must validate it prior to returns being filed by the agent (see Section 3).
3. The receipt of an RAA for magnetic tape filing revokes all prior reporting agent authorizations but has no effect on any other

power of attorney or authorization.

4. The RAA may authorize the reporting agent to receive copies of notices, correspondence and transcripts with respect to employment returns filed by the designee.
5. Requests from a reporting agent for information or adjustments on an account for which the taxpayer has authorized magnetic tape filing will be honored by the service center.

.04 The scope of the RAA for submission of federal tax deposits on magnetic tape will be governed by the following instructions:

.1 The RAA will delegate to the reporting agent the power to prepare and submit FTDs for taxes reported on Forms 940, 941 and 943.

.2 The RAA becomes effective for the tax period the agent/taxpayer notifies the Service that he/she is responsible for submitting federal tax deposits and remains in effect until revoked or terminated. The RAA must be submitted timely and the Service must validate it prior to any submission of federal tax deposits by the agent (see Section 3).

.3 An RAA that is limited to submitting FTDs for a taxpayer does not entitle the agent to receive copies of notices and correspondence for a taxpayer. It does permit an agent to request information or submit information on the deposits submitted by the agent. This includes any penalties that may result from such deposits.

.05 An RAA can be prepared to cover both functions, magnetic tape filing of certain employment tax returns and magnetic tape submission of federal tax deposits in payment of the taxes reported on certain employment tax returns.

.1 If the RAA covers both functions, the taxpayer may authorize the agent to receive copies of notices and correspondence with respect to employment tax returns filed by the designee.

.2 If one function of the RAA (either magnetic tape filing or FTD submission) is revoked, the other remains in effect. However, if a return is added to a function, a new RAA must be submitted.

.06 Requests for taxpayer address changes may not be made by the reporting agent. Requests for address changes for taxpayers that are reported under magnetic tape filing will be processed only if they originate with one of the following:

(a) The taxpayer,

(b) An employee of the Service, or

(c) An attorney-in-fact if the attorney has a full Power of Attorney for all tax matters concerning a taxpayer, and has filed a copy of the Power of Attorney with the Service.

SECTION 3. SUBMISSION OF REPORTING AGENT AUTHORIZATIONS

.01 Reporting Agents (RAs) who desire to file client/taxpayer employment tax returns on magnetic tape or make magnetic tape submission of federal tax deposits relating to employment taxes must formally apply to the Internal Revenue Service for these privileges. Currently, the required information for these applications is contained within Revenue Procedures for Form 940 magnetic tape filing, for Forms 941/941E magnetic tape filing, and for submission on magnetic tape of Federal Tax Deposits for employment taxes. Contact the Internal Revenue Service at the addresses listed in section 6 for copies of the current revenue procedures.

.02 The applications governed by the referenced revenue procedures must be accompanied by the individual RAAs and a list of client/taxpayers for whom magnetic tape returns will be filed and/or federal tax deposits will be made.

.03 The list must be accompanied by a copy of the reporting agent authorizations (RAAs) signed by the taxpayer or authorized representative (See Section 2.01). A photocopy is acceptable. If, however, ''authorized representative'' includes the holder of a general power of attorney, additional precautions are needed to assure that the person executing the RAA has been specifically authorized, himself/herself, to sign returns on behalf of the taxpayer. The authorized representative must be someone with authority both to receive, and to designate others to receive, return information of the taxpayer.

.04 There are two methods of submitting the list of taxpayers for whom magnetic tape returns will be filed and/or federal tax deposits will be submitted; magnetic tape and paper listings. If the reporting agent wishes, he/she may always file the list on magnetic tape, but if the number of client/taxpayers for filing of magnetic tape returns exceeds 100, then the list must be filed on magnetic tape.

.05 Lists submitted on magnetic tape must be submitted in accordance with the specifications in sections 7 and 8. Magnetic tapes submitted with a significant number of errors will be returned to the Reporting Agent (RA) for correction. The magnetic tape file list can contain information on both magnetic tape return filing and magnetic tape submission of FTDs.

.06 Lists submitted on paper must be submitted in duplicate using the format indicated in exhibit #2 for both magnetic tape filing of returns and for submission of federal tax deposits.

.07 If in the course of business, the reporting agent wishes to add or delete client/taxpayers from his/her current authorized list, the format for both the magnetic tape file and the paper list is the same as for the initial listing submission.

.08 The list of additions or deletions should not exceed 500. Once an inventory of 500 is reached, it should be forwarded to the Service. If the submission exceeds 500, we cannot guarantee the records will be processsed within 30 days.

.09 The list of taxpayers to be added to the magnetic tape filing system and magnetic tape FTD submission system must be submitted by certain deadlines. This is because the Service requires time to validate the information on the list and the associated RAAs and to return a validated listing to the reporting agent.

.10 The deadlines must be met to enable the Service to return a validated listing to the Reporting Agent with a name control for each taxpayer listed. Under no circumstance should the Reporting Agent submit a taxpayer's return or FTD submission on magnetic tape without return of the validated listing from the Service with a name control for each taxpayer. The validated listing is the confirmation that the RAA has been accepted. In addition, the Service will notify the reporting agent if the taxpayer's return should be filed at a different service center from the one at which the taxpayer's last return was filed. If the Service has agreed to let the reporting agent consolidate filing in one Service Center, no additional confirmation will be made.

.11 The deadlines for the lists on paper or magnetic tape are the same, the first day of the last month of the tax period (period covered by the return). As an example, lists for RAAs involving Forms 940 and 943 must be submitted by the first day of December. Lists for RAAs involving Forms 941/941E must be submitted by the first day of the last month of the calendar quarter.

.12 When the reporting agent determines that he/she will no longer be filing tax returns or making FTD submissions for a taxpayer, action should be taken to notify the service center which accepted the RAA of one of the following conditions. This is done in association with submission of a delete list.

1. The delete list (paper or magnetic tape) should be accompanied by a statement (signed by the taxpayer or the reporting agent) for each taxpayer stating the taxpayer is out of business (state the effective date) and will no longer be liable for filing returns (Final Return) or making deposits.
2. The delete list (paper or magnetic) should be accompanied by a statement indicating the reporting agent will no longer be submitting returns or deposits on magnetic tape for the taxpayer who is still in business and is still liable for such returns (Discontinued Clients). This item may be included on the transmittal letter.

.13 The preparation of a paper listing (exhibit #2) is reasonably self explanatory. The following addresses questions that might arise. Examples of entries are provided on the exhibit.

1. Name and Address of Reporting Agent — self explanatory.
2. Agent Identifying Number — Two digit number assigned by IRS to reporting agents who submit federal tax deposits (not Employer Identification Number).
3. Agent Employer Identification Number — self explanatory.
4. List Type — Either Additions or Deletions. Separate paper lists must be prepared for additions and deletions.
5. Name of Agents Contact Point.
6. Phone Number of Agents Contact Point.
7. Client Account Number — Optional for benefit of agents.
8. Employer Identification Number — Of taxpayer.
9. Name Control — Blank when submitted by Agent. Will be filled in when returned to agent by IRS.
10. Taxpayer Name and Address — self explanatory.
11. RAA submitted for
    a) Return Filing 940 — Enter YYMM if RAA covers it. (see Section 7 for YYMM explanation)
    b) Return Filing 941 or 941E — Enter YYMM if RAA covers it.
    c) FTD submission 940 — Enter YYMM if RAA covers it.
    d) FTD submission 941 — Enter YYMM if RAA covers it.
    e) FTD submission 943 — Enter YYMM if RAA covers it.
    f) Notice to Agent — Put X if RAA covers it, but only if Return Filing is also covered.
12. Local Service Center — Service Center where taxpayer last filed taxreturns. Use the following abbreviations:
    ANSC = Andover, ATSC = Atlanta, AUSC = Austin, BSC = Brookhaven, CSC = Cincinnati, FSC = Fresno, KCSC = Kansas City, MSC = Memphis, OSC = Ogden, PSC = Philadelphia

SECTION 4. REPORTING AGENTS FILE

.01 By October 1, 1987, the service centers will be prepared to accept magnetic tape submissions from reporting agents. By November 1, 1987, all current reporting agents must submit lists of their current client/taxpayers using the format specified in Sections 7 and 8 (magnetic tape format). No copies of the authorizations need be submitted with these special lists. Delay in submitting these lists will delay the inclusion of the RAAs on the RAF and delay the receipt of benefits to be derived from it.

.02 The taxpayer record described in Exhibit 11 needs some clarification in its application to the special November 1, 1987 submission. The use of the fields is as described in Exhibit 11 with the following clarifications:

1. Positions 1-116 — Use as described in Exhibit 11.
2. Position 117 — Enter "Y", if Forms 940 are authorized to be filed on magnetic tape.
3. Positions 118-121 — Enter YYMM date of earliest return filed by taxpayer through magnetic tape for which you would wish to receive notices.
4. Position 122 — Enter "A".
5. Position 123 — Enter "Y", if Forms 941 are authorized to be filed on magnetic tape.
6. Position 124-127 — Enter YYMM date of earliest return filed by taxpayer through magnetic tape for which you would wish to receive notices.
7. Position 128 — Enter "A"
8. Positions 129-158 — Blank fill.
9. Positions 159-168 — Client Account Number, Optional use.
10. Position 169 — Enter "N" for all taxpayers for which an RAA is on file authorizing you to receive notices.
11. Positions 170-173 — Blank fill.
12. Positions 174-200 — Blank fill.

.03 The Internal Revenue Service will reconcile their existing files with the special submissions of the agents and will notify the agents of discrepancies with respect to missing authorizations and to authorizations no longer on the current list.

SECTION 5. FTD ONLY REPORTING AGENTS AUTHORIZATIONS

.01 At present, the Service will continue to manually maintain a file of RAAs that authorize federal tax deposit magnetic tape submissions without authorizing magnetic tape filing.

.02 These authorizations will be used to verify the right of an agent to discuss a taxpayer's account as it relates to federal tax deposits.

SECTION 6. ADDITIONAL INFORMATION

Requests for additional copies of this revenue procedure, requests for copies of appropriate input record element specifications, and requests for tape filing information should be addressed to the Director, Internal Revenue Service Center, at one of the following addresses:

1. North-Atlantic Region
    (a) Andover Service Center
    Management Support
    Branch, Mail Stop 105
    310 Lowell Street
    Andover, MA 05501
    (b) Brookhaven Service Center
    Management Support
    Branch, Mail Stop 110
    1040 Waverly Avenue
    Holtsville, NY 11742

2. Mid-Atlantic Region
   (a) Philadelphia Service Center
   Taxpayer Relations Branch,
   Drop Point 535
   P.O. Box 245
   Bensalem, PA 19020
3. Central Region
   (a) Cincinnati Service Center
   Management Support
   Branch, Mail Stop 2
   P.O. Box 267
   Covington, KY 41019
4. Southeast Region
   (a) Atlanta Service Center
   Management Support
   Branch, Mail Stop 30
   P.O. Box 47-421
   Doraville, GA 30362
   (b) Memphis Service Center
   Management Support
   Branch, Mail Stop 32
   P.O. Box 30309
   Airport Mail Facility
   Memphis, TN 38130
5. Midwest Region
   (a) Kansas City Service Center
   Management Support
   Branch, Mail Stop 3
   P.O.Box 24551
   Kansas City, MO 64131
6. Southwest Region
   (a) Austin Service Center
   Management Support
   Branch, Mail Stop 1055
   P.O. Box 934
   Austin, TX 78767
   (b) Ogden Service Center
   Management Support
   Branch, Mail Stop 1055
   1160 West 1200 South
   Ogden, UT 84201
7. Western Region
   (a) Fresno Service Center
   Management Support
   Branch, Mail Stop 28
   P.O. Box 12866
   Fresno, CA 93779

SECTION 7. CONVENTIONS AND DEFINITIONS

.01 Conventions

(a) Reporting Agents who submit their initial or add and delete lists on magnetic tape must conform to Level 3 of the ANSI Standard X3.27-1978 (Magnetic Tape Labels and File Structure for Information Interchange). Specifically this calls for recognition of the following label types: VOL1,HDR1, HDR2, EOV1, EOV2, EOF1, and EOF2 (see Exhibits 3 through 9 for specific label specifications). There will be no user labels or non-labeled tapes accepted for processing.

(b) Record Mark

No restrictions apply to record marks.

(c) Tape Mark

The tape marks will be automatically generated for an interchange tape (defined in Section 7.01). An example is provided in Section 8. Magnetic Tape Specifications .02.

.02 Definitions

Element	Description
Blocked Records	Two or more records grouped together between interrecord gaps.
Blocking Factors	The number of records grouped together to form a block.
b	Denotes a blank position.
EIN	Employer Identification Number.
File	A file consists of all tape records submitted by a reporting agent.
FTD	Federal Tax Deposit.
POA	Power of Attorney.
RAA	Reporting Agent Authorization.
Record	A group of related fields of information, treated as a unit.
Record Mark	Special character used either to limit the number of characters in data transfer or to separate blocked records on tape.
Reel	A spool of magnetic tape.
Reporting Agent	Person or organization preparing and filing magnetic tape equivalents of Federal tax returns and/or submitting federal tax deposits.
Reporting Agent List	List of additions or deletions.
Special Character	Any character that is not a numeral, letter, or blank.
Tape Mark	Special character that is written on tape.
Taxpayer	Persons or organization liable for the payment of tax. The taxpayer will be held responsible for the completeness, accuracy and timely submission of the magnetic tape files.
Unblocked Records	Single records written between interrecord gaps.
YYMM	Year Year Month Month of ending month of tax period in digits. Example: first quarter 1987 returns = 8703, fourth quarter 1987 = 8712, calendar year 1987 = 8712.
YYDDD	Year Year Day Day Day — Last two digits of year plus Julian Day (e.g. January 1st 1988 = 88001, January 31, 1988 = 88031).

SECTION 8. MAGNETIC TAPE SPECIFICATIONS

.01 These specifications prescribe the required format and content of the records to be included in the file, but not the methods or equipment to be used in their preparation. A physical tape reel must have the following physical characteristics:

Type of tape	½ inch Mylar base, oxide coated
Recording density	1600 BPI (bytes per inch)
Parity	Odd
Interrecord Gap	.6 inch for 1600 BPI
Recording Mode	ASCII
Track	9-Track
Recording Format	Reporting Agent will use a recording format of "F" (fixed length records).

.02 An acceptable file will contain, for each reporting agent, the following:

VOL1

HDR1

HDR2

TAPEMARK

REPORTING AGENT RECORD

TAXPAYER RECORD — as many as required, one for each RAA submitted.

END OF FILE TRAILER RECORD

TAPEMARK

EOF1

EOF2

TAPEMARK

TAPEMARK

.03 All records including headers and trailers, if used, must be written at the same density.

.04 Affix an external label to each tape with the following information:

1. Name of reporting agent,
2. Number of RAAS entries (submitted or deleted) on file (even if more than one reel comprises file),
3. Density (1600),
4. Channel (9),
5. Parity (odd),
6. Sequence number of reel and total number of reels in file (for example, 1 of 3).
7. Write in large type:

EXPEDITE
RAA MAGNETIC
TAPE SUBMISSION
DELIVER TO TAPE LIBRARY

.05 Record Length

The tape records prescribed in the specifications must be blocked at one record per block (200 tape character positions).

.06 Data

Only character data may be used. This means numeric fields cannot use overpunched signs and should be right justified with remaining unused positions zero filled. Special characters should be limited to -, &, % or / and can only be used in the name line fields and the street address fields of Reporting Agent ''RA'' Record and Taxpayer ''TP'' Record. Otherwise, characters must be numeric or alphabetic. All numeric data should be in unsigned ASCII characters (no binary data).

.07 Reporting Agent Record

Identifies the reporting agent who prepares and transmits the tape file and the RAAs (see Exhibit 10). The Agent Record must precede the first Taxpayer record reported on the first reel of the file. Contact the Magnetic Tape Coordinator for Business Tax Returns for additional details, if necessary.

.08 Client/Taxpayer Records

1. Taxpayer records contain information for each filer reported by the reporting agent (see Exhibit 11). The number of Taxpayer Records appearing on one tape file will depend on the number of taxpayers represented.
2. All records will be blocked individually with no other records in the block. Records should have a blocking factor for which blocks will not exceed 200 tape character positions. All records must be fixed length. Fields identified as indicators should always carry a value. Other fields must be left justified and blank filled on right with blank filling of non-significant fields.

.09 End of File Trailer Record

This record contains a count of all Taxpayer Records (see Exhibit 12). The Trailer record must be the last record on the agent's tape file. It can be followed only by a tape mark.

SECTION 9. EFFECTIVE DATE

This revenue procedure is completely effective January 31, 1988. However, section 4, which relates to the establishment of the Reporting Agents File and related technical specifications is effective October 1, 1987.

SECTION 10. EFFECT ON OTHER DOCUMENTS

The instructions contained in this revenue procedure supersede authorization information contained in Revenue Procedures for Form 940 magnetic tape filing, for Forms 941/941E magnetic tape filing, and for submissions on magnetic tape of Federal Tax Deposits for employment taxes.

EXHIBIT 1

Form **8655** (July 1988)

Department of the Treasury — Internal Revenue Service

Reporting Agent Authorization

OMB No. 1545-1058
Expires: 06-30-91

1. Taxpayer name	2. Taxpayer identifying number
3. Address	4. City, State, and ZIP code
5. Reporting agent name *(Reporting agents file returns on magnetic tape and/or file Federal tax deposits for a taxpayer.)*	6. Identifying number
7. Reporting agent address	8. City, State, and ZIP code

____________________ is hereby appointed as reporting agent with authority to sign and file Federal employment tax returns on magnetic tape and/or make Federal tax deposits *(FTD)* for the above stated taxpayer.

☐ Check here if the reporting agent is authorized as a designee of the taxpayer to receive copies of notices, correspondence, and transcripts with respect to employment tax returns filed by the designee. This does not apply to authorizations limited to FTD submissions. *(Strike out any language that does not apply.)*

This authorization shall include the following Federal employment tax returns, beginning with the tax period indicated and remaining in effect through subsequent tax periods until notified by the taxpayer or the designee of termination or revocation of this authorization. Indicate which tax forms and/or Federal tax deposits apply.

Magnetic Tape Return Forms Filed	Beginning Period	FTD Payments	Beginning Period
☐ 941	________	☐ 941	________
☐ 941E	________	☐ 943	________
☐ 940	________	☐ 940	________

This reporting agent authorization revokes all earlier reporting agent authorizations but has no effect on any other power of attorney or authorization.

Signature of Taxpayer or Authorized Representative

If the reporting agent is to be authorized to receive notices, correspondence, and transcripts from the Internal Revenue Service, this document must be signed by someone who has authority to receive, and to designate a recipient of, the return information of the taxpayer.

Signature *(Required)*	Title *(If applicable)*	Date *(Required)*

If signed by a corporate officer, partner, or fiduciary on behalf of the taxpayer, I certify that I have the authority to execute this reporting agent authorization on behalf of the taxpayer.

Reporting Agent ▶	Signature	Date

Paperwork Reduction Act Notice

We ask for this information to carry out the Internal Revenue laws of the United States. Your response is voluntary. The estimated average time needed to complete this form, depending upon individual circumstances, is 5 minutes. If you have comments concerning the accuracy of this time estimate or suggestions for making this form more simple, we would be happy to hear from you. You can send your comments to the Internal Revenue Service, Washington, DC 20224, Attention: IRS Reports Clearance Officer TR:FP; or the Office of Information and Regulatory Affairs, Office of Management and Budget, Washington, DC 20503, Attention: Desk Officer for Internal Revenue Service.

Form 8655 (7-88)

EXHIBIT 2

Date of List

Reporting Agent's List

NAME of AGENT ______________________________

STREET ADDRESS ______________________________

CITY, STATE, ZIP ______________________________

Agent Identifying Number (Assigned by IRS) ______________________________

Agent Employer Identification Number ______________________________

List Type (Additions or Deletions) ______________________________

Name of Agent Contact Person ______________________________

Phone Number of Agent Contact Person ______________________________

CLIENT ACCOUNT NUMBER (Optional)	EMPLOYER IDENTI-FICATION NUMBER	NAME CONTROL (IRS SUPPLIED)	TAXPAYER NAME & ADDRESS	RAA SUBMITTED FOR: RETURN FILING 940	RETURN FILING 941	FTD SUBMISSION 940	FTD SUBMISSION 941	FTD SUBMISSION 943	NOTICE TO AGENT	LAST SERVICE CENTER OF FILING
10035	11-3578549		ABC Corp. 111 1st St. NY NY 10024	8812	8803	8812	8803	8812	X	BSC
10037	13-9363939		XYZ Corp. 555 5th Ave. NY NY 10036				8812	8812		BSC

Examples

1) The agent is submitting ABC Corp.'s RAA with the authority to file Forms 940 and 941 and submit FTDs for Forms 940, 941 and 943 with the right to receive copies of notices.

2) The agent is submitting XYZ Corp.'s RAA with the authority to submit FTDs for Forms 941 and 943. No right to receive notices is specified because no returns are being filed.

EXHIBIT 3

VOL1 Label

Character Postion		Acceptable values
1-4	*	VOL1
5-10		"6" digit reel number
11-79	*	Blanks
80	*	3 (indicates current level of ANSI standard)

* Asterisk indicates positions (fields) that are generally system generated (Vendors may differ somewhat). The reporting agent should make entries in all other fields.

EXHIBIT 4

HDR1 Label

Character Position		Acceptable values
1-4	*	HDR1
5-21		This is the file identifier. It is incumbent upon the Reporting Agent to supply this information. Entries must be left justified with blanks in remaining positions. Valid entry is RAF5001.
22-27		''6'' digit reel number
28-31	*	0001
32-35	*	0001
36-39		Specifies the current stage in bracket version in the succession of one file generation by the next. Generally will be 0001.
40-41		01
42-47		Creation Date. This date should be generated by the operating system and have the date the tape was created. The format is ''bYYDDD'' (Julian Date) a lower case ''b'' denotes a blank position.
48-53		Purge Date. This date should be generated by the operating system and have the date the tape will be purged. The format is ''bYYDDD'' (Julian Date) - a lower case ''b'' denotes a blank position. For Service use, specify the purge date as one year after the creation date.
54	*	blanks
55-60	*	zeros (''000000'')
61-80	*	blanks

* Asterisk indicates positions (fields) that are generally system enerated (Vendors may differ somewhat). The reporting agent should make entries in all other fields.

EXHIBIT 5

HDR2 Label

Character Position		Acceptable values
1-4	*	HDR2
5		F (indicator for fixed length records)
6-10		''00200''
11-15	*	All records will be 00200 in length.
16-50	*	blanks
51-52	*	Specify the buffer offset before the first record in the block. This should be 00.
53-80	*	blanks

* Asterisk indicates positions (fields) that are generally system generated (Vendors may differ somewhat). The reporting agent should make entries in all other fields.

EXHIBIT 6

EOF1 Label

Character Position		Acceptable values
1-4	*	EOF1
5-21		This is the file identifier. It is incumbent upon the Reporting Agent to supply this information. Entries must be left justified and blank filled. Valid entry is RAF5001.
22-27		''6'' digit reel number
28-31	*	0001
32-35	*	0001
36-39		Specifies the current stage in bracket version in the succession of one file generation by the next. Generally will be 0001.
40-41		01
42-47		Creation Date. This date should be generated by the operating system and have the date the tape was created. The format is ''bYYDDD'' (Julian Date) — a lower case ''b'' denotes a blank position.
48-53		Purge Date. This date should be generated by the operating system and have the date the tape will be purged. The format is ''bYYDDD'' (Julian Date) — a lower case ''b'' denotes a blank position. For Service use, specify the purge date as one year after the creation date.
54	*	blanks
55-60	*	The number of blocks on the tape reel
61-80	*	blanks

* Asterisk indicates positions (fields) that are generally system generated (Vendors may differ somewhat). The reporting agent should make entries in all other fields.

EXHIBIT 7

EOF2 Label

Character Position		Acceptable values
1-4	*	EOF2
5		F (indicator for fixed length records)
6-10	*	''00200''
11-15	*	All records will be 00200 in length.
16-50	*	blanks
51-52	*	Specify the buffer offset before the first record in the block. This should be 00.
53-80	*	blanks

* Asterisk indicates positions (fields) that are generally system generated (Vendors may differ somewhat). The reporting agent should make entries in all other fields.

EXHIBIT 8

EOV1 Label

Character Position		Acceptable values
1-4	*	EOV1
5-21		This is the file identifier. It is incumbent upon the Reporting Agent to supply this information. Entries must be left justified and blank filled. Valid entry is RAF5001.
22-27		"6" digit reel number
28-31	*	0001
32-35	*	0001
36-39		Specifies the current stage in bracket version in the succession of one file generation by the next. Generally will be 0001.
40-41	01	
42-47		Creation Date. This date should be generated by the operating system and have the date the tape was created. The format is "bYYDDD" (Julian Date) a lower case "b" denotes a blank position.
48-53		Purge Date. This date should be generated by the operating system and have the date the tape will be purged. The format is "bYYDDD" (Julian Date) a lower case "b" denotes a blank position. For Service use, specify the purge date as one year after the creation date.
54	*	blanks
55-60	*	The number of blocks on the tape reel
61-80	*	blanks

* Asterisk indicates positions (fields) that are generally system generated (Vendors may differ somewhat). The reporting agent should make entries in all other fields.

EXHIBIT 9

EOV2 Label

Character Position		Acceptable values
1-4	*	EOV2
5		F (indicator for fixed length records)
6-10		"00200"
11-15	*	All records will be 00200 in length.
16-50	*	blanks
51-52	*	Specify the buffer offset before the first record in the block. This should be 00.
53-80	*	blanks

* Asterisk indicates positions (fields) that are generally system generated (Vendors may differ somewhat). The reporting agent should make entries in all other fields.

EXHIBIT 10

REPORTING AGENT RECORD

General Information

The Reporting Record identifies the Reporting Agent who is submitting the file of client/taxpayers. This record must precede the first Taxpayer Record reported on the first reel of the tape file.

Tape Position	Element Name	Entry or Definition
1-2	Record Type	Enter "RA" to indicate reporting agent header record.
3-4	RA-ID Number	Enter the two digit number assigned by IRS. If none assigned, enter blanks.
5-13	RA-EIN	Enter nine numeric characters of reporting agent's EIN. Do not include hyphen.
14-48	RA-Name	Enter first name line of reporting agent. Valid characters are A-Z, 0-9, ampersand, hyphen, right hand bracket and one blank between each word. The comma, period, number sign, apostrophe and multiple blanks are invalid characters. Left justify and blank fill.
49-83	RA-Second Name Line	Enter second name line of reporting agent, if desired (for Doing Business As (DBA) or Trading As (TA)). Valid characters are A-Z, 0-9, ampersand, hyphen, right hand bracket and one blank. Left justify and blank fill.
84-118	RA Street Address	Enter street address of reporting agent. Valid characters are A-Z, 0-9, ampersand, hyphen, slash "/", percent sign "%" and one blank between each word. Invalid characters are the number sign, period, apostrophe and multiple blanks. Left justify and blank fill.
119-138	RA City	Enter City of reporting agent. Valid characters are A-Z, 0-9, hyphen and one blank. Left justify and blank fill.
139-140	RA State Code	Enter State Code of reporting agent.
141-149	RA Zip Code	Enter zip code of reporting agent.
150-159	RA Phone Number	Enter ten numerics of reporting agent's phone number. Do not include hyphens.
160-195	RA Contact Point	Name of individual to serve as Reporting Agent's primary contact point.
196-200	Reserved	Enter blanks.

EXHIBIT 11

TAXPAYER RECORD

General Information

A Taxpayer record is required for each taxpayer.

See instructions for special November 1987 submission in Section 4.

Tape Position	Element Name	Entry or Description
1-2	Taxpayer Record Type	Enter "TP" to indicate a taxpayer record.
3-11	Taxpayer EIN	Enter 9 numerics of taxpayer EIN. Do not enter hyphens.
12-46	Taxpayer Name	Enter name of taxpayer. Valid characters are A-Z, 0-9, ampersand, hyphen, right hand bracket and one blank between each word. The comma, period, number sign, apostrophe and multiple blanks are invalid characters. Left justify and blank fill.
47-50	Taxpayer Name Control	Enter Name Control of taxpayer as provided by IRS. Use only on delete submissions.
51-85	Taxpayer Street Address	Enter address of taxpayer. Valid characters are A-Z, 0-9, ampersand, hyphen, slash "/", percent "%" and one blank between each word. Invalid charachters are the number sign, period, apostrophe and multiple blanks. Left justify and blank fill.
86-105	Taxpayer City	Enter city of taxpayer. Valid characters are A-Z, 0-9, hyphen and one blank. Left justify and blank fill.
106-107	Taxpayer State Code	Enter State Code of taxpayer.
108-116	Taxpayer Zip Code	Enter zip code of taxpayer.
117	940 Indicator	Enter "Y" if RAA submitted for filing Form 940 on magnetic tape. Enter blank if not.
118-121	940-Tax Period	Enter four digit numeric YYMM tax period for Form 940. Use beginning YYMM if RAA being submitted. Use YYMM of last return to be filed if RAA is being withdrawn. Leave blank if 940 indicator is blank. The earliest valid tax period is 8612.
122	940 Action Code	Enter "A" if RAA is being submitted. Enter "D" if RAA is being withdrawn. Leave blank if 940 indicator is blank.
123	941/941E Indicator	Enter "Y" if RAA submitted for filing Form 941/941E on magnetic tape. Enter blank if not.
124-127	941-Tax Period	Enter four digit numeric YYMM tax period for Form 941/941E. Use beginning YYMM if RAA is being submitted. Use YYMM of last return to be filed if RAA is being withdrawn. Leave blank if 941/941E indicator is blank. The earliest valid tax period is 6903.
128	941/941E Action Code	Enter "A" if RAA is being submitted. Enter "D" if RAA is being withdrawn. Leave blank if 941/941E indicator is blank.
129-140	Reserved for future use. Blank fill.	
141	940 FTD Indicator	Enter "Y" if RAA is for FTD for Form 940. Blank if it does not cover FTDs for Form 940.
142-145	940 FTD Tax Period	Enter four digit numeric YYMM tax period for FTD for Form 940. Use beginning YYMM if RAA being submitted.Use YYMM of last return to be filed if RAA is being withdrawn. Leave blank if 940 FTD indicator is blank.
146	940 FTD Action Code	Enter "A" if RAA is being submitted. Enter "D" if RAA is being withdrawn. Leave blank if 940 FTD indicator is blank.
147	941 FTD Indicator	Enter "Y" if RAA is for FTD for Form 941. Blank if it does not cover FTDs for Form 941.
148-151	941 FTD Tax Period	Enter four digit numeric YYMM tax period for FTD for Form 941. Use beginning YYMM if RAA being submitted. Use YYMM of last return to be filed if RAA is being withdrawn. Leave blank if 941 FTD indicator is blank.
152	941 FTD Action Code	Enter "A" if RAA is being submitted. Enter "D" if RAA is being withdrawn. Leave blank if 941 FTD indicator is blank.

EXHIBIT 11 (Continued)

Tape Position	Element Name	Entry or Description
153	943 FTD Indicator	Enter "Y" if RAA is for Form 943. Blank if it does not cover FTDs for Form 943.
154-157	943 FTD Tax Period	Enter the four digit numeric YYMM tax period for Form 943. Use beginning YYMM if RAA is being submitted. Use YYMM of last return to be filed if RAA is being withdrawn. Leave blank if 943 FTD indicator is blank.
158	943 FTD Action Code	Enter "A" if RAA is being submitted. Enter "D" if RAA is being withdrawn. Leave blank if 943 FTD indicator is blank.
159-168	Client Account Number	Enter Client account number if desired. Left justify and blank fill. Field may be left blank if desired.
169	Notice Indicator	Enter "N" if authorized to receive a copy of taxpayers notices. If not, blank fill.
170-173	Last Service Center	Enter one of the four character representations listed below for Service Center where client filed last tax return: ANSC = Andover FSC = Fresno ATSC = Atlanta KCSC = Kansas City AUSC = Austin MSC = Memphis BSC = Brookhaven OSC = Ogden CSC = Cincinnati PSC = Philadelphia
174-200	Reserved	Enter blanks.

EXHIBIT 12

END OF FILE TRAILER RECORD

General Information

The End of File Trailer Record. This record type must be the last record on the agent's tape file. It can be followed only by a tape mark.

Tape Position	Element Name	Entry or Definition
1	Record Type	Enter "E".
2-7	Number of TP Records	Enter the sum of TP Records you are reporting on the file. Zero fill on left. Use numeric characters without a sign representation.
8-200	Reserved	Enter blanks.

26 CFR 601.201: Rulings and determination letters. (Also Part I, Sections 170, 664, 2522; 1.170A-6, 1.664-2, 1.664-3, 25.2522(c)-3.)

Rev. Proc. 89-19

SECTION 1. BACKGROUND

Rev. Proc. 89-21, page 842, this Bulletin, makes available a sample declaration of trust that meets the applicable requirements under section 664(d)(1) of the Internal Revenue Code for an inter vivos charitable remainder annuity trust providing for annuity payments during one life.

Rev. Proc. 89-20, this page, this Bulletin, makes available a sample declaration of trust that meets the applicable requirements under section 664(d)(2) of the Code for an inter vivos charitable remainder unitrust providing for unitrust payments during one life.

Rev. Proc. 89-3, page 761, this Bulletin, sets forth areas of the Internal Revenue Code under the jurisdiction of the Associate Chief Counsel (Technical) in which the Internal Revenue Service will not issue advance rulings or determination letters. Section 4 of Rev. Proc 89-3 lists areas in which rulings or determination letters will not ordinarily be issued.

SEC. 2. PROCEDURE

Rev. Proc. 89-3 is amplified by adding to section 4 the following:

Section 170—Charitable, Etc., Contributions and Gifts.— Whether a transfer to an inter vivos charitable remainder trust described in section 664 of the Code that provides for annuity or unitrust payments for one measuring life qualifies for a charitable deduction under section 170(f)(2)(A).

Section 664—Charitable Remainder Trusts.—Whether an inter vivos charitable remainder annuity trust or unitrust that provides for annuity or unitrust payments for one measuring life satisfies the requirements described in section 664 of the Code.

Section 2522—Charitable and Similar Gifts.—Whether a transfer to an inter vivos charitable remainder trust described in section 664 of the Code that provides for annuity or unitrust payments for one measuring life qualifies for a charitable deduction under section 2522(c)(2)(A).

SEC. 3. EFFECTIVE DATE

This revenue procedure will apply to all ruling requests received in the National Office after February 27, 1989, the date of publication of this revenue procedure.

SEC. 4. EFFECT ON OTHER REVENUE PROCEDURES

Rev. Proc. 89-3 is amplified.

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26 CFR 601.201: Rulings and determination letters. Also Part I, Sections 170, 664, 2522; 1.170A-6, 1.664-3, 25.2522(c)-3.)

Rev. Proc. 89-20

SECTION 1. PURPOSE

This revenue procedure makes available a sample form of declaration of trust that meets the requirements for a charitable remainder unitrust as described in section 664(d)(2) of the Internal Revenue Code.

SEC. 2. BACKGROUND

The Internal Revenue Service receives and responds to requests for rulings dealing with the qualification of trusts as charitable remainder trusts and the availability of deductions for contributions made to such trusts. In many of these requests, the trust instruments and charitable objectives are very similar. Consequently, in order to provide a service to taxpayers and to save the time and expense involved in requesting and processing a ruling on a proposed charitable remainder unitrust, taxpayers who make transfers to a trust that substantially follows the sample trust instrument contained herein can be assured that the Service will recognize the trust as meeting all of the requirements of a charitable remainder unitrust, provided the trust operates in a manner consistent with the terms of the trust instrument and provided it is a valid trust under applicable local law.

SEC. 3. SCOPE AND OBJECTIVE

The sample declaration of trust made available by section 4 of this revenue procedure meets all of the applicable requirements under section 664(d)(2) of the Code for an inter vivos charitable remainder unitrust providing for unitrust payments during one life, followed by distribution of the trust assets to the charitable remainder beneficiary, if the trust document also creates a valid trust under local law. If the trust instrument makes reference to this revenue procedure and adopts a document substantially similar to the sample, the Service will recognize the trust as satisfying all of the applicable requirements of section 664(d)(2) of the Code and the corresponding regulations. Moreover, for transfers to a qualifying charitable remainder unitrust, the remainder interest will be deductible under sections 170(f)(2)(A) and 2522(c)(2)(A) for income and gift tax purposes, respectively. Therefore, it will not be necessary for a taxpayer to request a ruling as to the qualification of a substantially similar trust, and the Service generally will not issue such a ruling. See Rev. Proc. 89-19, this page, this Bulletin. The Service, however, will continue to issue rulings to taxpayers who create trusts that are not substantially similar to the sample trusts.

SEC. 4. SAMPLE CHARITABLE REMAINDER UNITRUST

On this ___ day of ________, 19_____, I, ______________, (hereinafter referred to as "the Donor") desiring to establish a charitable remainder unitrust, within the meaning of Rev. Proc. 89-20 and section 664(d)(2) of the Internal Revenue Code (hereinafter referred to as "the Code") hereby create the ____________ Charitable Remainder Unitrust and designate __________________ as the initial Trustee.

1. *Funding of Trust.* The Donor transfers to the Trustee the property described in Schedule A, and the Trustee accepts such property and agrees to hold, manage and distribute such property of the Trust under the terms set forth in this Trust instrument.

2. *Payment of Unitrust Amount.* The Trustee shall pay to [a living individual] (hereinafter referred to as "the Recipient") in each taxable year of the Trust during the Recipient's life a unitrust amount equal to [*at least five*] percent of the net fair market value of the assets of the Trust valued as of the first day of each taxable year of the Trust (the "valuation date"). The unitrust amount shall be paid in equal quarterly amounts from income and, to the extent that income is not sufficient, from principal. Any income of the Trust for a taxable year in excess of the unitrust amount shall be added to principal. If the net fair market value of the Trust assets is incorrectly determined, then within a reasonable period after the value is finally determined for Federal tax purposes, the Trustee shall pay to the Recipient (in the case of an undervaluation) or receive from the Recipient (in the case of an overvaluation) an amount equal to the difference between the unitrust amount properly payable and the unitrust amount actually paid.

3. *Proration of the Unitrust Amount.* In determining the unitrust amount, the Trustee shall prorate the same on a daily basis for a short taxable year and for the taxable year of the Recipient's death.

4. *Distribution to Charity.* Upon the death of the Recipient, the Trustee shall distribute all of the then principal and income of the Trust (other than any amount due Recipient or Recipient's estate, under paragraphs 2 and 3, above) to __________ (hereinafter referred to as the Charitable Organization). If the Charitable Organization is not an organization described in sections 170(c), 2055(a), and 2522(a) of the Code at the time when any principal or income of the Trust is to be distributed to it, then the Trustee shall distribute such principal or income to such one or more organizations described in sections 170(c), 2055(a), and 2522(a) as the Trustee shall select in its sole discretion.

5. *Additional Contributions.* If any additional contributions are made to the Trust after the initial contribution, the unitrust amount for the year in which the additional contribution is made shall be [*the same percentage as in paragraph 1*] percent of the sum of (a) the net fair market value of the Trust assets as of the first day of the taxable year (excluding the assets so added and any income from, or appreciation on, such assets) and (b) that proportion of the value of the assets so added that was excluded under (a) that the number of days in the period that begins with the date of contribution and ends with the earlier of the last day of the taxable year or the Recipient's death bears to the number of days in the period that begins on the first day of such taxable year and ends with the earlier of the last day in such taxable year or the Recipient's death. In the case where there is no valuation date after the time of contribution, the assets so added shall be valued at the time of contribution.

6. *Prohibited Transactions.* The income of the Trust for each taxable year shall be distributed at such time and in such manner as not to subject the Trust to tax under section 4942 of the Code. Except for the payment of the unitrust amount to the Recipient, the Trustee shall not engage in any act of self-dealing, as defined in section 4941(d), and shall not make any taxable expenditures, as defined in section 4945(d). The Trustee shall not make any investments that jeopardize the charitable purpose of the Trust, within the meaning of section 4944, or retain any excess business holdings, within the meaning of section 4943.

7. *Successor Trustee.* The Donor reserves the right to dismiss the Trustee and to appoint a successor Trustee.

8. *Taxable Year.* The taxable year of the Trust shall be the calendar year.

9. *Governing Law.* The operation of the Trust shall be governed by the laws of the State of __________. However, the Trustee is prohibited from exercising any power or discretion granted under said laws that would be inconsistent with the qualification of the Trust under section 664(d)(2) of the Code and the corresponding regulations.

10. *Limited Power of Amendment.* The Trust is irrevocable. However, the Trustee shall have the power, acting alone, to amend the Trust in any manner required for the sole purpose of ensuring that the Trust qualifies and continues to qualify as a charitable remainder unitrust within the meaning of section 664(d)(2) of the Code.

11. *Investment of Trust Assets.* Nothing in this Trust instrument shall be construed to restrict the Trustee from investing the Trust assets in a manner that could result in the annual realization of a reasonable amount of income or gain from the sale or disposition of Trust assets.

IN WITNESS WHEREOF __________ and __________ [TRUSTEE] by its duly authorized officer have signed this agreement the day and year first above written.

____

[DONOR]

____

[TRUSTEE]

By ______________________________

[Acknowledgements, Witnesses, etc.]

SEC. 5 APPLICATION

The Service will recognize a trust as meeting all of the requirements of a qualified charitable remainder unitrust under section 664(d)(2) of the Code if the trust instrument makes reference to this document and is substantially similar to the sample provided in section 4, provided the trust operates in a manner consistent with the terms of the trust instrument and provided it is a valid trust under applicable local law. A trust that contains substantive provisions in addition to those provided by section 4 (other than provisions necessary to establish a valid trust under applicable local law) or that omits any of these provisions will not necessarily be disqualified, but neither will it be assured of qualification under the provisions of this revenue procedure.

SEC. 6. EFFECTIVE DATE

This revenue procedure is effective for ruling requests received in the National Office after February 27, 1989, the date of publication of this revenue procedure in the Internal Revenue Bulletin.

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26 CFR 601.201: Rulings and determination letters. (Also Part I, Sections 170, 664, 2522; 1.170A-6, 1.664-2, 25.2522(c)-3.)

Rev. Proc. 89-21

SECTION 1. PURPOSE

This revenue procedure makes available a sample form of declaration of trust that meets the requirements for a charitable remainder annuity trust as described in section 664(d)(1) of the Internal Revenue Code.

SEC. 2. BACKGROUND

The Internal Revenue Service receives and responds to requests for rulings dealing with the qualification of trusts as charitable remainder trusts and the availability of deductions for contributions made to such trusts. In many of these requests, the trust instruments and charitable objectives are very similar. Consequently, in order to provide a service to taxpayers and to save the time and expense involved in requesting and processing a ruling on a proposed charitable remainder annuity trust, taxpayers who make transfers to a trust that substantially follows the sample trust instrument contained herein can be assured that the Service will recognize the trust as meeting all of the requirements of a charitable remainder annuity trust, provided the trust operates in a manner consistent with the terms of the trust instrument and provided it is a valid trust under applicable local law.

SEC. 3. SCOPE AND OBJECTIVE

The sample declaration of trust made available by section 4 of this revenue procedure meets all of the applicable requirements under section 664(d)(1) of the Code for an inter vivos charitable remainder annuity trust providing for annuity payments during one life, followed by distribution of the trust assets to the charitable remainder beneficiary, if the trust document also creates a valid trust under local law. If the trust instrument makes reference to this revenue procedure and adopts a document substantially similar to the sample, the Service will recognize the trust as satisfying all of the applicable requirements of section 664(d)(1) of the Code and the corresponding regulations. Moreover, for transfers to a qualifying charitable remainder annuity trust, the remainder interest will be deductible under sections 170(f)(2)(A) and 2522(c)(2)(A) for income and gift tax purposes, respectively. Therefore, it will not be necessary for a taxpayer to request a ruling as to the qualification of a substantially similar trust, and the Service generally will not issue such a ruling. See Rev. Proc. 89-19, page 841, this Bulletin. The Service, however, will continue to issue rulings to taxpayers who create trusts that are not substantially similar.

SEC. 4. SAMPLE CHARITABLE REMAINDER ANNUITY TRUST

On this ___ day of _______________, 19___, I, _____________________ (hereinafter referred to as "the Donor") desiring to establish a charitable remainder annuity trust, within the meaning of Rev. Proc. 89-21 and section 664(d)(1) of the Internal Revenue Code (hereinafter referred to as "the Code") hereby create the _____________________ Charitable Remainder Annuity Trust ("the Trust") and designate _______________ as the initial Trustee.

1. *Funding of Trust.* The Donor transfers to the Trustee the property described in Schedule A, and the Trustee accepts such property and agrees to hold, manage and distribute such property of the Trust under the terms set forth in this Trust instrument.

2. *Payment of Annuity Amount.* The Trustee shall pay to [a living individual] (hereinafter referred to as "the Recipient") in each taxable year of the Trust during the Recipient's life an annuity amount equal to [*at least five*] percent of the net fair market value of the assets of the Trust as of this date. The annuity amount shall be paid in equal quarterly amounts from income and, to the extent income is not sufficient, from principal. Any income of the Trust for a taxable year in excess of the annuity amount shall be added to principal. If the net fair market value of the Trust assets is incorrectly determined, then within a reasonable period after the value is finally determined for Federal tax purposes, the Trustee shall pay to the Recipient (in the case of an undervaluation) or receive from the Recipient (in the case of an overvaluation) an amount equal to the difference between the annuity amount(s) properly payable and the annuity amount(s) actually paid.

3. *Proration of the Annuity Amount.* In determining the annuity amount, the Trustee shall prorate the same on a daily basis for a short taxable year and for the taxable year of the Recipient's death.

4. *Distribution to Charity.* Upon the death of the Recipient, the Trustee shall distribute all of the then principal and income of the Trust (other than any amount due Recipient or Recipient's estate under paragraphs 2 and 3, above) to ___________ (hereinafter referred to as the Charitable Organization). If the Charitable Organization is not an organization described in sections 170(c), 2055(a), and 2522(a) of the Code at the time when any principal or income of the Trust is to be distributed to it, then the Trustee shall distribute such principal or income to such one or more organizations described in sections 170(c), 2055(a), and 2522(a) as the Trustee shall select in its sole discretion.

5. *Additional Contributions.* No additional contributions shall be made to the Trust after the initial contribution.

6. *Prohibited Transactions.* The income of the Trust for each taxable year shall be distributed at such time and in such manner as not to subject the Trust to tax under section 4942 of the Code. Except for the payment of the annuity amount to the Recipient, the Trustee shall not engage in any act of self-dealing, as defined in section 4941(d), and shall not make any taxable expenditures, as defined in section 4945(d). The Trustee shall not make any investments that jeopardize the charitable purpose of the Trust, within the meaning of section 4944, or retain any excess business holdings, within the meaning of section 4943.

7. *Successor Trustee.* The Donor reserves the right to dismiss the Trustee and to appoint a successor Trustee.

8. *Taxable Year.* The taxable year of the Trust shall be the calendar year.

9. *Governing Law.* The operation of the Trust shall be governed by the laws of the State of ___________. However, the Trustee is prohibited from exercising any power or discretion granted under said laws that would be inconsistent with the qualification of the Trust under section 664(d)(1) of the Code and the corresponding regulations.

10. *Limited Power of Amendment.* The Trust is irrevocable. However, the Trustee shall have the power, acting alone, to amend the Trust in any manner required for the sole purpose of ensuring that the Trust qualifies and continues to qualify as a charitable remainder annuity trust within the meaning of section 664(d)(1) of the Code.

11. *Investment of Trust Assets.* Nothing in this Trust instrument shall be construed to restrict the Trustee from investing the Trust assets in a manner that could result in the annual realization of a reasonable amount of income or gain from the sale or disposition of Trust assets.

IN WITNESS WHEREOF __________ and _____________ [TRUSTEE] by its duly authorized officer have signed this agreement the day and year first above written.

____
[DONOR]

____
[TRUSTEE]

By _______________________

[Acknowledgements, Witnesses, etc.]

SEC. 5. APPLICATION

The Service will recognize a trust as meeting all of the requirements of a qualified charitable remainder annuity trust under section 664(d)(1) of the Code if the trust instrument makes reference to this document and is substantially similar to the sample provided in section 4, provided the trust operates in a manner consistent with the terms of the trust instrument and provided it is a valid trust under applicable local law. A trust that contains substantive provisions in addition to those provided by section 4 (other than provisions necessary to establish a valid trust under applicable local law) or that omits any of these provisions will not necessarily be disqualified, but neither will it be assured of qualification under the provisions of this revenue procedure.

SEC. 6. EFFECTIVE DATE

This revenue procedure is effective for ruling requests received in the National Office after February 27, 1989, the date of publication of this revenue procedure in the Internal Revenue Bulletin.

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26 CFR 601.201. Rulings and determination letters.

Rev. Proc. 89-22

SECTION 1. BACKGROUND

Rev. Proc. 89-3, page 761, this Bulletin, sets forth areas in which advance rulings or determination letters will not be issued by the Internal Revenue Service. Section 5 of Rev. Proc. 89-3 is entitled "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."

SEC. 2. PROCEDURE

Rev. Proc. 89-3 is amplified by adding to section 5 the following new paragraph:

Sections 83 and 451.—Property Transferred in Connection with Performance of Services; General Rule for Taxable Year of Inclusion.—When compensation is realized by a person who, in connection with the performance of services, is granted a nonstatutory option without a readily ascertainable fair market value to purchase stock at a price that is less than the fair market value of the stock on the date the option is granted.

SEC. 3. EFFECTIVE DATE

This revenue procedure applies to all ruling requests on hand in the National Office on March 6, 1989, the date of publication of this revenue procedure in the Internal Revenue Bulletin, as well as to requests received thereafter.

SEC. 4. EFFECT ON OTHER REVENUE PROCEDURES

Rev. Proc. 89-3 is amplified.

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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 170, 509; 1.170A-9, 1.509(a)-3.)

Rev. Proc. 89-23

SECTION 1. PURPOSE

The purpose of this revenue procedure is to set forth guidelines under which grant-making private foundations will not be considered to be responsible for substantial and material changes in the sources of financial support of recipient organizations that are described in sections 170(b)(1)(A)(vi) or 509(a)(2) of the Internal Revenue Code.

SEC. 2. BACKGROUND

01. Generally, under sections 1.170A-9(e)(4)(v)(b), 1.170A-9(e)(5)(iii)(c), 1.509(a)-3(c)(1)(iii), and 1.509(a)-3(e)-(3) of the Income Tax Regulations, when an organization has received a ruling or determination letter, or an advance ruling or determination letter, that it has been classified as a publicly supported organization described in sections 170(b)(1)-(A)(vi) or 509(a)(2) of the Code, the treatment of grants and contributions and the status of grantors and contributors to the organization under sections 170, 507, 545(b)(2), 556(b)(2), 642(c), 4942, 4945, 2055, 2106(a)(2), and 2522 will not be affected by a subsequent loss of classification as a publicly supported organization until notice of loss of classification is published. However, a grantor or contributor may not rely on such an organization's classification if the grantor or contributor is responsible for or aware of a substantial and material change in the organization's sources of support that subsequently results in the organization's loss of classification as a publicly supported organization. For example, a substantial and material change in sources of support may result from the receipt of an unusually large contribution that does not qualify as an unusual grant under sections 1.170A-9(e)(6)(ii) or 1.509(a)-3(c)(3). See Sec. 2.01 of Rev. Proc. 81-6, 1981-1 C.B. 620.

02. If in any taxable year there is a substantial and material change in an organization's sources of support, the computation period used to determine whether the organization meets the requirements of the section 170(b)(1)(A)-(vi) or 509(a)(2) financial support tests consists of the taxable year in question and the four immediately preceding taxable years rather than the four immediately preceding taxable years. If an organization has been in existence for less than five taxable years, the computation period consists of the taxable year in question and the number of years preceding that taxable year that the organization has been in existence. This computation period is in lieu of the usual computation period rules. See sections 1.170A-9(e)-(4)(v) and 1.509(a)-3(c)(1)(ii) of the regulations and Sec. 2.02 of Rev. Proc. 81-6.

03. Gifts, grants and contributions made by a private foundation to another private foundation are not qualifying distributions under section 4942(g) of the Code unless the recipient is either (i) an operating foundation under section 4942(j)(3) or (ii) a pass-through foundation under section 4942(g)(3) from which the grantor obtains the records required by section 4942(g)(3)(B). Therefore, a private foundation may not be able to count a grant, for instance, as a qualifying distribution if the grant causes the recipient organization to loss its classification as a public charity.

04. Gifts, grants and contributions made by a private foundation to another private foundation are taxable expenditures under section 4945(d)(4) of the Code unless either (i) the recipient is an exempt operating foundation under section 4940(d)(2) or (ii) the grantor exercises expenditure responsibility under section 4945(h). Therefore, a private foundation may be subject to the section 4945(a) tax on taxable expenditures if it has not followed the expenditure responsibility requirements of section 4945(d)-(4) in regard to a grant that causes the recipient organization to lose its classification as a public charity.

05. Rev. Proc. 81-6 set forth guidelines under which a grantor or contributor will not be considered to be responsible for substantial and material changes in an organization's sources of support. Generally, these guidelines provide that a grantor or contributor will not be considered to be responsible for a substantial and material change in an organization's support if the aggregate of gifts, grants, or contributions received from such grantor or contributor for a taxable year is 25 percent or less of the aggregate support received by the donee organization from all sources other than that donor for the four taxable years immediately preceding such taxable year, or, if the donee organization has been in existence for fewer than five taxable years, the number of years for which the organization has been in existence prior to the taxable year being tested.

06. In 1984, Congress directed the Treasury Department to amend its regulations to permit greater reliance by private foundations on Internal Revenue Service classifications of new organizations in the first five years of their existence and in any other circumstances in which Treasury concludes that greater reliance is appropriate. H.R. Conf. Rep. No. 861, 98th Cong., 2d Sess. 1090 (1984), 1984-3 (Vol. 2) C.B. 344. Pending the issuance of regulations implementing the above directions, the Internal Revenue Service will follow the guidelines set forth below.

SEC. 3. GUIDELINES

01. Private foundations may continue to rely on the status of recipient organizations that have received rulings or determination letters to the extent provided in sections 1.170A-9(e)(4)(v)(b) and 1.509(a)-3(c)(1)(iii) of the regulations, and on the status of recipient organizations that have received advance rulings or determination letters to the extent provided in sections 1.170A-9(e)-(5)(iii)(c) and 1.509(a)-3(e)(3).

02. All grantors and contributors, including private foundations, may continue to rely on the guidelines set forth in Rev. Proc. 81-6.

03. In addition, a private foundation's gift, grant or contribution will not cause the private foundation to be considered to be responsible for, or aware of, a sub-

stantial and material change in the recipient organization's sources of support that results in the loss of the recipient organization's status under sections 170(b)(1)(A)(vi) or 509(a)(2) of the Code if the following conditions are met at the time of the making of the gift, grant or contribution:

(1) The recipient organization has received a ruling or determination letter, or an advance ruling or determination letter, that it is described in sections 170(b)(1)(A)(vi) or 509(a)(2);

(2) Notice of a change of the recipient organization's status under sections 170(b)(1)(A)(vi) or 509(a)(2) has not been made to the public (such as by publication in the Internal Revenue Bulletin), and the private foundation has not acquired knowledge that the Internal Revenue Service has given notice to the recipient organization that it will be deleted from such status; and

(3) The recipient organization is not controlled directly or indirectly by the private foundation. A recipient organization is controlled by a private foundation for this purpose if the private foundation and disqualified persons (defined in section 4946(a)(1)(A) through (G)) with reference to the private foundation, by aggregating their votes or positions of authority, may require the recipient organization to perform any act which significantly affects its operations or may prevent the recipient organization from performing such act.

SEC. 4 AREAS NOT COVERED BY THIS REVENUE PROCEDURE

01. This revenue procedure does not apply to situations in which gifts, grants, or contributions are made by persons other than private foundations.

02. This revenue procedure does not affect Rev. Proc. 81-7, 1981-1 C.B. 621, under which grants will be considered to be unusual grants.

SEC. 5. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 81-6, 1981-1 C.B. 620, is amplified.

SEC. 6. EFFECTIVE DATE

This revenue procedure is effective for grants made after March 13, 1989.

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26 CFR 601.403: Miscellaneous excise taxes collected by return.

Rev. Proc. 89-24

SECTION 1. PURPOSE

This revenue procedure provides instructions for claiming a refund of an overpayment of excise tax on insurance policies when the claim is based on the provisions of the Convention Between The Government Of The United Kingdom Of Great Britain And Northern Ireland (On Behalf Of The Government Of Bermuda) And The Government Of The United States Of America Relating To The Taxation Of Insurance Enterprises And Mutual Assistance In Tax Matters (the "Treaty"), signed at Washington, D.C. on July 11, 1986, and effective January 1, 1986 with respect to the excise tax on certain insurance premiums.

SECTION 2. BACKGROUND

.01 Section 4371 of the Internal Revenue Code of 1986* imposes a tax on each policy of insurance or reinsurance issued by any foreign insurer or reinsurer.

.02 Section 4374 of the Code provides that the tax imposed by section 4371 shall be paid by any person who makes, signs, issues, or sells any of the documents and instruments subject to the tax, or for whose use or benefit the same are made, signed, issued or sold.

.03 Section 46.4374-1(a) of the Excise Tax Regulations provides that, in the case of premiums paid on or after January 1, 1966, the tax imposed by section 4371 of the Code shall be paid on the basis of a return. Such tax shall be remitted by the person who makes the payment of the premium to a foreign insurer or reinsurer or to any nonresident agent, solicitor, or broker. The phrase "person who makes the payment" means the resident person who actually transfers the money, check, or its equivalent to the foreign insurer or reinsurer (including transfers to any bank, trust fund, or similar recipient designated by the foreign insurer or reinsurer), or to any nonresident agent, solicitor, or broker.

.04 Pursuant to Article 4(1) of the Treaty, policies issued by an insurer or reinsurer that is a resident of Bermuda may be exempt from the tax imposed by section 4371 of the Code. This exemption applies to certain insurance premiums paid or credited on or after January 1, 1986. However, the exemption from excise tax available under Article 4(1) of the Treaty does not apply to premiums allocable to insurance coverage for periods beginning on or after January 1, 1990. Senate Resolution of Ratification (Oct. 21, 1988); *cf.* Technical and Miscellaneous Revenue Act of 1988, P.L. No. 100-647, section 6139, 102 Stat. 3342 (1988).

SECTION 3. REQUIREMENTS FOR REFUND OF EXCISE TAX

.01 A refund of section 4371 tax may be claimed only if the tax was attributable to a premium paid or credited to a Bermuda insurer or reinsurer who is certified by the Bermuda Registrar of Companies as having been a resident of Bermuda for the entire taxable period for which the refund is sought. Such certification may be in the form of a list compiled by the Registrar of Companies of all insurers or reinsurers that were residents on or after January 1, 1986. A copy of such a list or of an individual certification must be filed with any claim for refund of the insurance premium excise tax. For purposes of this revenue procedure, "taxable period" means the quarter (or part of a quarter) for which a return was filed reporting and paying the insurance premium excise tax for which the refund is sought.

.02 A refund of section 4371 tax may not be claimed with respect to premiums paid or credited to a Bermuda insurer or reinsurer to the extent that the risks covered by the premiums were reinsured by the Bermuda insurer or reinsurer with a person not entitled to the benefits of the Treaty or any other convention that provides an exemption for these taxes (Article 4(6) of the Treaty).

.03 A refund of section 4371 tax may be claimed with respect to premiums paid or credited to a Bermuda insurer or reinsurer only if at all times during the taxable period more than 50 percent of the number of shares of each class of the company's shares is owned, directly or indirectly, by one or more individual residents of Bermuda or the United States or citizens of the United States (Article 4(3)(a) of the Treaty). In applying this test, shares that are not registered to a named shareholder (that is, bearer shares) will be considered as owned by an individual who is neither a resident of Bermuda nor a citizen or resident of the United States.

*Any reference to the Internal Revenue Code of 1986 includes the Internal Revenue Code of 1954.

.04 A refund of section 4371 tax may not be claimed with respect to premiums paid to a Bermuda insurer or reinsurer if its income for the taxable period for which a refund is sought was used in substantial part, directly or indirectly, to make distributions with respect to beneficial ownership interests and are substantially disproportionate to such interests, or to meet liabilities to persons who were neither residents of Bermuda nor citizens or residents of the United States (Article 4(3)(b) of the Treaty).

For purposes of this test, the term "liabilities" refers to payments that reduce gross premiums or are deductible against gross income, including interest, royalties, and premiums paid in connection with reinsuring risks. To determine whether a taxpayer has paid a substantial part of its income to persons who were neither residents of Bermuda nor citizens or residents of the United States, the following computation is made on either an accrual or cash basis depending on the method of accounting that the taxpayer normally uses to keep its books and records:

Line 1 -Compute reinsurance premiums paid or accrued to all persons.

Line 2 -Compute gross premiums received or accrued.

Line 3 -Compute return premiums paid or accrued.

Line 4 -Subtract line 3 from line 2.

Line 5 -Divide the number from line 4 into the number from line 1.

Line 6 -Compute all liabilities paid to all persons. Do not include reinsurance premium liabilitiesc.

Line 7 -Add lines 3 and 1.

Line 8 -Subtract the number in line 7 from line 2.

Line 9 -Compute total gross income from non-insurance activities.

Line 10-Add lines 8 and 9.

Line 11-Divide the number in line 10 into the number from line 6.

Line 12-Add lines 11 and 5.

If line 12 is equal to or less than .50, the Service will generally not consider a taxpayer to have paid a substantial part of its income to meet liabilities to persons who were neither residents of Bermuda nor citizens or residents of the United States.

In the case of the payment of liabilities test set forth above, a lesser percentage may be applied upon examination.

.05 A refund of section 4371 tax may not be claimed with respect to premiums paid to a Bermuda insurer or reinsurer unless (1) the insurance premiums constitute income of an insurance company that was a controlled foreign corporation within the meaning of section 957(b) of the Code for the relevant taxable period; or (2) the insurance premiums constituted income of an insurance company that was subject to the rules of section 953(c) and was a controlled foreign corporation within the meaning of section 957(a), as modified by section 953(c)(1), and the premiums constituted related person insurance income within the meaning of section 953(c).

A refund of section 4371 tax may only be claimed with respect to premiums and tax paid or credited on or before December 31, 1989, for insurance coverage for periods prior to January 1, 1990.

SECTION 4. REFUND PROCEDURE

.01 A refund of section 4371 tax attributable to premiums paid to a Bermuda insurer or reinsurer may be claimed by either the Bermuda insurer or reinsurer, or by the United States insured or broker that reported and paid the tax to the Service, but not by both. No claim for refund will be paid or credited by the Internal Revenue Service, unless a Statement Under Penalties Of Perjury In Support Of Claim For Refund Of Insurance Premium Excise Tax described in sections 4.03 and 4.04 of this revenue procedure, whichever is applicable, is filed with the claim for refund.

.02 A claim filed by the Bermuda insurer or reinsurer for refund of insurance premium excise taxes must include a copy of a residency certificate issued by the Registrar of Companies establishing that the insurer or reinsurer was a resident of Bermuda for each quarter for which refund is claimed. In lieu of an individual certificate, the claimant may attach a list, prepared by the Registrar of Companies, of companies that were residents of Bermuda establishing that the claimant was a Bermuda resident for each quarter for which refund is claimed.

The claim for refund must include a list of names and addresses of the claimant's shareholders (or policyholders in the case of a mutual company), including, in the event that any direct shareholders (or policyholders in the case of a mutual company) are persons other than individuals, the names and addresses of those individuals who hold shares indirectly through such direct shareholders or policyholders. However, in the case of a claimant or shareholder of a claimant the principal class of shares of which are subject to substantial and regular trading on a recognized stock exchange in the United States or Bermuda, the names and addresses of individual beneficial owners need not be provided. The claim for refund must also include, with respect to each quarter for which refund is sought, information as to the percentage of outstanding shares of each class of stock owned by each shareholder and the computation described in section 3.04 of this revenue procedure.

In addition, the claim for refund must include information to establish that the Bermuda insurer or reinsurer was a controlled foreign corporation within the meaning of section 957(b) or section 953(c) of the Code, and that the income was treated as subpart F income to the United States shareholders of the Bermuda insurer or reinsurer.

The claim for refund must include information to enable the Service to identify the tax account(s) to which the excise tax for which a refund is sought was deposited at the time of payment. At a minimum, this information must include a schedule of the names, addresses, and taxpayer identification numbers of the person or persons filing the return on which the excise tax was reported; policy numbers; amount of taxable premiums per policy by quarter; amount of tax paid per quarter; and amount of refund requested per quarter. In addition, a claim must include the name, address, and taxpayer identification number of each insured; the policy number and term; the date the premium was paid; the amount of the premium; the amount of the excise tax paid on the premium; and the date the tax was paid to the Internal Revenue Service.

.03 A claim for refund filed by a Bermuda insurer or reinsurer must include, in addition to the documents and information required by section 4.02 of this revenue procedure, the following Statement Under Penalties of Perjury:

STATEMENT UNDER PENALTIES OF PERJURY IN SUPPORT OF CLAIM FOR REFUND OF INSURANCE PREMIUM EXCISE TAX

Under penalties of perjury, (Name and address of Bermuda insurer or reinsurer claiming refund); and (name(s), address(es), and taxpayer identification number(s) of United States insured(s) [and/or broker(s)] that reported and paid the tax for which refund is sought) represent:

(1) That this Statement is filed in support of a claim for refund of insurance premium excise tax imposed by section 4371 *et seq.* of the Internal Revenue Code of 1986*, pursuant to the exemption provided by Article 4 of the United States-Bermuda Insurance Enterprises and Mutual Assistance Tax Treaty ("Treaty"), as modified by the Senate reservation;

(2) That (Name of Bermuda insurer or reinsurer) was eligible for benefits under the Treaty for the quarters ended ________________________;

(3) That none of the risks for which premiums were paid by the insured(s) [and/or broker(s)] and for which claims for refund of the excise tax have been filed, were reinsured with a person not entitled to exemption from such tax under the Treaty or another treaty that applies to such taxes;

(4) That the United States insured(s) [and/or broker(s)] withheld the following insurance premium excise tax from the premiums paid to (name of Bermuda insurer or reinsurer) [or paid the following insurance premium excise tax on the premiums paid to (name of Bermuda insurer or reinsurer)] and filed Quarterly Federal Excise Tax Returns, Forms 720, reporting and paying such tax to the Internal Revenue Service:

Insured's [and/or Broker's] Name

Quarter	Amount of Tax Paid

(5) That the Bermuda insurer or reinsurer and the insured(s) [and/or broker(s)] request refund of the insurance premium excise tax that has been reported and paid to the Internal Revenue Service for quarters ended ________________________;

(6) That the Bermuda insurer or reinsurer has timely filed one or more Claim, Form 843, for refund of the insurance premium excise tax;

(7) That the Bermuda insurer or reinsurer has filed powers of attorney from the insured(s) [and/or broker(s)] specifically authorizing the Internal Revenue Service to mail to the representative of the Bermuda insurer or reinsurer any check for refund resulting from allowance of the claim filed for insurance premium excise tax (*see* Statement of IRS Procedural Rules, §601.506(b)(1));

(Name of Bermuda insurer or reinsurer) and (name(s) of United States insured(s) and/or broker(s)) agree:

(1) That the sole person(s) beneficially entitled to refund of the insurance premium excise tax for quarters ended ____________________, is (are) the insured(s) [and/or broker(s)] [or that the sole person beneficially entitled to refund of the insurance premium excise tax for quarters ended ________________, is the Bermuda insurer or reinsurer].

(2) That neither (name of Bermuda insurer or reinsurer) and (name(s) of the insured(s) [and/or broker(s)]) nor any other person affiliated with them will make any claim outside this Agreement with respect to refund of the amount of insurance premium excise tax claimed in any Form 843 filed in connection with this Agreement.

(3) That any refund of tax, plus statutory interest, made by the Internal Revenue Service resulting from allowance of the claim for refund of insurance premium excise tax filed by the Bermuda insurer or reinsurer will be mailed to the insured(s) [and/or broker(s)] in care of the representative of the Bermuda insurer or reinsurer in accordance with the power of attorney that the insured(s) [and/or broker(s)] have given to such representative;

(4) That, for purposes of Internal Revenue Service verification of any or all facts and representations made in connection with the claim for refund of the insurance premium excise tax, the Bermuda insurer or reinsurer and the insured(s) [and/or broker(s)] will maintain for a period of 5 years from the date of this Agreement, accounts and records of items of insurance and reinsurance that will be made available upon written request by the Internal Revenue Service at the place mutually agreed upon by the Service and the Bermuda insurer or reinsurer and the insured(s) [and/or broker(s)]. The Bermuda insurer or reinsurer will also maintain for 5 years and make available for inspection records to establish eligibility for Treaty benefits, including records about the ownership of its outstanding stock as described in section 3.03 of this revenue procedure; about payment of liabilities as described in section 3.04 of this revenue procedure; and to confirm that its premium income received from the insured(s) [and/or broker(s)] was treated as subpart F income to United States shareholders of the Bermuda insurer or reinsurer as described in section 3.05 of this revenue procedure.

Under penalties of perjury, the undersigned representatives of [name of Bermuda insurer or reinsurer] and [names of insured(s) and/or broker(s)] declare that they have examined this Statement, including accompanying documents, and, to the best of their knowledge and belief, the facts presented in the Statement and documents are true, correct, and complete.

IN WITNESS WHEREOF, the above parties have subscribed their names to these presents, in triplicate.

Signed this (Date) day of (Month), (Year)

[Bermuda insurer or reinsurer]

By ____________________
Title ____________________

[Name(s) of insured(s) or broker(s)]

By ____________________
Title ____________________

.04 A refund claim filed by the insured(s) and/or broker(s) must include, in addition to the documents and information required by section 4.02 of this revenue procedure, the following Statement Under Penalties of Perjury:

STATEMENT UNDER PENALTIES OF PERJURY IN SUPPORT OF CLAIM FOR REFUND OF INSURANCE PREMIUM EXCISE TAX

Under penalties of perjury, (Name, address, and taxpayer identification number of United States insured or broker that reported and paid the tax for which refund is sought and that filed the claim for refund) (hereinafter "taxpayer"); and (name and address of Bermuda insurer or reinsurer to which the premiums were paid) represent:

(1) That this Statement is filed in support of a claim for refund of insurance premium excise tax imposed by section 4371 *et seq.* of the Internal Revenue Code of 1986*, pursuant to the exemption provided by Article 4 of the United States-Bermuda Insurance Enterprises and Mutual Assistance Tax Treaty ("Treaty"), as modified by the Senate reservation;

(2) That (name of Bermuda insurer or reinsurer) was eligible for benefits under the Treaty for the quarters ended ________________________;

(3) That none of the risks for which premiums were paid by the taxpayer and for which claims for refund of the excise tax

*Any reference to the Internal Revenue Code of 1986 includes the Internal Revenue Code of 1954.

*Any reference to the Internal Revenue Code of 1986 includes the Internal Revenue Code of 1954.

have been filed, were reinsured with a person not entitled to exemption from such tax under the Treaty or another treaty that applies to such taxes;

(4) That the taxpayer withheld the following insurance premium excise tax from the premiums paid to (name of Bermuda insurer or reinsurer) [or paid the following insurance premium excise tax on the premiums paid to (name of Bermuda insurer or reinsurer)] and filed Quarterly Federal Excise Tax Returns, Form 720, reporting and paying such tax to the Internal Revenue Service:

Taxpayer's Name	Quarter	Amount of Tax Paid

(5) That the taxpayer and the Bermuda insurer or reinsurer request refund of the insurance premium excise tax that has been reported and paid to the Internal Revenue Service for quarters ended ______________;

(6) That the taxpayer has timely filed one or more Claim, Form 843, for refund of the insurance premium excise tax;

(Name of United States insured or broker) and (name of Bermuda insurer or reinsurer) agree:

(1) That the sole person beneficially entitled to refund of the insurance premium excise tax for quarters ended ______________, is the taxpayer [or that the sole person beneficially entitled to refund of the insurance premium excise tax for quarters ended ______________, is the Bermuda insurer or reinsurer].

(2) That neither (name of Bermuda insurer or reinsurer) and (name(s) of the insured(s)[and/or broker(s)]) nor any person affiliated with them will make any claim outside this Agreement with respect to refund of the amount of insurance premium excise tax claimed in any Form 843 filed in connection with this Agreement.

(3) That any refund of tax, plus statutory interest, made by the Internal Revenue Service resulting from allowance of the claim for refund of insurance premium excise tax filed by taxpayer will be made to taxpayer.

(4) That, for purposes of Internal Revenue Service verification of any or all facts and representations made in connection with the claim for refund of the insurance premium excise tax, the taxpayer and the Bermuda insurer or reinsurer will maintain for a period of 5 years from the date of this Agreement, accounts and records of items of insurance and reinsurance that will be made available upon written request by the Internal Revenue Service at the place mutually agreed upon by the Service and the taxpayer and the Bermuda insurer or reinsurer. The Bermuda insurer or reinsurer will also maintain for 5 years and make available for inspection records to establish eligibility for Treaty benefits, including records about the ownership of its outstanding stock as described in section 3.03 of this revenue procedure; about payment of liabilities as described in section 3.04 of this revenue procedure; and to confirm that its premium income received from the taxpayer was treated as subpart F income to the United States shareholders of the Bermuda insurer or reinsurer, as described in section 3.05 of this revenue procedure.

Under penalties of perjury, the undersigned representative of [name of Bermuda insurer or reinsurer] and [names of insured(s) and/or broker(s)] declare that they have examined this Statement, including accompanying documents, and, to the best of their knowledge and belief, the facts presented in the Statement and documents are true, correct, and complete.

IN WITNESS WHEREOF, the above parties have subscribed their names to these presents, in triplicate.

Signed this (Date) day of (Month), (Year)

[Taxpayer's Name]

By

Title

[Bermuda insurer or reinsurer]

By

Title

.05 Any taxpayer or Bermuda insurer or reinsurer requesting a refund of insurance premium excise tax should submit a Claim, Form 843, in accordance with this revenue procedure, to the following address

Philadelphia Service Center
P.O. Box 245
Bensalem, PA 19020
Drop Point 102C

The claim must be accompanied by the required Statement and two copies of the Certificate of residency, or a list of resident insurance companies, issued by the Registrar of Companies of Bermuda.

SECTION 5. EFFECTIVE DATE

This revenue procedure is effective March 20, 1989, the date of its publication in the Internal Revenue Bulletin.

26 CFR 601.601: Rules and regulations.

Rev. Proc. 89-25

CONTENTS

PART B. MAGNETIC TAPE SPECIFICATIONS

PART A. GENERAL

SECTION 1. PURPOSE

.01 The purpose of this Revenue Procedure is to provide the requirements and conditions for filing pre-offset address request, annual certification, weekly update and agency address records on magnetic tape for federal debts which are eligible for the Federal Income Tax Refund Offset Program. This Revenue Procedure is issued under the authority contained in Section 7805 of the Internal Revenue Code of 1954 (68A STAT. 1153; 26 U.S.C 7805) and in Section 3720A of Subchapter 37 of Title 31 United States Code (98 STAT. 1153; 31 U.S.C. 3720A). See Exhibit A.1-1 for overview of project. The authorizations for the Refund Offset Program are as follows:

1. Deficit Reduction Act of 1984 - PL 98 369; Section 2653

2. Omnibus Budget Reconciliation Act of 1987 - PL 97-35; Section 2331

3. Child Support Enforcement Amendments of 1984, PL 98-378; Section 21

4. 26 U.S.C. 6402 (c)(d)

5. The Family Support Act of 1988, H.R. 1720

.02 Included in this Revenue Procedure are requirements for:

(a) submitting Pre-Offset Address Request records to secure the address from the taxpayer's latest income tax return to be used by the agency when notifying a taxpayer of a potential offset.

(b) submitting Annual Certification records for inclusion on the Debtor Master File.

(c) submitting Federal Agency's addresses and contacts on magnetic tape for inclusion on IRS offset notices to taxpayers.

(d) submitting Weekly Updates to 1) delete or decrease a previously certified debt or 2) indicate that the federal agency has refunded a previous federal income tax refund offset to a taxpayer.

.03 The Internal Revenue Service (IRS), upon receipt of Annual Certification records, will mark matching individual taxpayer accounts to prohibit refunding of overpayments to the taxpayer. When refundable credits (usually resultant from the filing of a current year tax return) are processed, an offset record is generated to the agency for the amount of obligation or the amount of the refund, whichever is less. This offset record will also reflect current taxpayer identifying information valid for the offset tax year, *i.e.*, SSN, name(s), and current address. Claims may be filed by an "injured spouse" to recover their portion of any joint overpayment which is not subject to offset by submitting Form 1040X and Form 8379.

.04 See Section 12 Part A for Information regarding Disclosure and Safeguards Requirements. .05 Specifications for the following agency submitted records are contained in this Revenue Procedure:

(a) Transmitter-Annual Pre-Offset Address Request Record

(b) Transmitter-Annual Pre-Offset Data Control Record

(c) Transmitter-Annual Certification Record

(d) Transmitter-Annual Certification Data Control Record

(e) Transmitter-Agency Address Record

(f) Transmitter-Agency Address Data Control Record

(g) Transmitter-Weekly Update Record

(h) Transmitter-Weekly Update Data Control Record

.06 Specifications for the following IRS records returned to the Federal Agency are contained in this Revenue Procedure:

(a) Service-Annual Pre-Offset Unprocessable Record

(b) Service-Annual Pre-Offset Address Request Record

(c) Service-Annual Pre-Offset Data Control Record

(d) Service-Annual Unprocessable Certification Record

(e) Service-Annual No Match Record

(f) Service-Annual No Match Data Control Record

(g) Service-Weekly Unprocessable Update Record

(h) Service-Weekly Collection (Offset/Claim) Record

(i) Service-Weekly Collection (Offset/Claim) Data Control Record

.07 Specifications for Header records are contained in Section 22 for Transmitter files and Section 23 for IRS files.

SEC. 2. NATURE OF CHANGES

.01. A new post office box has been assigned just for DMF. (P.O. Box 909 Kearneysville, WV. 25430)

.02. The addition of a milestone activity chart. (Part A. Sect. 4)

.03. The addition of a deceased indicator. (Part A. Sect. 3, Sect. 7.06), (Part B. Sect. 8,13)

.04. The addition of a Judgement Debt Indicator. (Part A. Sect. 3), (Part B. Sect. 5,10)

.05. The Delinquent Date definition has been reworded. (Part A. Sect. 3)

.06. The Agency Location Code definition is reworded. (Part A. Sect. 3)

.07. The Spousal Claim definition is reworded (Part A. Sect. 3) The explanation concerning injured spouse claims has been reworded. (Part A. Sect. 10.05)

.08. The symbols for the DMF Project Staff have been changed to TR:R:A.

.09. The current CP 47 is included (Overpaid Tax applied to Past-Due Obligation). Exhibit A.10-4. Offset Notice (Part A. Sect. 10)

.10. There is a requirement now to write in the replacement tape number on the transmittal letter. Exhibit A.4-1. Transmittal Letter. (Part A. Sect. 4.08)

.11. The Reporting schedule has been updated to reflect the 1989 shipping dates. (Part A. Sect. 4.01)

.12. Field Name in Service-Weekly Collection Data Control Record changed from ''Transfer Amount'' to ''Excess Offset Amount''.

.13. New refund adjustment record processing, TC 131 type 2 record. (Part B. Sect. 17), (Part B. Sect. 18), (Part. B. Sect. 19)

.14. Authorizations for the Refund Offset Program. (Part A. Sect. 1)

.15. Problem Case Referral Form added. Exhibit A.11-1. (Part A. Sect. 11.03))

.16. All references to NCC and National Computer Center have been changed to MCC and Martinsburg Computing Center.

.17. The Spousal Definition was changed. (Part A. Sect. 3)

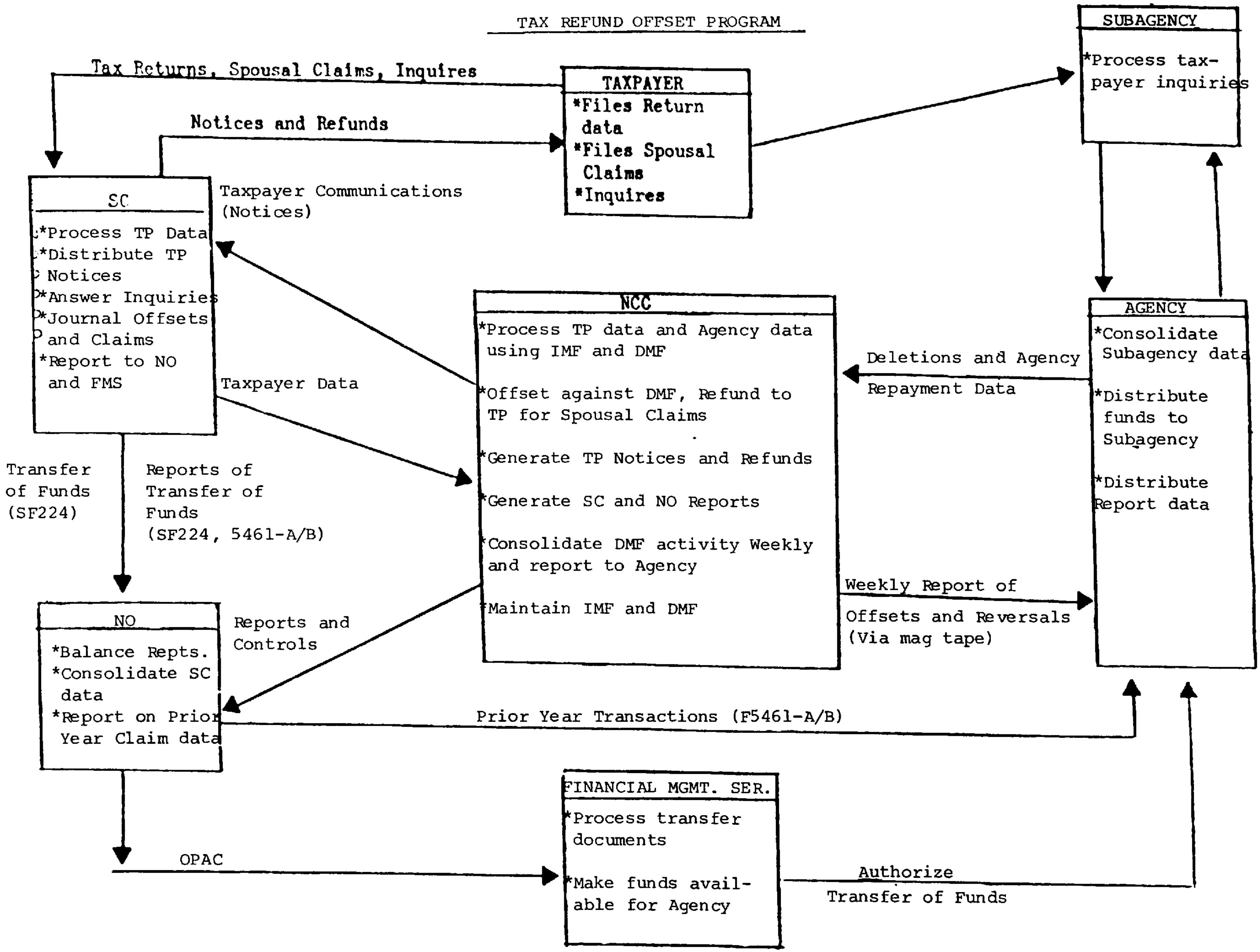
.18. Added line to backup file explanation, but not concerning form 3220. (Part A. Sect. 5.05)

.19 Various editorial changes.

Exhibit A.1-1

WEEKLY PROCESSING

TAX REFUND OFFSET PROGRAM



SEC. 3. DEFINITIONS

ELEMENT	DESCRIPTION
Agency Code	This is a two digit numeric code assigned by IRS to identify the Federal Agency involved. The term "agency", as used in this document, is meant to be the Department level within the Federal Government. One agency code will be assigned to an Agency (Department). Different functions within a Department may be assigned a sub-agency code or a series of sub-agency codes (see definition below). Records submitted for a unique agency code must be consolidated prior to being sent to IRS. IRS will return consolidated records to a single Data Processing center.
Agency Case Number	This is the identifying number of the obligor's file at the submitting agency. Field is optional. Use is recommended when an agency does not use the SSN as the primary account/case number.
Agency Locator Code(ALC)	The Agency Location Code is a unique identifier assigned to every government agency for the purpose of reporting receipts and disbursments for each agency. An ALC is necessary to participate in the OPAC system.
Deceased Indicator	An indicator set by the IMF to show that the obligor is deceased.
Delinquent Date	Date the obligation became delinquent. Certification records with a delinquent date 10 yrs old or more by the first offset cycle effective date will be returned (except OCSE Debts and Judgement Debts)
DMF Account	A record that has been created as a result of certification by a federal agency's claim that has matched an account on the Individual Master File. This record consists of an entity section and at least one agency subsection.
File	For the purpose of this revenue procedure, a file consists of all tape records submitted by a Transmitter.
GOALS	The Government On-Line Accounting Link System is an automated accounting system designed by the Department of Treasury through which federal agencies can transmit and receive accounting and financial data.
IMF	The Individual Master File is a comprehensive file containing entity information and transaction activity for each individual taxpayer account.
Invalid Segment	The portion of the IMF which contains all SSN's which are currently considered invalid. Records submitted for invalid SSN's will be returned to the submitting agency and will not cause a refund freeze or allow a refund offset.
Judgement Debt	A debt arising from a judicial decision and therefore not subject to the 10 year statute of limitations for offsetting.
Local Code	This is a three digit code used to associate an Agency Address Record (Agency Name, Address, telephone numbers) with an individual obligor for use on IRS offset notices. A local code of "000" is required for each subagency.
MCC	Martinsburg Computing Center P.O. Box 909 Kearneysville, WV. 25430 FTS 937-8345 NON-FTS (304) 267-2911 EXT 345
Name Control	When cases (original certifications and updates) are submitted to the IRS for processing, the SSN and Name Control are used for matching against the taxpayer's account. Records that do not match exactly on SSN and Name Control will be returned to the submitting agency. To ensure that submissions are processable, the following examples demonstrate the proper manner to derive the Name Control field.

NAME	NAME CONTROL	NAME	NAME CONTROL
John Brown	BROW	Mark D'Allesandro	DALL
John A. Lee	LEE *	Pedro Torres-Lopes	TORR
James P. En Sr.	EN *	Joe McCarthy	MCCA
John O'Neill	ONEI	Mr. Eng U	U *
Mary Van Buren	VANB	Mary X-Williams	X-WI
John Diben Edetto	DIBE	Juan De Jesus	DEJE
John A. El-Roy	EL-R		

*Name Controls of less than four (4) significant characters must be left justified and blank filled. Embedded blanks are not allowed. A single hyphen is allowed in all but the first digit of the name control.

Obligor	The person against whom a Federal Agency has certified a delinquent debt.
OPAC	The On-Line Payment and Collection System option of GOALS is an automated accounting system used to transfer the funds weekly to the participating agencies.
Service	The Internal Revenue Service.
Special Character	Any character that is not a numeral, a letter or a blank.
Spousal Claim	An amended return filed by a spouse whose share of a joint overpayment was applied to the other spouse's debt. The allowable amount of the claim will be refunded to the non-obligated spouse and deducted from the offsetting agency. The refund will be addressed to both taxpayers.
SSA	Social Security Administration
SSN	Social Security Number assigned by SSA.
Subagency Code	This is a two digit alpha-numeric code assigned by the agency. The agency must consider the types of delinquent accounts an obligor may have. If multiple accounts are present, a separate subagency code must be used to collect each debt. This code may be any alpha numeric combination. Zero is a valid subagency code. All subagency codes assigned by an agency must be approved by IRS.
Transmitter	Participating Federal Agencies preparing tape files.

SEC. 4. MILESTONE CHART/REPORTING SCHEDULES/TRANSMITTAL FORMS

.01 MILESTONE ACTIVITY CHART

ACTIVITY	TARGET/COMPLETION DATES
1) Annual Pre-Offset Address Request Record Tape	Aug. 11,1988(TEST) Aug. 25,1988(PRODUCTION)
2) Annual Certification Record Tape	Nov. 15,1988(TEST) Jan. 5,1989(PRODUCTION)
3) Agency Address File Tape or Record Tape	Dec. 6,1988(TEST) Jan. 9,1989(PRODUCTION)
4) Weekly Update Record Tape	Dec. 13,1988(TEST) Jan. 26,1989(PRODUCTION)

.02 *Weekly REPORTING/TRANSFER OF ON-Line Payment and Collection System (OPAC) Schedule* - The Debtor Master File Program is a reimbursable progam and all participating agencies reimburse the IRS for all administrative costs. This is accomplished through the On-Line Payment and Collection (OPAC) System option on the Government On-Line Accounting Link System (GOALS). The actual transfer of funds in this program is coordinated by the IRS DMF Coordinator, Returns Processing and Accounting Division (TR:R:A), 1111 Constitution Avenue, N.W., Room 7516, Washington, D.C. 20224,(FTS 343-0145; non-FTS (202) 343-0145), and each participating agency.

Each Monday, through the OPAC system, the net collections are transferred from the IRS Clearing Account 20F3875.11 to each agency's ALC number. The money is available as soon as the transfer is effected; however, the agency will not "see" it on OPAC until the next workday as the data base is updated overnight. The IRS provides the agencies with a transaction file containing collection (offset/claim) information in the form of magnetic tapes (Service-Weekly Collection (Offset/Claim) File) on a cycle basis. The weekly OPAC transfer of funds should match the amounts contained on the Weekly Collection Tape. The following chart shows each offset cycle (week) and the effective date (transfer of funds) for that cycle. Note that these are all Monday dates. If the dates happen to fall on a holiday, the transfer of funds will take place the next workday. Also included are the due dates for the Weekly Update tapes and approximate shipping dates for the Weekly Unprocessable and Collection files.

SCHEDULE

DATE 1 = Weekly update due date(THURSDAY)

DATE 2 = Approximate shipping date for Unprocessable File(SATURDAY)

DATE 3 = Approximate shipping date for Collection File(THURSDAY)

DATE 4 = Effective date of Offsets and OPAC Transfer(MONDAY)

CYCLE	DATE 1	DATE 2	DATE 3	DATE 4
8905	01/26/89	01/28/89	02/02/89	02/13/89
8906	02/02/89	02/04/89	02/09/89	02/20/89
8907	02/09/89	02/11/89	02/16/89	02/27/89
8908	02/16/89	02/18/89	02/23/89	03/06/89
8909	02/23/89	02/25/89	03/02/89	03/13/89
8910	03/02/89	03/04/89	03/09/89	03/20/89
8911	03/09/89	03/11/89	03/16/89	03/27/89
8912	03/16/89	03/18/89	03/23/89	04/03/89
8913	03/23/89	03/25/89	03/30/89	04/10/89
8914	03/30/89	04/01/89	04/06/89	04/17/89
8915	04/06/89	04/08/89	04/13/89	04/24/89
8916	04/13/89	04/15/89	04/20/89	05/01/89
8917	04/20/89	04/22/89	04/27/89	05/08/89
8918	04/27/89	04/29/89	05/04/89	05/15/89
8919	05/04/89	05/06/89	05/11/89	05/22/89
8920	05/11/89	05/13/89	05/18/89	05/29/89
8921	05/18/89	05/20/89	05/25/89	06/05/89
8922	05/25/89	05/27/89	06/01/89	06/12/89
8923	06/01/89	06/03/89	06/08/89	06/19/89
8924	06/08/89	06/10/89	06/15/89	06/26/89
8925	06/15/89	06/17/89	06/22/89	07/03/89
8926	06/22/89	06/24/89	60/29/89	07/10/89
8927	06/29/89	07/01/89	07/06/89	07/17/89
8928	07/06/89	07/08/89	07/13/89	07/24/89
8929	07/13/89	07/15/89	07/20/89	07/31/89
8930	07/20/89	07/22/89	07/27/89	08/07/89
8931	07/27/89	07/29/89	08/03/89	08/14/89
8932	08/03/89	08/05/89	08/10/89	08/21/89
8933	08/10/89	08/12/89	08/17/89	08/28/89
8934	08/17/89	08/19/89	08/24/89	09/04/89
8935	08/24/89	08/26/89	08/31/89	09/11/89
8936	08/31/89	09/02/89	09/07/89	09/18/89
8937	09/07/89	09/09/89	09/14/89	09/25/89
8938	09/14/89	09/16/89	09/21/89	10/02/89
8939	09/21/89	09/23/89	09/28/89	10/09/89
8940	09/28/89	09/30/89	10/05/89	10/16/89
8941	10/05/89	10/07/89	10/12/89	10/23/89
8942	10/12/89	10/14/89	10/19/89	10/30/89
8943	10/19/89	10/21/89	10/26/89	11/06/89
8944	10/26/89	10/28/89	11/02/89	11/13/89
8945	11/02/89	11/04/89	11/09/89	11/20/89
8946	11/09/89	11/11/89	11/16/89	11/27/89
8947	11/16/89	11/18/89	11/23/89	12/04/89
8948	11/23/89	11/25/89	11/30/89	12/11/89
8949	11/30/89	12/02/89	12/07/89	12/18/89
8950	12/07/89	12/09/89	12/14/89	12/25/89
8951	12/14/89	12/16/89	12/21/89	01/01/90
8952	12/21/89	12/23/89	12/28/89	01/08/90

.03 WEEKLY UPDATE SCHEDULE Each agency may submit weekly update information to either delete or decrease an obligation amount or to indicate an agency refund/repayment has been made. These tapes must be received by the Martinsburg Computing Center no later than Thursday night of each week in order to meet MCC's weekly update cycle. Any tape received after this time may not be input until the following week. IRS will return any records found unprocessable to the participating agency within seven days. NOTE: Agencies must send weekly updates as timely as possible to prevent erroneous offsets or refunds from occurring.

.04 TRANSMITTAL LETTER - Tapes submitted to IRS must be accompanied by a letter as detailed in Exhibit A.4-1 in Part A, Section 4.08 below. Use the following chart to determine run title and file name. The symbol ## in the file name is replaced with your agency code (*i.e.*, 01) as assigned by IRS.

TYPE OF DATA	RUN TITLE	FILE NAME
Pre-Offset Address Request Records	440-03 Annual Pre-Offset	440-PO-##
Annual Certification Records	440-03 Annual	440-AC-##
Agency Address Records	440-20 Agency Address	440-AA-##
Agency Address Update Records	480-15 Agency Add. Update	480-AA-##
Weekly Update Records	445-12 Weekly	445-WK-##

IRS will acknowledge receipt of Agency tapes by returning a signed copy of the transmittal letter. If the Agency does not receive the acknowledgment within one week, they must contact the MCC Debtor Master File Coordinator at FTS 937-8345 (NON-FTS (304) 267-2911 EXT 345) to verify receipt of tape. NOTE: For tapes being returned to MCC (not an agency generated production or test file) please mark the transmittal "returned".

.05 TAPE TRANSMITTAL FORM IRS/MCC will supply each agency with pre-printed forms (Form 3220) to be completed and shipped along with each Weekly Update tape file sent to IRS. Do not ship tapes and transmittal documents separately. This form is in addition to the Transmittal Letter outlined in Part A, Section 4.04 above. This transmittal form will be supplied for use with the TRANSMITTER WEEKLY UPDATE PRODUCTION file only. See Exhibit A.4-2 in Part A, Sec. 4.08 below.

.06 Upon Shipment of Production tapes, the Debtor Master File Coordinator at the IRS Martinsburg Computing Center must be notified on FTS 937-8345 (NON-FTS (304)-267-2911 EXT 345). Please limit these calls to Monday through Friday between the hours of 8:00 AM and 4:00 PM (Eastern Time).

.07 EXPRESS MAIL - ALL TAPES SENT TO MCC MUST USE EXPRESS MAIL NEXT DAY SERVICE.(USPS). Any deviations regarding tape shipment must be coordinated with the DMF COORDINATOR AT THE MCC ON FTS 937-8345 (NON-FTS (304)-267-2911 EXT 345). Please limit these calls to Monday through Friday between the hours of 8:00 AM and 4:00 PM (Eastern Time).

.08 EXHIBITS

EXHIBIT A.4-1 - TRANSMITTAL LETTER

Submitting Agency
Address
Telephone Number
Agency Code ##
Date

Internal Revenue Service
Martinsburg Computing Center
P.O. Box 909
Kearneysville, WV. 25430

Attention Debtor Master File Coordinator:

Enclosed please find a tape for the IRS Tax Refund Offset Project for submission to the DMF (select run title from Section 4.04 above) Run.

File Name: (select from Sec. 4.04 above)
Number of Records: ____________
Tape Number: ____________
Number of Blocks: ____________

CIRCLE EACH WHICH IS APPLICABLE

PRODUCTION TAPE	ORIGINAL or
TEST TAPE	REPLACEMENT (Replaces Reel Number ____________
RETURNED TAPE	BACKUP TAPE

MCC: Please sign below and return one copy to the submitting agency and keep one copy for your files.

____________________ ____________
TRANSMITTER (SIGNATURE/TITLE) Date

____________________ ____________
MCC Acknowledgment Date

EXHIBIT A.4-2 TAPE TRANSMITTAL FORM 3220

MASS STORAGE MEDIA	☐ CHARGE-OUT	DATE		JOB RUN NUMBER		
	☐ REMOTE LOG	MACHINE	OP CODE 11	CYCLE NUMBER	Batch / Cycle DPW / Group	
	☒ TRANSMITTAL	TYPE	CONTROL	TRANSMITTAL NUMBER	From GP5 / Number A / To NC2	

I/O	TC	SERIAL NO	JOB-RUN-FILE-ID (FROM)	MEDIA SEQUENCE	CREATION DATE	RETENTION (DAYS)	STATUS	PROG NO	BLOCK COUNT	ERRORS	DR
0	5	CV	445WK##*								

ORIGINAL (AGENCY) REEL NUMBER — B

NUMBER OF RECORDS — C

NUMBER OF BLOCKS — D

NAME OF PERSON CONTACTED — E

DATE OF CONTACT — F

TIME OF CONTACT — G

ROUTING/REMARKS

AGENCY ## INPUT FOR WEEKLY RUN OF 445-12 (DMF)

FROM: FEDERAL AGENCY NAME
ADDRESS/NAME OF COMPUTER FACILITY
TAPE WAS SENT FROM
YOURTOWN, USA

SCHEDULING CONTROLS

SIGNATURE

DATE

DEPARTMENT OF THE TREASURY INTERNAL REVENUE SERVICE FORM 3220 (REV. 7-82)

EXHIBIT A.4-2 - TAPE TRANSMITTAL FORM 3220 CON'T

Four items must be filled in prior to shipping a tape file:

Item A	insert a Transmittal Number here. This number can be used as reference when calling MCC to verify receipt of tapes.
Item B	insert original reel number. (Upon receipt, MCC will assign a number of its own under Serial No.)
Item C	insert number of records on the file. This should include data records only.
Item D	insert number of data blocks on the file.
Item E	insert name of person contacted at MCC regarding shipment of this tape.
Item F	insert date of contact in item E.
Item G	insert time of contact in item E.

Additional notes for Form 3220

The ## symbols will be the actual agency code assigned by IRS.

A unique number for each agency will be assigned and placed in box 17.

* MCC may add a 2 or 3 digit literal to the file I.D. for each agency.

SEC. 5. SUBMISSION DATES FOR MAGNETIC TAPES

.01 IRS requires participating agencies to provide test tapes for the purpose of compatibility testing as soon as possible after July 1. Tapes must be mailed to:

Internal Revenue Service
Martinsburg Computing Center
P.O. Box 909
Kearneysville, WV. 25430
ATTN: DEBTOR MASTER FILE COORDINATOR

.02 The following final due dates have been established for the submission of TEST tapes and PRODUCTION tapes. Please note that all tapes must be *received* at MCC no later than the final dates shown below. Submission of tapes prior to these dates is acceptable and encouraged. A TEST tape must be submitted prior to a PRODUCTION tape.

	TAPE FILE	FINAL Due Dates for	
		TEST TAPE(s)	PROD TAPE(s)
(a)	Transmitter-Annual Pre-Offset Address Request Record Tape	Aug. 11,1988	Aug. 25,1988
(b)	Transmitter-Annual Certification Record Tape	Nov. 15, 1988	* Jan. 5, 1989
(c)	Transmitter Agency Address File Tape or Letter	Dec. 6,1988	Jan. 9, 1989
(d)	Transmitter-Weekly Update Record Tape	Dec. 13,1988	Starting Jan. 26,1989 and every Thursday evening thereafter

*If a Transmitter-Annual Certification Record Tape is received after this date, there is no guarantee it will be included in the annual certification processing. If it is not so included, the accounts on those tapes will not be subject to offset for the entire calendar year.

SERVICE TEST TAPES- will be created and sent to the agency approximately one week after the receipt of the agency test tape.

.03 Pre-Offset Address Request processing will begin in July and continue on an "as needed" basis thru August 25, 1988. The agency must schedule their participation with the DMF Project Staff. A minimum of one weeks lead time is required. Tape files are due at MCC by Thursday evening prior to the scheduled cycle. The following is the Pre-Offset Schedule:

SCHEDULE

DATE 1 = Tape Due at Martinsburg Computing Center(THURSDAY)

DATE 2 = Approximate MCC shipping date of Unprocessable File(SAT.)

DATE 3 = Approximate MCC shipping date of Pre-Offset Address File(THURSDAY)

CYCLE	DATE 1	DATE 2	DATE 3
8827	06/30/88	07/02/88	07/07/88
8829	07/14/88	07/16/88	07/21/88
8831	07/28/88	07/30/88	08/04/88
8833	08/11/88	08/13/88	08/18/88
8835	08/25/88	08/27/88	09/01/88

.04 Upon Shipment of Production Tapes, the Debtor Master File Coordinator at the IRS Martinsburg Computing Center must be notified on FTS 937-8345 (NON-FTS (304)-267-2911 EXT 345). Please limit these calls to Monday through Friday between the hours of 8:00 AM and 4:00 PM Eastern Time).

.05 *BACKUP TAPE FILES* - It is suggested that a backup of the Production Transmitter-Annual Certification Records file be sent to IRS. This will minimize the chance of an agency not being included in the year's certification in the event the original tape is lost, damaged or unreadable. Any paperwork accompanying the backup file should be annotated that it is a backup file.

NOTE: A backup tape should be sent for the Annual Certification file only.

SEC. 6. INTERNAL REVENUE PROCESSING OF MAGNETIC TAPES

.01 All tapes submitted must conform exactly to this Revenue Procedure. IF TAPES ARE UNPROCESSABLE, THEY WILL BE RETURNED TO THE SUBMITTING AGENCY FOR CORRECTION AND REPLACEMENT. Files received from agencies that contain any of the following error conditions will be returned in their entirety as unprocessable. The Martinsburg Computing Center will contact the Agency when an unprocessable file is being returned.

(a) A record contains an invalid money amount field (non-numeric).

(b) The control record does not balance with the data records on count and/or amount.

(c) An unprocessable tape header is encountered.

.02 Each unprocessable record will be returned intact with an error code inserted in the record explaining the reason for its return. Part B Sec. 7, 12 and 19 contain the Unprocessable Record layouts which include explanations for each error code.

SEC. 7. PRE-OFFSET ADDRESS REQUEST PROCESSING

.01 Prior to submission of Annual Certification Records, Federal agencies must obtain the latest IRS address information from an individual's tax account by submitting Annual Pre-Offset Address Request Records to IRS. Transmitter-Annual Pre-Offset Address Request Records must contain all elements as specified in Part B, Sec. 5 & 6 of this Revenue Procedure. Agencies must contact the IRS DMF Program Coordinator, Returns Processing & Accounting Division (TR:R:A), 1111 Constitution Ave. NW, Washington, D.C. 20224, (FTS 343-0145, NON-FTS (202) 343-0145,), to schedule their participation in Pre-Offset Processing. This processing will begin in July. Pre-Offset TEST tapes must be received no later than August 11, 1988. Pre-Offset PRODUCTION tapes must be received no later than August 25, 1988, to be included in the last scheduled processing cycle. See exhibits A.7-1 and A.7-2.

The purpose of this processing is to obtain address information for use in making a reasonable attempt to notify the obligor of the agencies intent to refer their case to IRS. A reasonable attempt to notify the debtor means that the Agency may use the address they maintain for the debtor if they believe that to be the most current. However, if the notice comes back undeliverable, then the agency must attempt to notify the debtor at the mailing address obtained from the Service. The agency must use the address received from the Service pursuant to section 6103(m)(2), (m)(4) or (m)(5) of the Code as appropriate within a period of one year preceding the attempt to notify the debtor.

NOTE: REGARDLESS OF WHICH ADDRESS THE AGENCY PLANS TO USE, PARTICIPATION IN PRE-OFFSET ADDRESS PROCESSING IS MANDATORY.

.02 Upon receipt of a file containing Transmitter-Annual Pre-Offset Address Request Records, IRS will validate all records. Those records deemed unprocessable will be returned to the submitting agency containing all elements as specified in Part B, Sec. 7 of this Revenue Procedure. Processable records will be matched against the Individual Master File (IMF).

.03 Files received from agencies that contain any of the following error conditions will be returned in their entirety as unprocessable. The Martinsburg Computing Center will contact the Agency when an unprocessable file will be returned.

(a) A record contains an invalid money amount field (non-numeric).

(b) The control record does not balance with the data records on count and/or amount.

(c) An unprocessable tape header is encountered.

.04 Records not matching the IMF on SSN and Name Control will be returned to the submitting agency containing all elements as specified in Part B, Sec. 8 & 9.

.05 Records matching the IMF on SSN but not on Name Control will cause extraction of the name line for the SSN as contained on the IMF. The format of the record returned from IRS is specified in Part B, Sec. 8 & 9.

NOTE: The return by IRS of a name line does NOT imply the SSN is correct and the agency name control field is wrong. The agency MUST examine each of these records manually (*i.e.*, not via a computer program!) to determine if the name line IRS has is truly the obligor the agency is attempting to obtain an address for and subsequently certify for offset. Under NO circumstances may an agency routinely use the name and/or name control supplied by IRS.

.06 Records matching the IMF on both SSN and Name Control will cause extraction of the Street Address, City, State and ZIP Code as contained on the IMF. The format of the record returned from IRS is specified in Part B, Sec. 8 & 9. In addition, an indicator will be set if the IMF indicates the obligor is deceased.

.07 Because of the similarity in the Pre-Offset and Annual Certification Process, participation in Pre-Offset will allow Federal Agencies to not only receive obligors addresses but also test and review the condition of their data prior to Annual Certification. The submitting agency will be able to review the Unprocessable and No-Match records prior to Annual Certification. Records failing any validity checks at Annual Certification will result in the loss of a potential offset(s) for that processing year.

.08 Agencies are reminded that using any data provided by IRS for other than this program is a conflict with Disclosure provisions and can result in suspension from the program. (See Part A Section 12 Disclosure & Safeguard Requirements.)

SEC. 8. ANNUAL DEBTOR MASTER FILE PROCESSING

.01 The federal agencies participating in this program must submit their Annual Certification records in accordance with the specifications in Part B, Sec. 10 & 11 of this Revenue Procedure. A TEST tape of Annual Certification records must be received no later than November 15, 1988. The PRODUCTION file must be received no later than January 5, 1989. See exhibits A.8-1, A.8-2.

.02 Upon receipt of a tape containing the Annual Certification records, IRS will validate all records. Those deemed unprocessable will be returned on a separate tape file to the submitting agency containing all elements as specified in Part B, Sec. 12 of this Revenue Procedure including the error reason code. Processable records will be matched against the Individual Master File (IMF).

.03 Tapes received from agencies that contain any of the following error conditions will be returned in their entirety as unprocessable. The Martinsburg Computing Center will contact the Agency when an unprocessable tape is being returned.

(a) A record contains an invalid money amount field (non-numeric).

(b) The control record does not balance with the data records on count and/or amount.

(c) An unprocessable tape header is encountered.

.04 Those records that do not find a match on the Individual Master File (IMF) will be returned on a separate tape file to the submitting agency containing all elements as specified in Part B, Sec. 13 & 14 of this Revenue Procedure.

.05 Records finding a match on the IMF will create a refund freeze condition. The Debtor Master File (DMF) is initialized annually only from processable certification records that match the IMF. The DMF file can be updated on a weekly basis through offsets and claims from the IMF, and through decreases, deletes and agency refund repayments from the submitting agencies. New accounts cannot be added to the file after the beginning of the calendar year, nor can obligation amounts be increased.

.06 Records finding a match and with an indication on the IMF that the obligor is deceased will cause an error code 05 information record to be returned on the No-Match File.

EXHIBIT A.7-1

PRE-OFFSET PROCESSING

TAX REFUND OFFSET PROGRAM

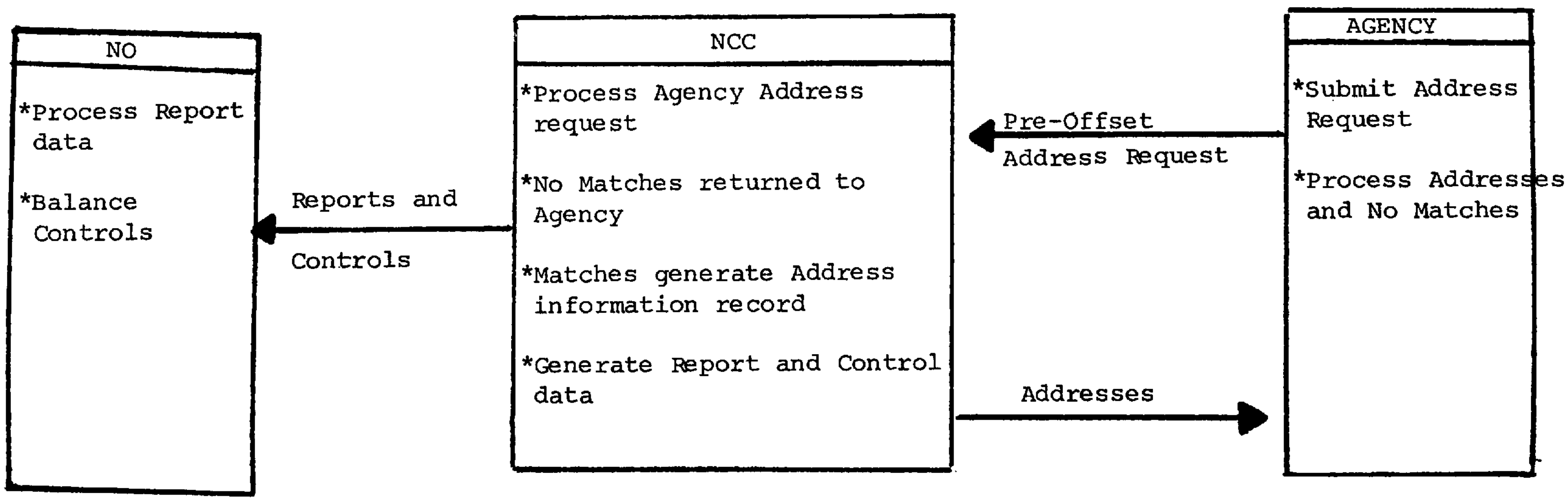
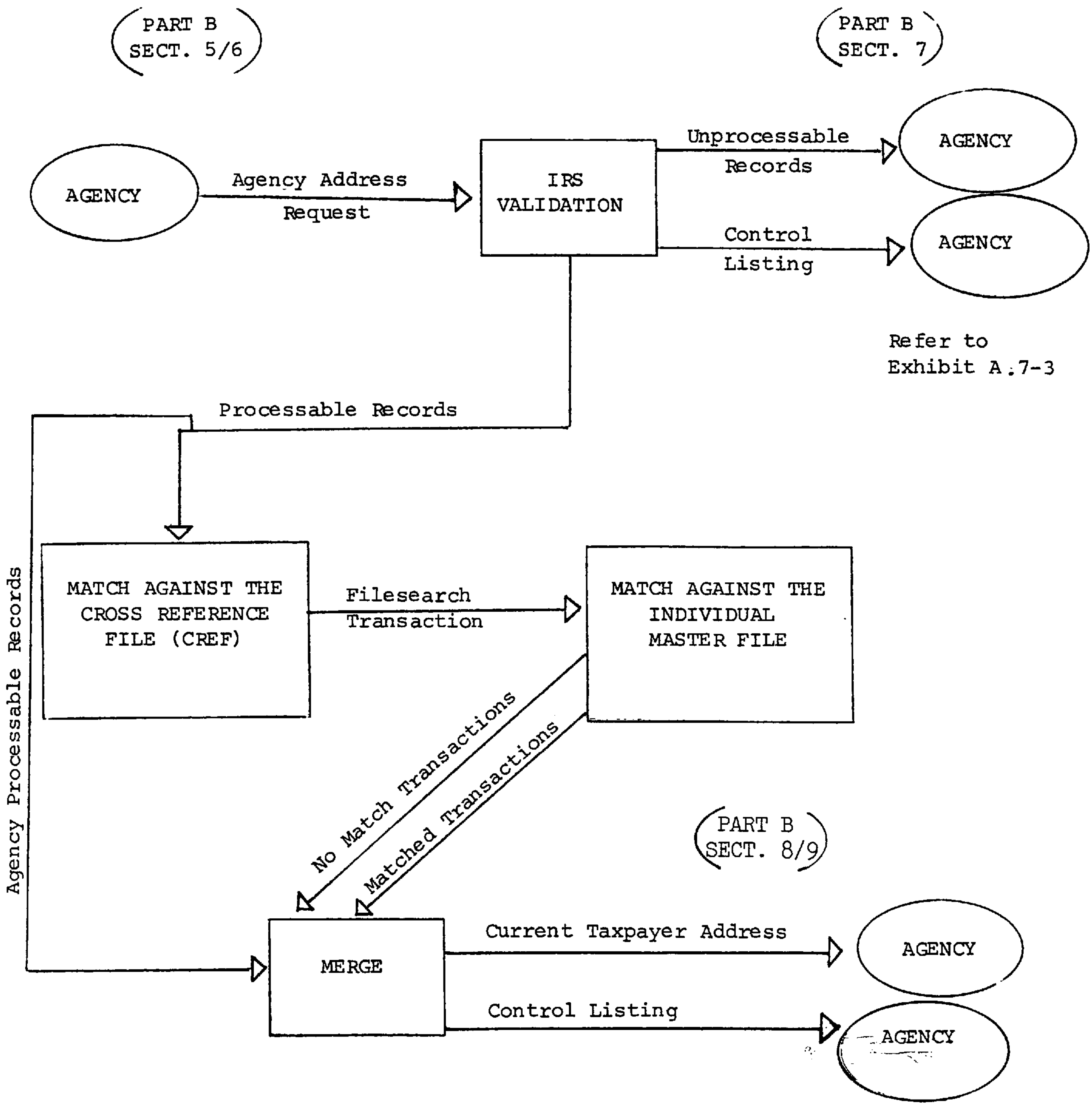


EXHIBIT A.7-2

PRE-OFFSET PROCESSING (JULY-SEPT)



Refer to Exhibit A.7-4

EXHIBIT A.7-3

PROJECT/RUN/FILE 440-03-12

PAGE

CYCLE YYCC

DATE MMDDYY

PRE-OFFSET/ANNUAL

(AGENCY) AGENCY VALIDITY REPORT

	COUNT	AMOUNT
TOTAL RECORDS INPUT	X,XXX	$ XX,XXX,XXX.XX[1]
VALID RECORDS OUTPUT	X,XXX	$ XX,XXX,XXX.XX
INVALID RECORDS OUTPUT	XXX	$ X,XXX,XXX.XX
ERROR CODE 01	XX	$ XXX.XX
ERROR CODE 02	XX	$ XXX.XX
ERROR CODE 03	XX	$ XXX.XX
ERROR CODE 04	XX	$ XXX.XX
ERROR CODE 05	XX	$ XXX.XX
ERROR CODE 06	XX	$ XXX.XX
ERROR CODE 07	XX	$ XXX.XX
ERROR CODE 08	XX	$ XXX.XX
ERROR CODE 09	XX	$ XXX.XX
ERROR CODE 10	XX	$ XXX.XX
ERROR CODE 11-15	RESERVED	$ XXX.XX
TOTAL RECORDS OUTPUT	X,XXX	$ XXX,XXX.XX

EXHIBIT A.7-4

PROJECT/RUN/FILE 440-17-15

CYCLE YYCC

PAGE XX

DATE MM-DD-YY

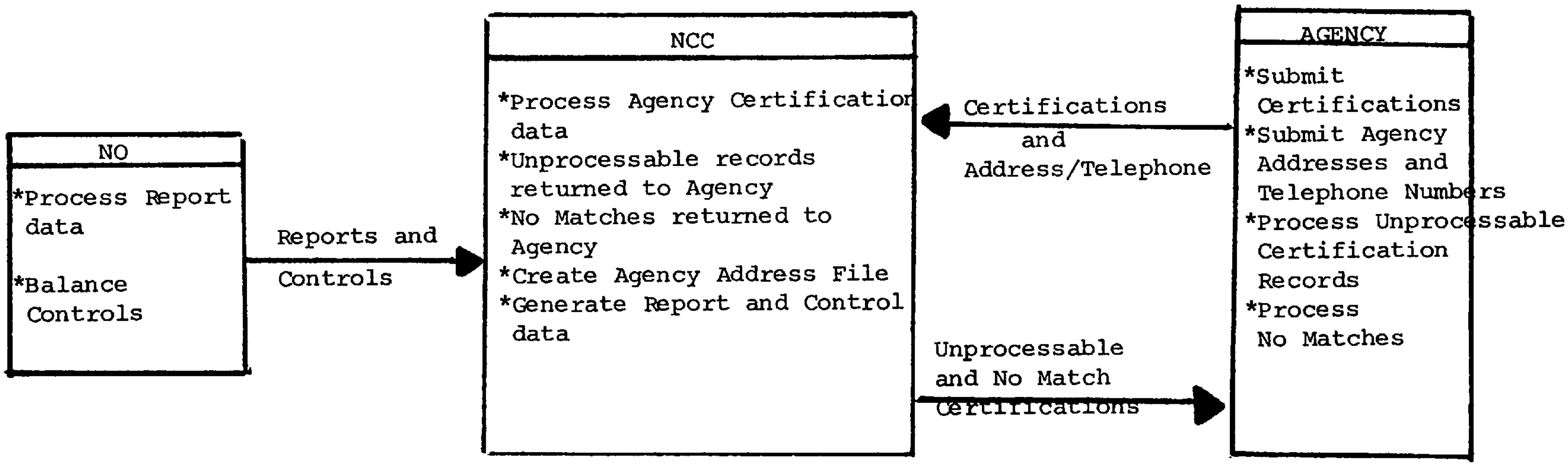
PREOFFSET
ADDRESS REQUEST
CONTROL LISTING
(AGENCY)

ERROR CODE	NUMBER OF REQUEST	AMOUNT OF OBLIGATION
01	X,XXX	$ X,XXX,XXX.XX
02	X,XXX	$ X,XXX,XXX.XX
03	X,XXX	$ X,XXX,XXX.XX
04-10	X,XXX	$ X,XXX,XXX.XX
TOTAL	X,XXX	$ X,XXX,XXX.XX

EXHIBIT A.8-1

ANNUAL PROCESSING

TAX REFUND OFFSET PROGRAM



ANNUAL CERTIFICATION (JANUARY)

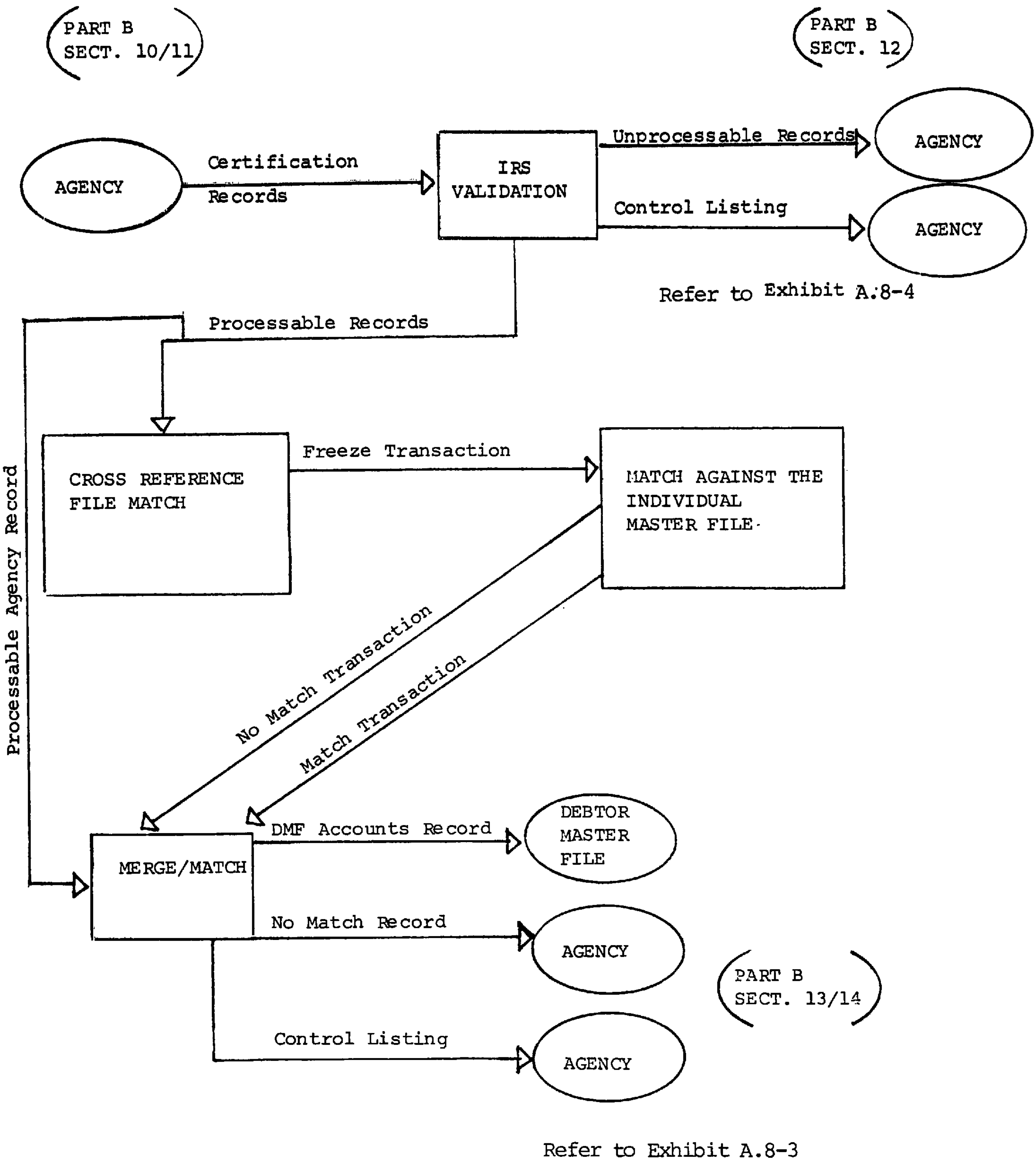


EXHIBIT A.8-2

EXHIBIT A.8-3

PROJECT/RUN/FILE 440-08-15

CYCLE YYCC

PAGE XX

DATE MM-DD-YY

ANNUAL
NO MATCH RECORDS
CONTROL LISTING
(AGENCY)

ERROR CODE	NUMBER OF RECORDS	AMOUNT OF OBLIGATION
01	X,XXX	$ X,XXX,XXX.XX
02	X,XXX	$ X,XXX,XXX.XX
03	X,XXX	$ X,XXX,XXX.XX
04	X,XXX	$ X,XXX,XXX.XX
05 (INFO)	X,XXX	$ X,XXX,XXX.XX
06-10	X,XXX	$ X,XXX,XXX.XX
TOTAL	X,XXX	$ X,XXX,XXX.XX

EXHIBIT A.8-4

PROJECT/RUN/FILE 440-03-12

PAGE

CYCLE YYCC

DATE MMDDYY

PRE-OFFSET/ANNUAL

(AGENCY) AGENCY VALIDITY REPORT

	COUNT	AMOUNT
TOTAL RECORDS INPUT	X,XXX	$ XX,XXX,XXX.XX[1]
VALID RECORDS OUTPUT	X,XXX	$ XX,XXX,XXX.XX
INVALID RECORDS OUTPUT	XXX	$ X,XXX,XXX.XX
ERROR CODE 01	XX	$ XXX.XX
ERROR CODE 02	XX	$ XXX.XX
ERROR CODE 03	XX	$ XXX.XX
ERROR CODE 04	XX	$ XXX.XX
ERROR CODE 05	XX	$ XXX.XX
ERROR CODE 06	XX	$ XXX.XX
ERROR CODE 07	XX	$ XXX.XX
ERROR CODE 08	XX	$ XXX.XX
ERROR CODE 09	XX	$ XXX.XX
ERROR CODE 10	XX	$ XXX.XX
ERROR CODE 11-15	RESERVED	
TOTAL RECORDS OUTPUT	X,XXX	$ XXX,XXX.XX

.07 Accounts on the DMF will be prioritized and federal income tax refunds offset based on the following criteria:

(a) Office of Child Support Enforcement (AFDC)-Aid to Families with Dependent Children claims and state foster care and adoption assistance program claims.

(b) All other participating agencies based on the earliest delinquent date. In the event the delinquency date is the same, the account with the larger obligation will be subject to offset first.

(c) Office of Child Support Enforcement-(non-AFDC) NON-Aid to Families with Dependent Children claims.

SEC. 9. AGENCY ADDRESS FILE

.01 An Agency Address File will be created annually by IRS and will contain address and contact point information which will be included on all related IRS generated taxpayer correspondences. A central address (local code ''000'') for each Subagency and at the option of the agency, local addresses (additional local codes), must be provided for inclusion on IRS notices. Agencies will have the ability to correct/update address information throughout the processing year. The first line of the address (Agency Name field) must contain the name of the participating agency (*i.e.*, U.S. Department of Education, Office of Child Support Enforcement, etc.). This field will display as the first address line on the notice the taxpayer receives at the time his refund is offset and must clearly identify which agency has received the collection.(See Example below) No reference will be made to IRS within the Agency Address. At least one address with local code ''000'' is required for each subagency. See Exhibit A.9-1.

Example: Agency Certification Record:

Obligor = Marjorie Mixon
Agency Code = 01
Subagency Code = GA
Local Code = 029

Agency Address Record
Agency Code = 01
Subagency Code = GA
Local Code = 029
Agency Address Info. = Child Support Office
Atlantic Judicial Circuit
941 E.G. Miles Parkway
P.O. Box 9
Hinesville, Georgia 31313

Agency Phone Info. = (912) 876-4154 (LOCAL)
(814) 555-1212 (Collect)
1-800-626-2912 (Toll Free)
(Nationwide/Toll Free)

When an offset for the above obligor occurs, an offset notice will be generated as in Exhibit A.10.4.

It is required by IRS that the Agency supply at least one toll- free or collect telephone number. Space is provided for three phone numbers. More than one toll-free or collect number may be used.

NOTE: The telephone number(s) do not have to be different for each local code. The Agency may assign one toll-free number for all subagencies.

Initial address information must be submitted on magnetic tape except as noted below. A TEST tape MUST be submitted no later than December 6, 1988. The PRODUCTION tape must be submitted no later than January 9, 1989. All magnetic media address information must conform to the specifications in Part B, Sec. 15 & 16 of this Revenue Procedure.

NOTE: If an Agency has 5 or less Address records, the address information may be submitted via the Updates to Agency Address File procedure as described in 9.02 below.

.02 Updates to Agency Address File VIA Memorandum

Revisions to the Agency Address file submitted at the beginning of the processing year may be submitted whenever necessary. A memorandum must be mailed to the National Office, Returns Processing & Accounting Division, Attn: Debtor Master File Coordinator, in the format outlined in 9.03 below. Agencies will be notified when the update(s) have been completed. NOTE: Complete address information, including telephone number, must be submitted for all updates (additions and changes).

.03 CHANGE OF ADDRESS LETTER - A memorandum, in the format shown in Exhibit A.9-2 below, must be used to notify IRS of changes or additions to the Agency Address File.

.04 Updates to Agency Address File Via Tape File - Revisions to the Agency Address file may be submitted via a tape file. The format is identical to the initial address (Part B, sections 15 & 16) except that the ''update indicator'' must be appropriately set. A memorandum letter (Exhibit A.9-2) must be submitted to the DMF Coordinator with an attached listing of the address changes on the tape file.

SEC. 10. WEEKLY DEBTOR MASTER FILE PROCESSING

.01 Federal Agencies are encouraged to submit Transmitter Weekly Update Records. These records must be in accordance with specifications in Part B, Sections 17 & 18 of this Revenue Procedure. A TEST file must be received no later than December 13, 1988. PRODUCTION files must be received no later than each THURSDAY night, beginning January 26, 1989, if they are to be timely processed that week. Tapes received later than Thursday may not be processed until the following week. See exhibit A.10-1.

.02 Weekly updates can include the following types of records:

(a) DECREASES - the record used by the submitting agency to reduce a previously certified amount of obligation. IRS will reduce the current amount of obligation by the amount reflected in the DECREASE record. The remaining obligation will be subject to refund offset whenever credits become available.

(b) DELETES this record is basically the same as a DECREASE record except that when the amount of decrease is applied to the outstanding obligation amount, as reflected by IRS, the result is $25.00 or less. In this case, IRS will consider the record as a DELETE. A DELETE record must be used whenever a submitting agency intends to eliminate a previously certified case from the DMF.

It should be noted that whenever IRS processes a DELETE record, the obligor will no longer be subjected to the refund offset program for that agency/subagency combination, for the remainder of the processing year.

(c) AGENCY REFUND RECORD - this record is used to alert IRS that an agency has directly repaid either a portion or the entire amount of an IRS offset. This record should be forwarded to IRS at the earliest possible date. Failure to send this record to IRS whenever this situation arises could result in IRS erroneously allowing an injured spousal claim and billing the agency for the amount. The amount of refund by the agency is included in the record.

(d) AGENCY REFUND CORRECTION this record is used to correct (DECREASE) the amount of an incorrect Agency Refund Record(s) previously submitted to and processed by IRS. Failure to send this record to IRS may result in IRS erroneously disallowing all or a portion of an injured spouse claim.

.03 Upon receipt of the tape containing the Transmitter Weekly Update Records, IRS will validate all records. Those deemed unprocessable will be returned to the submitting agency intact with an error code inserted into the record as specified in Part B, Sec. 19 of this Revenue Procedure. Processable records will be used to update the Debtor Master File.

.04 Files received from agencies that contain any of the following error conditions will be returned in their entirety as unprocessable. The Martinsburg Computing Center will contact the Agency when an unprocessable file is being returned.

(a) A record contains an invalid money amount field (non-numeric).

(b) The control record does not balance with the data records on count and/or amount.

(c) An unprocessable tape header is encountered.

.05 Each week IRS will process individual income tax data including 1040 tax returns, injured spouse claims and other tax related reversals. These actions will be reflected on the Debtor Master File as follows:

(a) Offsets are made on individual income tax return refunds where the taxpayer has a liability on the Debtor Master File. A notice(CP-47) advising the taxpayer of the offset will be generated by IRS (see Exhibit A.10-4). Individual offset records will be sent weekly to the submitting federal agency on the Service-Weekly Collection (Offset/Claim) Record File as specified in Part B, Sec. 20 & 21 of this Revenue Procedure.

ADDRESS FILE

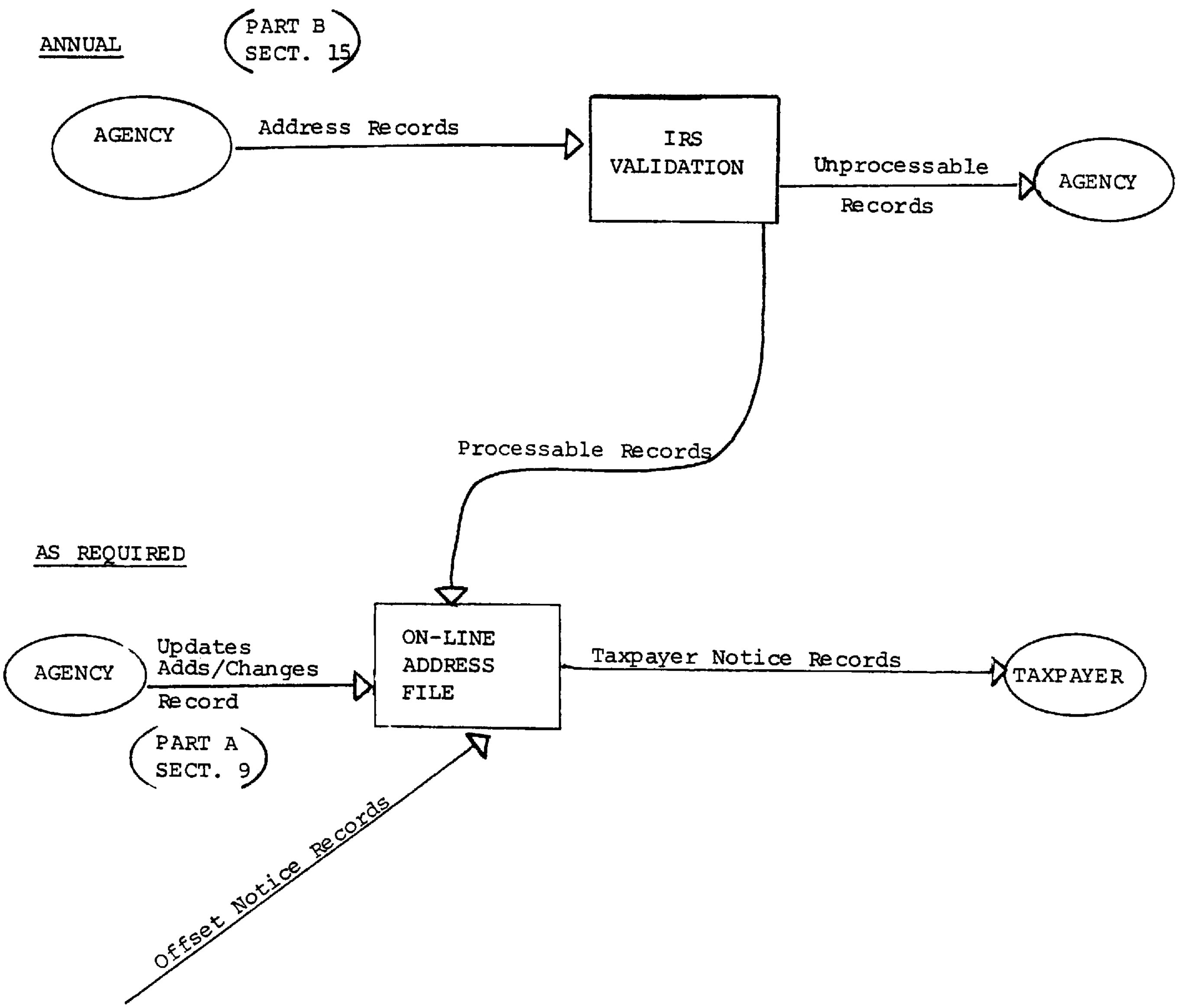


EXHIBIT A.9-1

Submitting
Agency
Address
Telephone Number

Internal Revenue Service
Returns Processing & Accounting Division TR:R:A
Room 7046
1111 Constitution Ave N.W.
Washington, D.C. 20224

Attention Debtor Master File Coordinator:

Attached is a list of address changes that will be on the address update tape forwarded to MCC.

or

Enclosed please find a list of address changes.

agency code ________
subagency code ________
local code ________
local telephone number ________________
toll-free number ________________
toll-free or collect ________________
Agency Name ________________
address line #1 ________________
address line #2 ________________
address line #3 ________________
address line #4 ________________

This is to (check one) _____ ADD _____ CHANGE the above address.

IRS: Please sign acknowledgment below and return one copy. A copy is enclosed for your files.

Requester ______________________________ ____________

SIGNATURE/TITLE DATE

______________________________ ____________

TR:R.A Acknowledgment Date

WEEKLY AGENCY UPDATE (JAN-DEC)

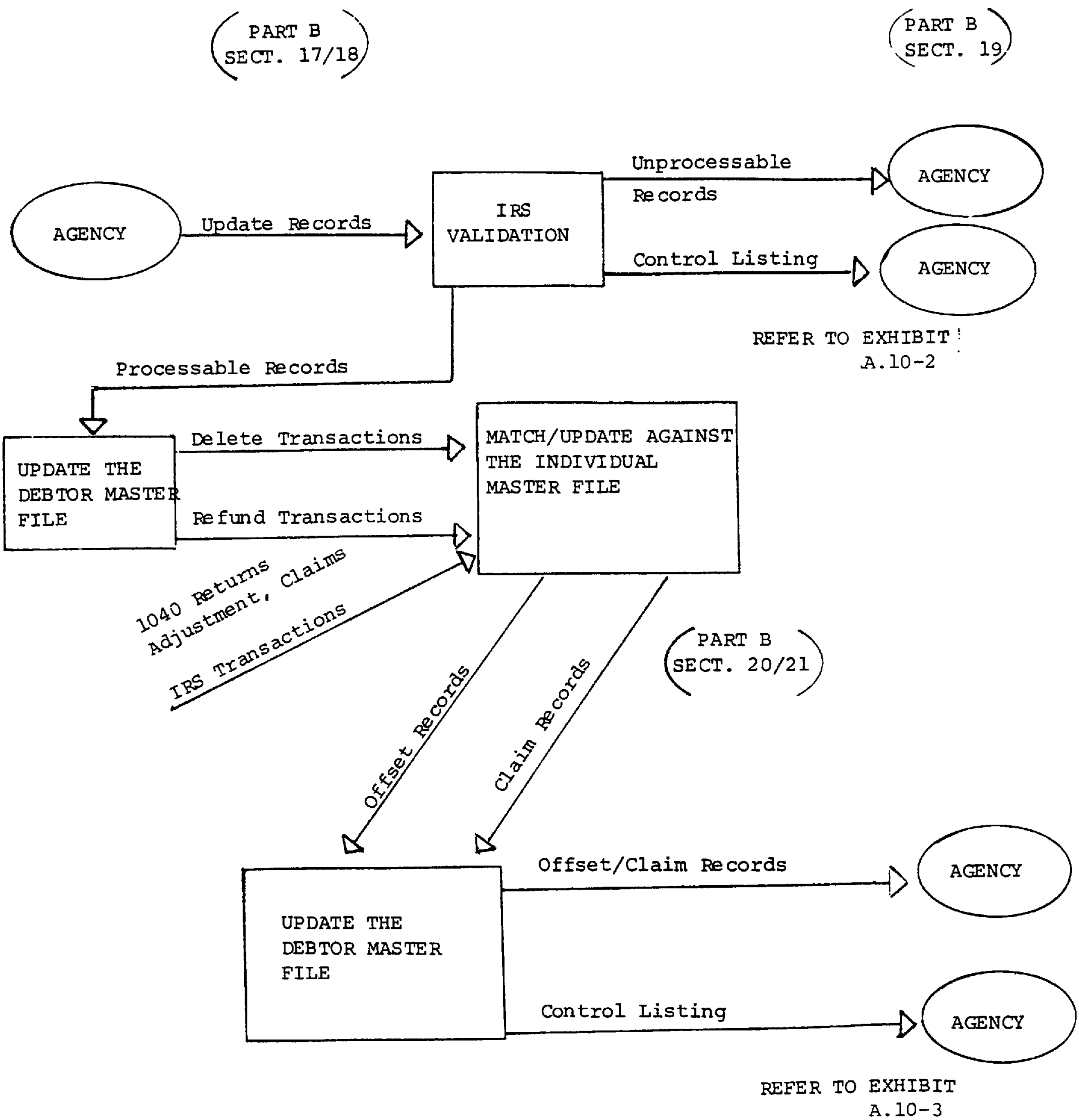


EXHIBIT A-10-1

EXHIBIT A.10-2

PROJECT/RUN/FILE 445-12-11

PAGE

CYCLE YYCC

DATE RUN MM-DD-YY

IRS DEBTOR MASTER FILE

WEEKLY AGENCY VALIDITY LISTING
(AGENCY)

	COUNT	AMOUNT	COUNT	AMOUNT
TOTAL RECORDS INPUT FILE 445-WK-01			XX,XXX	$ X,XXX,XXX.XX
PROCESSABLE RECORDS OUT FILE 445-12-11				
DELETES	X,XXX	$ XX,XXX,XXX.XX		
DECREASES	X,XXX	$ XX,XXX,XXX.XX		
AGENCY REPAYMENT	XX	$ X.XX		
UNPROCESSABLE RECORDS OUT FILE 445-12-12		XXX		$ XX,XXX.XX
INFORMATION RECORDS OUT FILE 445-12-12		XXX		$ X.XX
NO MATCH CODE 01	XXX	$ X.XX		
NO MATCH CODE 02	XXX	$ X.XX		
NO MATCH CODE 03	XXX	$ X.XX		
NO MATCH CODE 04	XXX	$ X.XX		
NO MATCH CODE 05	XXX	$ X.XX		
NO MATCH CODE 06	XXX	$ X.XX		
NO MATCH CODE 07	XXX	$ X.XX		
NO MATCH CODE 08 INFO	XXX	$ X.XX		
NO MATCH CODE 09	XXX	$ X.XX		
NO MATCH CODE 10	XXX	$ X.XX		
NO MATCH CODE 11	XXX	$ X.XX		
NO MATCH CODE 12	XXX	$ X.XX		
NO MATCH CODE 13	XXX	$ X.XX		
NO MATCH CODE 14-20	RESERVED			

EXHIBIT A.10-3

PROJECT/RUN/FILE 445-17-11

PAGE 1

CYCLE YYCC

DATE MM-DD-YY

WEEKLY AGENCY MERGE REPORT

AGENCY (AGENCY)

	COUNT	AMOUNT
OFFSETS	XX,XXX	$ XXX,XXX.XX
CLAIMS	XXX	$ XXX,XXX.XX
NET COLLECTIONS	XX,XXX	$ XXX,XXX.XX

251989022 SR 30 8712 8811 880328 0800 07209-849-81164-8 105449

Department of the Treasury
Internal Revenue Service
ATLANTA, GA 39901

Date of this notice: MAR. 28, 1988
Taxpayer Identifying Number: 252-98-9022
Form: 1040A Tax Period: DEC. 31, 1987

MARJORIE MIXON
PO BOX 771
TIFTON GA 31793-0771

FOR ASSISTANCE FROM THE AGENCY TH
REFERRED YOUR DEBT TO US, YOU MAY
WRITE TO:

CHILD SUPPORT OFFICE
ATLANTIC JUDICIAL CIRCUIT
941 E.G. MILES PARKWAY
P.O. BOX 9
HINESVILLE, GEORGIA 31313

OR CALL:

(912) 876-4154 LOCAL
(814) 555-1212 COLLECT
1-800-626-2912 TOLL FREE
(IRS NUMBERS ARE LISTED BELOW)

OVERPAID TAX APPLIED TO PAST-DUE OBLIGATION AFDC GA

AS REQUIRED BY SECTION 6402(C) OR (D) OF THE INTERNAL REVENUE CODE, WE HAVE APPLIED ALL OR PART OF YOUR REFUND TO FULLY OR PARTIALLY SATISFY A PAST-DUE OBLIGATION REFERRED TO US BY ANOTHER GOVERNMENT AGENCY. IF YOU HAVE QUESTIONS ABOUT THIS OBLIGATION OR BELIEVE THE AMOUNT IS IN ERROR, YOU MUST CONTACT THAT AGENCY AT THE ADDRESS OR TELEPHONE NUMBER AS SHOWN IN THE UPPER RIGHT OF THIS NOTICE.

IF YOU ARE MARRIED FILING A JOINT RETURN AND ONE OF YOU INCURRED THIS DEBT SEPARATELY FROM YOUR SPOUSE, WHO HAS NO LEGAL RESPONSIBILITY FOR THE DEBT, BUT WHO HAS INCOME, WITHHOLDING AND/OR ESTIMATED TAX PAYMENTS, THAT SPOUSE MAY BE ENTITLED TO HIS OR HER SHARE OF THE JOINT REFUND.

IF YOUR SPOUSE MEETS THE REQUIREMENTS SHOWN ABOVE, HE OR SHE MAY RECEIVE HIS OR HER SHARE OF THE JOINT REFUND BY FILING FORM 8379, INJURED SPOUSE ALLOCATION, AND FORM 1040X, AMENDED U.S. INDIVIDUAL INCOME TAX RETURN. THE FORM 1040X SHOULD SHOW THE SAME "MARRIED FILING JOINT RETURN" STATUS AND THE SAME SOCIAL SECURITY NUMBERS OF BOTH SPOUSES IN THE SAME ORDER AS THEY APPEAR ON THE ORIGINAL TAX RETURN. PLEASE ADD THE WORDS "INJURED SPOUSE" AT THE TOP OF THE FORM 1040X AND MAIL BOTH FORMS TO THE INTERNAL REVENUE SERVICE CENTER WHERE YOU FILED YOUR INCOME TAX RETURN. ALSO, YOU SHOULD CLEARLY INDICATE HOW ANY INCOME, ITEMIZED DEDUCTIONS, EXEMPTIONS, CREDITS AND TAX PAYMENTS AS ORIGINALLY CLAIMED SHOULD BE DIVIDED BETWEEN THE TWO SPOUSES. YOU MUST FURNISH THIS INFORMATION BEFORE ANY ADJUSTMENT CAN BE MADE. THE INJURED SPOUSE MUST SIGN THE RETURN. WE WILL FIGURE AND ISSUE THE INJURED SPOUSE PORTION OF THE JOINT REFUND. IN COMMUNITY PROPERTY STATES THE JOINT REFUND MUST BE DIVIDED ACCORDING TO STATE LAW.

IF YOU HAVE ANY QUESTIONS ABOUT THE INJURED SPOUSE CLAIM OR NEED HELP IN COMPLETING THE FORMS 8379 AND 1040X PLEASE CALL YOUR LOCAL INTERNAL REVENUE SERVICE OFFICE AT THE TELEPHONE NUMBER IN THE LOWER LEFT CORNER.

OBLIGOR'S SSN: 252-98-9022

TAX STATEMENT

REFUND ON INCOME TAX RETURN:.................	$900.00
AMOUNT OF REFUND APPLIED TO THE AGENCY DEBT:.	$900.00
AMOUNT TO BE APPLIED TO OTHER OBLIGATIONS, REFUNDED, OR APPLIED TO YOUR ESTIMATED TAX:.. (IF THERE IS AN AMOUNT TO BE REFUNDED BY IRS, ANY INTEREST DUE YOU WILL BE ADDED.)	$.00

FOR REFUND INFORMATION CALL:
522-0050 LOCAL ATLANTA
1-800-424-1040 OTHER GA

(b) Injured spouse claims are filed as amended returns by a non -obligated spouse who files a joint return with a debtor who has been certified for offset by a state or federal agency. The non-obligated spouse may be entitled to all or a portion of the refund, depending on his/her share of the income earned and credits claimed. The claim may be filed at the same time the Federal Income Tax Return is filed in order to receive his/her refund *prior* to offset. However, it may also be filed after the offset has occurred. If the claim is filed with the Federal Income Tax Return, the IRS will process the claim and refund the appropriate amount to the injured spouse. Any remaining overpayment would then be offset to the agency which certified the debtor. Injured spouses have 6 years to file a claim. Therefore, a claim record may be generated for a prior year offset.

(c) If the claim is filed after an offset occurs, the IRS will process the claim as above and refund the appropriate amount to the injured spouse. The amount allowed (refunded) will in turn be charged to the submitting agency and reflected on the Service-Weekly Collection (Offset/Claim) Record file as specified in Part B, Sec. 20 &21. Other tax related reversals of offsets, such as bankruptcy cases or erroneous offsets of payments received in response to proposed tax assessments, will also be included on this file.

.06 The Weekly Update Records for the last offset cycle are due on December 21, 1989. This will be the last update file processed for the 1989 program.

.07 Each week the Debtor Master File Coordinator at MCC must be notified on FTS 937-8347 (NON-FTS (304)-267-2911 EXT 347) whether or not a weekly update tape has/will be shipped.

SEC. 11 PROBLEM RESOLUTION CONTACTS

.01. This section explains the procedures for contacting appropriate IRS personnel. The agency will use the two contact points listed below depending on the nature of the problem or question.

.02. CONTACT POINTS

CONTACT	SUBJECT
DMF PROJECT STAFF TR:R:A IR 7516 1111 Constitution Ave Washington, D.C. 20224 FTS 343-0145 NON FTS (202) 343-0145 Contact Hours: Mon-Fri 1-4 pm eastern	- Policy/Issue Items - Requested Changes - Individual Case Problems Accounting/Transfer of Funds - Scheduling of Pre-Offset Address Request Processing - Transmittal of Test Tapes Pre-Production) Due dates - Revenue Procedures Discrepancies - Record/File Formats and Specifications and test tapes (Project staff may refer questions to programming staff.)
MCC Operations Staff P.O. Box 909 Kearneysville, WV 25430 FTS 937-8345 Debtor Master File Coordinator NON FTS (304) 267-2911 EXT 345 Contact Hours: Mon-Fri 8am - 4pm eastern	- Transmittal of Tapes (Production) - Tape Problems (replacement tapes, Tape Shipments, etc.)

.03. Individual Case Problems

A. Please have the following information on the problem case referral form before submitting. (See Exhibit A.11-1)

1. Agency Name
2. Obligor Name
3. Obligor Social Security Number
4. Date of Offset
5. Amount of Offset
6. Brief description of problem.
7. Spouses SSN if known.

.04. The Agency will provide the DMF Project Staff with a single point of contact

EXHIBIT A.11-1

FEDERAL TAX REFUND OFFSET PROGRAM
PROBLEM CASE REFERRAL

DATE:

TO:

TAXPAYER'S NAME:

ADDRESS:

SOCIAL SECURITY NUMBER:

SUBMITTING AGENCY/SUB-AGENCY:

PROCESSING YEAR:

PROBLEM:

ATTACHMENTS: (i.e., IRS, Agency, and taxpayer letters)

AGENCY CONTACT AND PHONE NUMBER:

SEC. 12 DISCLOSURE & SAFEGUARD REQUIREMENTS

.01 Sections 6103(l)(10)(b) and 6103(l)(11)(B) of the Internal Revenue Code explicitly restrict participating agencies' use of return information provided in connection with agencies' requests for reductions under IRC 6402(c) and (d). Agencies are permitted to use return information "only for the purpose of, and to the extent necessary in, establishing appropriate agency records or in the defense of any litigation or administrative procedure ensuing from a reduction made under Section 6402(c) or (d)." Agencies using the information for other than the Federal Tax Refund Offset Program can be suspended from the program.

02. Officers and employees of federal agencies who disclose return information in a manner or for a purpose not authorized by sections 6103(l)(10) or 6103(l)(11) of the Code are subject to the criminal penalty provisions of section 7213. Federal agencies who disclose return information in a manner or for a purpose not authorized by sections 6103(l)(10) or 6103(l)(11) are also subject to the civil damages provisions of section 7431.

03. Any unauthorized disclosure of return information must be reported to the nearest Internal Revenue Service Regional Inspector. The name, address, and telephone number of this individual may be obtained from the DMF Project Staff.

04. Return information which is obtained by an agency under sections 6103(l)(10) or 6103(l)(11) of the Code is subject to the safeguard, recordkeeping, and reporting requirements of section 6103(p)(4). If the return information becomes a part of the agency case file regarding a specific taxpayer, the case file must be segregated to the maximum extent possible and safeguarded under the terms and conditions of section 6103(p)(4). Destruction of returns or return information is also governed by section 6103(p)(4).

05. An agency which receives return information pursuant to sections 6103(l)(10) or 6103(l)(11) of the Code must submit a safeguard procedures report within 30 days of initial receipt of the return information. The report will detail the security accorded the information, the individuals who may request and have access to the information, the flow of the information once the agency has received it, as well as other information which will give a comprehensive picture of the need for, the use of, and the disposal of the return information. Publication 1075 gives additional information about the safeguard procedures report and may be obtained from the Internal Revenue Service district disclosure officer in the district in which the agency is located.

.06 The agency must also submit an annual safeguard activity report giving current information on its safeguard program. The information required for this report is also detailed in Publication 1075. Pursuant to section 6103(p)(4) of the Code and the regulation thereunder, the Service has the authority to conduct its own safeguard reviews if it believes that return information is not being properly safeguarded.

.07 It is the responsiblility of any agency which uses a contractor to make certain that all safeguards are in place and utilized by the contractor.

PART B. MAGNETIC TAPE SPECIFICATIONS

SECTION 1. INTRODUCTION

.01 The magnetic tape specifications define the required format and contents of the records to be included in the file. These specifications must be adhered to. Deviations from these requirements must be preapproved by IRS. These specifications are for the participating agency that sends the magnetic tapes to MCC and is not intended to mandate subagency to agency specifications.

.02 IRS will accept tapes from and return tapes to one Data Processing Center for each Agency.

SEC. 2. TAPE AND FILE SPECIFICATIONS

.01 All records will be fixed length and conform to the given Record Specifications provided herein.

.02 All records except the Header and Trailer Labels must be blocked.

.03 All files must be in 9 channel ASCII (American National Standard Code For Information Interchange) with odd parity.

.04 All files must contain ANSI (American National Standard Institute) Header and Trailer Labels. Specific Header Label file information is specified in Part B, Sec. 22 & 23.

.05 Tape Density (BPI) must be as follows:

(a) 1600 or 6250 for tapes submitted to IRS (preferably 6250)

(b) 1600 for all tapes created by IRS for the Agency

.06 All tape files must have the following characteristics:

(a) Type of tape - ½ inch Mylar base, oxide coated, and

(b)Interblock Gap - ¾ inch.

.07 The logical record size (LRECL) and blocksize (BLKSIZE) for TRANSMITTER FILES are as follows:

FILE	LRECL	BLKSIZE
Annual Pre-Offset Address Request File	150	Note 1
Annual Certification File	150	Note 1
Agency Address File (Original and Update)	300	Note 1
Weekly Update File	50	Note 1

Note 1: BLKSIZE can be any multiple of the LRECL but may not exceed 32,000.

.08 The logical record size (LRECL) and blocksize (BLKSIZE) for SERVICE FILES are as follows:

FILE	LRECL	BLKSIZE
Annual Pre-Offset Unprocessable File	150	1950
Annual Pre-Offset Address Request File	215	1935
Annual Unprocessable Certification File	150	1950
Annual No-Match File	185	2035
Weekly Unprocessable Update File	50	2000
Weekly Collection (Offset/Claim) File	250	2000

.09 IRS programs may be capable of accommodating some minor deviations from these specifications. Federal Agencies that do require minor deviations, must contact the DMF Project Coordinator at the National Office on FTS 343-0151 (NON-FTS (202) 343-0151). Tapes from participating agencies will be submitted to:

IRS
Martinsburg Computing Center
P.O. Box 909
Kearneysville, WV. 25430
ATTN: DEBTOR MASTER FILE COORDINATOR

Under no circumstances may tapes deviating from the specifications in this Revenue Procedure be submitted without prior written approval from IRS.

SEC. 3. LOGICAL SEQUENCE OF FILES

.01 The data on Transmitter FILES may be in any logical sequence as long as the DATA CONTROL record is the very last record of each file.

.02 SERVICE FILES

(a) SERVICE-ANNUAL PRE-OFFSET UNPROCESSABLE FILE will be in the same sequence as received on the Transmitter-Annual Pre-Offset Address Request File. NOTE: there will NOT be a Data Control record on this file.

(b) SERVICE-ANNUAL PRE-OFFSET ADDRESS REQUEST FILE will be in Social Security Number (SSN) order.

(c) SERVICE-ANNUAL UNPROCESSABLE FILE will be in the same sequence as received on the Transmitter-Annual Certification File. NOTE: there will NOT be a Data Control record on this file.

(d) SERVICE-ANNUAL NO MATCH FILE will be in Social Security Number (SSN) order.

(e) SERVICE-WEEKLY UNPROCESSABLE FILE will be in the same sequence as received on the Transmitter-Weekly Update File. NOTE: there will NOT be a Data Control record on this file.

(f) SERVICE-WEEKLY COLLECTION (OFFSET/CLAIM) FILE will be in Social Security Number (SSN) within Subagency order. NOTE: There will be a Data Control record (CNTL) following the data for each Subagency. In addition, there will be a Cumulative Control record (CUM) present as the very last record on the file.

SEC. 4. RESERVED

SEC. 5. TRANSMITTER-ANNUAL PRE-OFFSET ADDRESS REQUEST RECORD

The Annual Pre-Offset Address Request Record contains information on potential obligors. These records are formatted identically to the Annual Certification Record and are used by the agency as a means for obtaining the latest address information and checking status of data. The address will be appended to the end of the incoming record. All records will be returned to the participating agency. ONLY ONE RECORD ALLOWED PER SSN WITH THE SAME AGENCY CODE AND SUBAGENCY CODE. RECORDS WITH THE SAME SSN, AGENCY CODE , SUBAGENCY CODE WILL CAUSE THE FIRST RECORD TO BE ACCEPTED AND THE SUBSEQUENT RECORDS TO BE REJECTED AS DUPLICATES.

RECORD NAME : TRANSMITTER-ANNUAL PRE-OFFSET ADDRESS REQUEST RECORD

Tape Position	Field Title	Length	Description and Remarks
1-2	Agency Code	2	REQUIRED. Code assigned to Agency by IRS
3-4	Subagency Code	2	REQUIRED. Code Assigned by Agency and recognized and appoved by IRS. (See Definitions Part A, Sec. 3)
5	Subagency Priority Code	1	REQUIRED. Indicates subagency with highest priority for OCSE. Must be 0 or 1 for agencies 01 or 02. Zero filled for all other agencies.
6-9	Name Control	4	REQUIRED. Enter the first 4 significant characters of the obligor's last name. Last names of less than four characters must be left justified filling the unused positions with blanks. Embedded blanks must be removed. (See Definitions - Part A, Sec. 3)
10-19	SSN	10	REQUIRED. Enter the obligor's Social Security Number as assigned by SSA. Right justify. The first numeric will be zero.
20-39	Last Name	20	REQUIRED. Enter the obligors Last Name. Left justify and fill with blanks. It may contain embedded blanks. Hyphens and apostrophes are allowed but no other special characters.
40-54	First Name	15	REQUIRED. Enter the obligor's First Name. Left justify and fill with blanks. It may contain embedded blanks but no numerics. Hyphens are allowed but no other special characters.
55-64	Amount Owed	10	REQUIRED. Enter the amount owed by the obligor. The amount must be entered in dollars and cents. Do not enter dollar signs, commas, decimal points or sign amounts. The Amount Owed must be right justified and unused positions must be zero filled.
65-66	Agency	2	OPTIONAL. For Agency use. If not used, fill with blanks.
67-69	Local Code	3	REQUIRED. FIPS code for OCSE only. Must be numeric. If not available or if agency/subagency has only one Local Code, fill with zeros (See Definitions, Part A, Sec. 3).
70-84	Agency Case Number	15	OPTIONAL. Identifies account for agency files. Use is recommended when an agency does not use the SSN as the primary account/case number. If not used, fill with blanks.
85-86	Filler	2	RESERVED. Fill with Blanks.
87-92	Delinquent Date	6	REQUIRED. The date at which the obligation wàs delinquent. Format of YYMMDD. Required for all obligations, including Judgement Debts. Zero fill for agencies 01 and 02. (See Definitions,Part A,Sect.3).
93	Judgement Debt Indicator	1	REQUIRED. Blank fill unless it is a Judgement Debt. A 'J' identifies a Judgement Debt excluding it from the 10 year statute of limitations requirement. (See Definitions,Part A, Sect.3).

RECORD NAME : TRANSMITTER-ANNUAL PRE-OFFSET ADDRESS REQUEST RECORD - continued

Tape Position	Field Title	Length	Description and Remarks
94	Reserved	1	RESERVED. Blank fill.
95-150	Filler	56	RESERVED. Fill with blanks.

SEC. 6. TRANSMITTER-ANNUAL PRE-OFFSET DATA CONTROL RECORD

Identifies the cumulative counts and amounts for all records on the Transmitter Annual Pre-Offset tape file. This record must appear as the last data record on the tape file which is submitted to IRS. If the Record Count or Obligation Amount does not balance when the tape is processed, the complete tape file will be rejected, causing that agency not to be able to participate in Pre-Offset.

RECORD NAME :TRANSMITTER-ANNUAL PRE-OFFSET CONTROL RECORD

Tape Position	Field Title	Length	Description and Remarks
1-4	Record ID	4	REQUIRED. Enter the constant ''CNTL''. This identifies the end of processable records.
5-12	Record Count	8	REQUIRED. Enter record count of Annual Pre-Offset records.
13-24	Obligation Amount	12	REQUIRED. Enter the cumulative total amount for all records, right justified, zero filled.
25-150	Filler	126	REQUIRED. Fill with Blanks.

SEC. 7. SERVICE-ANNUAL PRE-OFFSET UNPROCESSABLE RECORD

Identifies records which were found to be unprocessable during validity processing. All fields remain the same as input on the Transmitter Annual Pre-Offset Address Request Record except in positions 85 & 86 where IRS inserts an error code.

RECORD NAME : SERVICE-ANNUAL PRE-OFFSET UNPROCESSABLE RECORD

Tape Position	Field Title	Length	Description and Remarks
1-2	Agency Code	2	PRESENT. Code assigned to Agency by IRS.
3-4	Subagency Code	2	PRESENT. Code Assigned by Agency and recognized and approved by IRS. (See Definitions, Part A, Sec. 3.)
5	Subagency Priority Code	1	PRESENT. Indicates subagency with highest priority for OCSE. Must be 0 or 1 for agencies 01 or 02. Zero filled for other agencies.
6-9	Name Control	4	PRESENT. The first 4 significant characters of the obligor's last name. Last names of less than four characters will be left justified filling the unused positions with blanks. (See Defintions, Part A, Sec. 3.)
10-19	SSN	10	PRESENT. The obligor's Social Security Number as assigned by SSA. Right justify. The first numeric must be zero.
20-39	Last Name	20	PRESENT. The obligors Last Name. Left justified and filled with blanks.
40-54	First Name	15	PRESENT. Enter the obligor's First Name. Left justified and filled with blanks. It must not contain any embedded blanks or numerics.
55-64	Amount Owed	10	PRESENT. The amount owed by the obligor. The amount will be entered in dollars and cents. The Amount Owed will be right justified and unused positions must be zero filled.
65-66	Agency Information	2	PRESENT. Information as provided by by each agency and approved by IRS.
67-69	Local Code	3	PRESENT. FIPS code used by OCSE. For other agencies as approved by IRS.

Tape Position	Field Title	Length	Description and Remarks
70-84	Agency Case Number	15	PRESENT. Identifies account number for agency files. Use is recommended when an agency does not use the SSN as the primary account/case number. If not used, fill with blanks.
85-86	Error Code	2	GENERATE. IRS will insert the appropriate error code: 01-invalid agency code 02-invalid subagency code 03-invalid name control 04-invalid SSN 05-obligation (Amount Owed field) is less than tolerance 06-delinquent date too old 07-invalid delinquent date format 08-priority code not 0 or 1 09-duplicate record (same SSN, agency, and subagency) 10-Last and First Name blank 11-15-RESERVED.
87-92	Delinquent Date	6	PRESENT. From input record.
93	Judgement Debt Indicator	1	PRESENT. From input record.
94	Reserved	1	RESERVED. Blank fill.
95-150	FILLER	56	REQUIRED. Fill with blanks.

SEC. 8. SERVICE-ANNUAL PRE-OFFSET ADDRESS REQUEST RECORD

This Service Annual Pre-Offset Address Request Record contains address information for all obligor accounts that have been matched to the IMF. The Error Code will be set and the address or nameline may be appended to the end of the incoming record. These records will be returned to the participating agency annually.

RECORD NAME : SERVICE-ANNUAL PRE-OFFSET ADDRESS REQUEST RECORD

Tape Position	Field Title	Length	Description and Remarks
1-2	Agency Code	2	PRESENT. Code assigned to Agency by IRS
3-4	Subagency Code	2	PRESENT. Code Assigned by Agency and recognized and approved by IRS. (See Definitions, Part A Sec. 3)
5	Subagency Priority Code	1	PRESENT. Indicates subagency with highest priority for OCSE. Must be 0 or 1 for agencies 01 or 02. Zero filled for all other agencies.
6-9	Name Control	4	PRESENT. Enter the first 4 significant characters of the obligor's last name. Last names of less than four characters should be left justified filling the unused positions with blanks. Embedded blanks must be removed. (See Definitions, Part A Sec. 3)
10-19	SSN	10	PRESENT. Enter the obligor's Social Security Number as assigned by SSA. Right justify. The first numeric will be zero.
20-39	Last Name	20	PRESENT. Enter the obligors Last Name as provided by the agency. Left justified and filled with blanks.
40-54	First Name	15	PRESENT. Enter the obligor's First Name as provided by the agency. Left justified and filled with blanks.

Tape Position	Field Title	Length	Description and Remarks
55-64	Amount Owed	10	PRESENT. Enter the amount owed by the obligor. The amount must be entered in dollars and cents. Do not enter dollar signs, commas, decimal points or negative amounts. The Amount Owed must be right justified and unused positions must be zero filled.
65-66	Agency Information	2	PRESENT. For use by each agency. If not used, fill with blanks.
67-69	Local Code	3	PRESENT. FIPS code for OCSE. For other agencies, as approved by IRS.
70-84	Agency Case Number	15	PRESENT. Identifies account number for agency files. Use is recommended when an agency does not use the SSN as the primary account/case number. If not used, fill with blanks.
85-86	Error Code	2	GENERATED. IRS will insert the appropriate code from the table below. ERROR CODE EXPLANATION: 00 Record matched to IMF, Address information follows. 01 SSN does not match IMF. 02 SSN matches IMF but Name Control does not match. IMF Name-line data follows. 03 SSN is listed on invalid segment of the IMF or another condition causes the record to go unpostable. 04-10 RESERVED.
87-92	Delinquent Date	6	PRESENT. From input record.
93	Judgement Debt Indicator	1	PRESENT. From input record.
94	Deceased Indicator	1	Generated. Value of 'D' indicates obligor deceased per IRS records. Otherwise blank.
95-150	FILLER	56	PRESENT. Filled with blanks.
151-185	Street Address/ Name	35	PRESENT. If the Error Code is 00, field contains latest mailing address of obligor. NOTE: The street address may be blank. If the Error Code is 02, the entire name as it appears on the IMF, formatted Last Name, First Name. (Example Public, John & Mary) will appear in this field. For Error Codes 01 and 03, this field will be filled with blanks.
186-210	City and State	25	PRESENT. The obligor's city and state of residence if the Error Code is 00; otherwise blanked filled. Note: the City/State field may contain City/Country for foreign address.
211-215	ZIP Code	5	PRESENT. The obligor's ZIP Code if the Error Code equals 00; otherwise blanked filled.

SEC. 9. SERVICE-ANNUAL PRE-OFFSET DATA CONTROL RECORD

Identifies the cumulative counts of all matched and unmatched records on IRS Annual Pre-Offset Address Request tape file. This record will appear as the last data record on the tape file that IRS will return to the participating agency.

RECORD NAME : SERVICE-ANNUAL PRE-OFFSET CONTROL RECORD

Tape Position	Field Title	Length	Description and Remarks
1-4	Record ID	4	PRESENT. Enter the constant "CNTL". This identifies the end of processable records.
5-12	Total Match	8	PRESENT. Enter the cumulative record count for all records that have been correctly matched with a corresponding IMF account.

RECORD NAME : SERVICE-ANNUAL PRE-OFFSET CONTROL RECORD - continued

Tape Position	Field Title	Length	Description and Remarks
13-20	Total No Match	8	PRESENT. Enter the cumulative record count for all records unable to be correctly matched with a corresponding IMF account.
21-215	Filler	195	PRESENT. Filled with blanks.

SEC. 10. TRANSMITTER-ANNUAL CERTIFICATION RECORD

Records submitted to initialize the Debtor Master File identifying the obligor and amount of obligation. These records are submitted annually by the Agency for each obligor having a delinquent debt to that agency. ONLY ONE RECORD ALLOWED PER SSN WITH THE SAME AGENCY CODE AND SUBAGENCY CODE. RECORDS WITH THE SAME SSN, AGENCY CODE, SUBAGENCY CODE WILL CAUSE THE FIRST RECORD TO BE ACCEPTED AND THE LATER RECORDS TO BE REJECTED AS DUPLICATES.

RECORD NAME : TRANSMITTER-ANNUAL CERTIFICATION RECORD

Tape Position	Field Title	Length	Description and Remarks
1-2	Agency Code	2	REQUIRED. Code assigned to Agency by IRS
3-4	Subagency Code	2	REQUIRED. Code Assigned by Agency and recognized and approved by IRS. (See Definitions - Part A Sec. 3)
5	Subagency Priority Code	1	REQUIRED. Indicates subagency with highest priority for OCSE. Must be 0 or 1 for agencies 01 or 02. Zero filled by other agencies
6-9	Name Control	4	REQUIRED. Enter the first 4 significant characters of the obligor's last name. Last names of less than four characters should be left justified filling the unused positions with blanks. Apostrophes and embedded blanks must be removed, a hyphen is allowed in position 2, 3 or 4. (See Definitions, Part A, Sec. 3)
10-19	SSN	10	REQUIRED. Enter the obligors Social Security Number as assigned by SSA. Right justify. The first numeric must be zero.
20-39	Last Name	20	REQUIRED. Enter the obligors Last Name. Left justify and fill with blanks. It may contain embedded blanks. Hyphens and apostrophes are allowed but no other special characters.
40-54	First Name	15	REQUIRED. Enter the obligor's First Name. Left justify and fill with blanks. It may contain embedded blanks but no numerics. Hyphens are allowed but no other special characters.
55-64	Amount Owed	10	REQUIRED. Enter the amount owed by the obligor. The amount must be entered in dollars and cents and must be unsigned. The Amount Owed must be right justified and unused positions must be zero filled. Amount owed may never be less than $25.00. Higher minimum obligation amounts may be assigned by agency and recognized and approved by IRS.
65-66	Agency Information	2	OPTIONAL. For Agency use.
67-69	Local Code	3	REQUIRED. FIPS code for OCSE only. Must be numeric. If not available or if agency/subagency has only one Local Code, fill with zeros (See Definitions, Part A, Sec. 3).
70-84	Agency Case Number	15	OPTIONAL. Identifies account number for agency files. Use is recommended when an agency does not use the SSN as the primary account/case number. If not used, fill with blanks.
85-86	FILLER	2	REQUIRED. Fill with Blanks.
87-92	Delinquent Date	6	REQUIRED. The date at which the obligation was delinquent. Format of YYMMDD. Required for all obligations, including Judgement Debts. Zero fill for agencies 01 and 02. (See Definitions, Part A, Sect.3).

RECORD NAME : TRANSMITTER-ANNUAL CERTIFICATION RECORD - continued

Tape Position	Field Title	Length	Description and Remarks
93	Judgement Debt Indicator	1	REQUIRED. Blank fill unless it is a Judgement Debt. A 'J' identifies a Judgement Debt excluding it from the 10 year statute of limitations requirement. (See Definitions,Part A, Sect.3).
94	reserved	1	RESERVED. Blank fill.
95-150	FILLER	56	REQUIRED. Fill with blanks.

SEC. 11. TRANSMITTER-ANNUAL CERTIFICATION DATA CONTROL RECORD

Identifies the cumulative counts and amounts for all records on the Transmitter Annual Certification tape file. This record must appear as the last data record on the tape file which is submitted to IRS. If the Record Count or Obligation Amount does not balance when the tape is processed, the complete tape file will be rejected, potentially resulting in that agency not being able to participate for that year.

RECORD NAME : TRANSMITTER-ANNUAL CERTIFICATION CONTROL RECORD

Tape Position	Field Title	Length	Description and Remarks
1-4	Record ID	4	REQUIRED. Enter the constant "CNTL". This identifies the end of processable records tape file.
5-12	Record Count	8	REQUIRED. Enter the number of Annual Certification records. Right justify and fill with zeroes.
13-24	Obligation Amount	12	REQUIRED. Enter the cumulative total of Amount Owed for all obligors. The amount must be entered in dollars and cents. Do not enter dollar signs, commas, decimal points or negative amounts. The Obligation Amount must be right justified and unused positions must be zero filled.
25-150	FILLER	126	RESERVED. Fill with Blanks.

SEC. 12. SERVICE-ANNUAL UNPROCESSABLE CERTIFICATION RECORD

Identifies records which were found to be unprocessable during validity processing. All fields remain the same as input on the Transmitter Annual Certification Record except in positions 85 & 86 where IRS inserts an error code.

RECORD NAME : SERVICE-ANNUAL UNPROCESSABLE CERTIFICATION RECORD

Tape Position	Field Title	Length	Description and Remarks
1-2	Agency Code	2	PRESENT. Code assigned to Agency by IRS
3-4	Subagency Code	2	PRESENT. Code Assigned by Agency and recognized and approved by IRS. (See Definitions - Part A, Sec. 3)
5	Subagency Priority Code	1	PRESENT. Indicates subagency with highest priority for OCSE. Must be 0 or 1 for agencies 01 or 02. Zero filled by other agencies.
6-9	Name Control	4	PRESENT. Enter the first 4 significant characters of the obligor's last name. Last names of less than four characters will be left justified filling the unused positions with blanks. Apostrophes and embedded blanks must be removed, hyphens are allowed in position 2, 3 or 4. (See Definitions - Part A, Sec. 3)
10-19	SSN	10	PRESENT. The obligor's Social Security Number as assigned by SSA. Right justify and first numeric must be zero.
20-39	Last Name	20	PRESENT. The obligor's Last Name. Left justified and filled with blanks. It will contain last name of obligor as submitted by the agency.
40-54	First Name	15	PRESENT. Enter the obligor's First Name. Left justified and filled with blanks. It will contain first name of obligor as submitted by the agency.

Tape Position	Field Title	Length	Description and Remarks
55-64	Amount Owed	10	PRESENT. The amount owed by the obligor. The amount will be entered in dollars and cents. The Amount Owed will be right justified and unused positions must be zero filled.
65-66	Agency Information	2	PRESENT. Information as provided by by each agency and approved by IRS.
67-69	Local Code	3	PRESENT. FIPS code for OCSE. For other agencies, as approved by IRS.
70-84	Agency Case Number	15	PRESENT. Identifies account number for agency files. Use is recommended when an agency does not use the SSN as the primary account/case number. If not used, fill with blanks.
85-86	Error Code	2	PRESENT. IRS will insert error code which applies: 01-invalid agency code 02-invalid subagency 03-invalid name control 04-invalid SSN 05-obligation (Amount Owed field) less than tolerance 06-delinquent date too old 07-invalid delinquent date format 08-priority code not 0 or 1 09-duplicate record (same SSN, Agency and Subagency 10-Last and First Name Blank 11-15-RESERVED
87-92	Delinquent Date	6	PRESENT. From input record.
93	Judgement Debt Indicator	1	PRESENT. From input record.
94	reserved	1	RESERVED. Blank fill.
95-150	FILLER	56	PRESENT. Filled with blanks.

SEC. 13. SERVICE-ANNUAL NO MATCH RECORD

Identifies Transmitter Annual Certification Records which do not match the Individual Master File. The explanation for this can be found in the Error Code Field of the record. A fixed field is added to the end of the input record and the IRS Nameline is inserted on all no match code 02 records. All other fields remain the same as input on the Transmitter Annual Certification Record.

RECORD NAME : SERVICE-ANNUAL NO MATCH RECORD

Tape Position	Field Title	Length	Description and Remarks
1-2	Agency Code	2	PRESENT. Code assigned to Agency by IRS
3-4	Subagency Code	2	PRESENT. Code Assigned by Agency and recognized and approved by IRS. (See Definitions - Part A, Sec. 3)
5	Subagency Priority Code	1	PRESENT. Indicates subagency with highest priority for OCSE. Must be 0 or 1 for agencies 01 or 02. Zero filled by other agencies.
6-9	Name Control	4	PRESENT. Enter the first 4 significant characters of the obligor's last name. Last names of less than four characters will be left justified filling the unused positions with blanks. Apos- trophes and embedded blanks will be removed, a hyphen is allowed in position 2, 3 or 4. (See Definitions - Part A, Sec. 3)
10-19	SSN	10	PRESENT. Enter the obligor's Social Security Number as assigned by SSA. Right justify and first numeric will be zero.

Tape Position	Field Title	Length	Description and Remarks
20-39	Last Name	20	PRESENT. Enter the obligors Last Name. Left justified and filled with blanks. It will contain last name of obligor as submitted by the agency.
40-54	First Name	15	PRESENT. The obligor's First Name. Left justified and filled with blanks. It will contain first name of obligor as submitted by the agency.
55-64	Amount Owed	10	PRESENT. The amount owed by the obligor. The amount must be entered in dollars and cents. Do not enter dollar signs, commas, decimal points or negative amounts. The Amount Owed must be right justified and unused positions must be zero filled.
65-66	Agency Information	2	PRESENT. Information as necessary to be determined by each agency and recognized and approved by IRS. If not used, fill with blanks.
67-69	Local Code	3	PRESENT. FIPS code used by OCSE. For other agencies, as approved by IRS.
70-84	Agency Case Number	15	PRESENT. Identifies account number for the agency files. Use is recommended when an agency does not use the SSN as the primary account/case number. If not used, fill with blanks.
85-86	Error Code	2	PRESENT. The IRS will insert the appropriate code from the table below. ERROR CODE EXPLANATION 01 SSN does not match IMF. 02 SSN matches IMF but Name Control does not match. 03 SSN is listed on the invalid segment of the IMF or another condition causes the record to go unpostable. 04 SSN matches IMF but Account contains Bankruptcy Freeze. 05 Information Record SSN matches IMF. Account frozen. IMF indicates obligor is deceased (Deceased Ind = D). 06-10 Reserved.
87-92	Delinquent Date	6	PRESENT. From input record.
93	Judgement Debt Indicator	1	PRESENT. From input record.
94	Deceased Indicator	1	Generated. Value of 'D' indicates obligor deceased per IRS records. Otherwise blank.
95-150	FILLER	56	PRESENT. Blank-filled.
151-185	IMF NAME LINE	35	PRESENT. Inserted by IRS on all no match code 02. Will be formatted Last name, First name *e.g.*, Public, John & Mary. Field will be blank filled on all other records.

SEC. 14. SERVICE-ANNUAL NO MATCH DATA CONTROL RECORD

Identifies the cumulative counts and amounts for all records on the Service Annual No Match tape file. This record will appear as the last data record on the tape file that IRS will return to the submitting agency.

RECORD NAME : SERVICE-ANNUAL NO MATCH CONTROL RECORD

Tape Position	Field Title	Length	Description and Remarks
1-4	Record ID	4	PRESENT. The constant "CNTL." This identifies the end of processable records.
5-12	Total No Match	8	PRESENT. The cumulative record count for all obligor SSN's which did not match the IMF. Right justified and filled with zeroes.

RECORD NAME : SERVICE-ANNUAL NO MATCH CONTROL RECORD - continued

Tape Position	Field Title	Length	Description and Remarks
13-24	Obligation Amount	12	PRESENT. The cumulative total in Amount Owed for all obligor SSN's which did not match the Individual Master File. The amount will be entered in dollars and cents. No dollar signs, commas, decimal points or negative amounts. The Obligation Amount will be right justified and unused portions will be zero filled.
25-185	FILLER	161	PRESENT. Filled with Blanks.

SEC. 15. TRANSMITTER-AGENCY ADDRESS RECORD

The Agency Address Record contains address information which will be included on Service notices to taxpayers. Agencies may submit a central address to refer all obligor inquiries or may submit local addresses.

RECORD NAME: AGENCY ADDRESS RECORD

Tape Position	Field Title	Length	Description and Remarks
1-2	Agency Code	2	REQUIRED Agency Code as assigned by IRS.
3-4	Subagency Code	2	REQUIRED. As assigned by Agency and recognized and approved by IRS. (See Definitions, Part A Sec. 3)
5-7	Local Code	3	REQUIRED. FIPS code for OCSE only. Must be numeric. At least one local code "000" required for each subagency. (See Definitions, Part A, Sec. 3).
8	CHANGE INDICATOR	1	Blank for Annual Address File. For Change Address File, Values are: C = change address A = add address D = Delete address
9-21	FILLER	13	REQUIRED. Blank fill.
22-56	Agency Name	35	REQUIRED. Name of Agency *e.g.*, Department of Education
57-91	Address Line #1	35	REQUIRED. Address Lines 1 through 4 should contain additional address information. Embedded blank lines are not allowed, all lines will be formatted from top to bottom.
92-126	Address Line #2	35	*e.g.*, Note the Agency Name field and the address lines will appear on the offset notice as follows: Agency Name - US Dept of Education
127-161	Address Line #3	35	Line #1- Federal Offset Program Line #2- J.J. Federal Building
162-196	Address Line #4	35	Line #3- 124 Main St. Line #4- Anywhere, WA 11111
197-199	FILLER	3	REQUIRED. Filler - Character Blank
200-225	Local Telephone Number	26	OPTIONAL - however, a local number is required if the toll-free number(s) is not available nationwide.
200	Telephone Type Indicator	1	REQUIRED - enter a '1' if a telephone number is present. Enter a '0' if number not present
201-214	*Telephone Number	14	REQUIRED - If TYPE is '0', blank fill. Otherwise, format '(202) 555-1212'
215	*Filler	1	REQUIRED - blank fill
216-225	*Identifier	10	REQUIRED additional information for local number or blank fill. Examples: 'LOCAL' 'BALT ONLY' 'EXT 451' 'LOCAL BALT'

RECORD NAME: AGENCY ADDRESS RECORD continued

Tape Position	Field Title	Length	Description and Remarks
226-251	Instate Toll-Free Number	26	OPTIONAL
226	Telephone Type Indicator	1	REQUIRED - enter a '2' if a telephone number is present. Enter a '0' if number not present
227-240	*Telephone Number	14	REQUIRED - If TYPE is '0', blank fill. Otherwise, format '(800) 555-1212' or '1-202-555-1212'
241	*Filler	1	REQUIRED - blank fill
242-251	*Identifier	10	REQUIRED - Example 'INSTATE XX' where XX is the state code for that number 'Toll Free' 'Collect'
252-277	Nationwide Toll-Free Number	26	REQUIRED
252	Telephone Type Indicator	1	REQUIRED - enter a '3' to indicate a nationwide toll-free number or a '4' for collect.
253-266	*Telephone Number	14	REQUIRED - Format'(800) 555-1212' or '1-202-555-1212'
267	*Filler	1	REQUIRED - blank fill
268-277	*Identifier	10	REQUIRED - Example 'NATIONWIDE' or 'TOLL-FREE' or 'Collect'
278-300	FILLER	23	REQUIRED - blank fill

* These 25 characters from each phone number segment will be displayed "as is" on IRS Offset Notices. See Exhibit A-4 in Part A, Sec. 10.05.

SEC. 16. TRANSMITTER-AGENCY ADDRESS DATA CONTROL RECORD

Identifies the cumulative count of agency address records on the Agency Address tape file. This record must appear as the last data record on the tape file.

RECORD NAME: AGENCY ADDRESS FILE CONTROL RECORD

Tape Position	Field Title	Length	Description and Remarks
1-4	CNTL	4	REQUIRED. Constant "CNTL"
5-10	Record Count	6	REQUIRED. Number of Addresses on Tape. Right justified, zero filled.
11-300	FILLER	290	REQUIRED. Blank filled.

SEC. 17. TRANSMITTER-WEEKLY UPDATE RECORD

These records will be submitted on a weekly basis by the Transmitter. Each record must contain an SSN, agency code, subagency code, and name control for an obligor that was originally established on the DMF. The record will contain an indicator denoting either a decrease to the original obligation amount, an offset(s) previously turned over to the participating agency has been refunded (fully or partially) directly to the obligor, or an adjustment (decrease) to a previously submitted refund record.

RECORD NAME : TRANSMITTER-WEEKLY UPDATE RECORD

Tape Position	Field Title	Length	Description and Remarks
1-2	Agency Code	2	REQUIRED. Code assigned to Agency by IRS
3-4	Subagency Code	2	REQUIRED. Code Assigned by Agency and recognized and approved by IRS. (See Definitions - Part A, Sec. 3)
5-8	Name Control	4	REQUIRED. Enter the first 4 significant characters of the obligor's last name. Last names of less than four characters should be left justified filling the unused positions with blanks. Embedded blanks should be removed. This field must be identical to the Name Control as submitted on the Annual Certification Tape File for the obligor.(See Definitions - Part A, Sec. 3)

RECORD NAME : TRANSMITTER-WEEKLY UPDATE RECORD - continued

Tape Position	Field Title	Length	Description and Remarks
9-18	SSN	10	REQUIRED. Enter the obligor's Social Security Number as assigned by SSA. This field must be identical to the SSN as submitted on the Annual Certification Tape File for the obligor. Right justify and first numeric must be zero.
19	Type Indicator	1	REQUIRED. Enter the appropriate code from the table below TYPE INDICATOR EXPLANATION: 0 Decrease or deletion in amount of obligation. 1 Refund by agency to obligor. 2 Adjustment(decrease) of previously submitted Refund (Type 1) Record(s)
20-29	Amount of Adjustment	10	REQUIRED. Enter the amount of adjustment to the obligation amount. The amount must be significant and entered in dollars and cents. Do not enter positive or negative signs, signs, dollar signs, or decimal points. The amount of adjustment must be right justified and unused positions must be zero filled. If Type Indicator is '1', this field contains amount of agency refund. If Type Indicator is '2', this field contains amount to decrease previously filed refund (type '1') records. Must be the difference between the original refund record and the correct amount.
30-31	FILLER	2	REQUIRED. BLANK FILL
32-33	YEAR OF ORIGINAL OFFSET	2	Significant on input for Refund/Repayment Records, record type (1) otherwise zero (0), for record type (0)
34-50	FILLER	17	REQUIRED. Blank Fill

SEC. 18. TRANSMITTER-WEEKLY UPDATE DATA CONTROL RECORD

Identifies the cumulative counts and amounts for all records on the Transmitter Weekly Update tape file. This record must appear as the last data record on the tape file which is submitted to IRS. If the counts and amounts do not balance when the tape is validated, the complete file is rejected and update functions are not performed.

RECORD NAME : TRANSMITTER-WEEKLY UPDATE CONTROL RECORD

Tape Position	Field Title	Length	Description and Remarks
1-4	Record ID	4	REQUIRED. Enter the constant "CNTL". This identifies the end of processable records.
5-10	Agency Refund/ Correction Count	6	REQUIRED. Enter the cumulative record count of all records having a refund or correction to a refund. (Type Indicator = 1 or 2)
11-16	Delete/Decrease Count	6	REQUIRED. Enter the cumulative record count of all records having a decrease or deletion of the Amount Owed. (Type Indicator = 0)
17-28	Total Money Amounts	12	REQUIRED. Enter the cumulative total in Amount of Adjustment (TYPE 0, TYPE 1 and TYPE 2 records). The amount must be entered in dollars and cents. Do not enter dollar signs, commas, decimal points or negative amounts. This field must be right justified and unused positions must be zero filled.
29-50	FILLER	22	RESERVED. Fill with Blanks.

SEC. 19. SERVICE-WEEKLY UNPROCESSABLE UPDATE RECORD

Identifies Transmitter Weekly Update Records which are deemed unprocessable by IRS. The explanation for this can be found in the No Match Code field of the record. All fields (except No Match code field) will be the same as input on Transmitter Weekly Update record.

RECORD NAME : SERVICE-WEEKLY UNPROCESSABLE UPDATE RECORD

Tape Position	Field Title	Length	Description and Remarks
1-2	Agency Code	2	PRESENT. Code assigned to Agency by IRS
3-4	Subagency Code	2	PRESENT. Code Assigned by Agency and recognized and approved by IRS. (See Definitions - Part A, Sec. 3)
5-8	Name Control	4	PRESENT. The first 4 significant characters of the obligor's last name. Last names of less than four characters will be left justified filling the unused positions with blanks. Special characters and embedded blanks will be removed. (See Definitions - Part A, Sec. 3)
9-18	SSN	10	PRESENT. The obligor's Social Security Number as assigned by SSA. Right justified and first numeric will be zero.
19	Type Indicator	1	PRESENT. The appropriate code from the table below TYPE INDICATOR EXPLANATION 0 Decrease or deletion in amount of obligation. 1 Refund by agency to obligor. 2 Adjustment(decrease) of previously submitted Refund(Type 1) Record(s).
20-29	Amount of Adjustment	10	PRESENT. The amount of adjustment to the obligation amount. The amount will be entered in dollars and cents. Dollar signs, commas, decimal points or negative amounts will not be present. The amount of adjustment will be right justified and unused positions will be zero filled.
30-31	Unprocessable Code	2	PRESENT.IRS will insert the appropriate code from the table below NO MATCH EXPLANATION: CODE 01 Invalid Agency Code 02 Invalid SSN or Name Control 03 Invalid Subagency Code 04 No matching record on the DMF 05 Delete previously processed for this obligor. 06 Agency Refund Repayment Record but no tax refund offset processed offset year 07 Invalid Type Indicator 08 Delete caused obligation to fall below zero ($00.00). (Delete records will be processed by IRS, no-match code returned for information only.) 09 Agency refund/repayment record amount in excess of offset(or original obligation if a delete or refund/repayment was previously processed). Record processed. 10 Amount of adjustment is zero 11 For IRS use only. 12 Duplicate record (same ssn, agency code,sub agency code & type). 13 Correction of refund record. Refund record not previously filed or amount of adjustment exceeds amount of previously filed refund. 14-20 Reserved
32-33	YEAR OF ORIGINAL OFFSET	02	PRESENT. From input.
34-50	FILLER	17	RESERVED. BLANK FILLED.

SEC. 20. SERVICE-WEEKLY COLLECTION (OFFSET/CLAIM) RECORD

Identifies DMF accounts which had in the current week either a federal income tax refund offset or a spousal claim and will contain the amount of that action. If the action is an offset, the latest address information will be inserted at the end of the record. If the action is a claim the record will be blank filled.

RECORD NAME : SERVICE-WEEKLY COLLECTION (OFFSET/CLAIM) RECORD

Tape Position	Field Title	Length	Description and Remarks
1	Type Indicator	1	PRESENT. A code will be inserted from the table below. TYPE INDICATOR EXPLANATION 0 Claim by an injured spouse for a share of an offset: due to not being liable for an obligation amount; or reversal to correct processing error 1 Offset against the obligation amount.
2-3	Agency Code	2	PRESENT. Code assigned to Agency by IRS
4-5	Subagency Code	2	PRESENT. Code Assigned by Agency and recognized and approved by IRS. (See Definitions - Part A, Sec. 3)
6-15	SSN	10	PRESENT.The obligor's Social Security Number as assigned by SSA. Right justified. The first numeric will be zero.
16-25	Amount	10	PRESENT. The amount of offset or claim (depending upon Type Indicator). The amount will be dollars and cents. No dollars signs, commas, decimal points or negative amounts. The Amount is right justified and unused positions will be zero filled. If Type Indicator is '0', the amount will be for a claim. If Type Indicator is '1', the amount will be for an offset.
26-27	YEAR OF ORIGINAL OFFSET	2	PRESENT. Contains the last 2 digits of the year of the offset being reversed. This field is applicable if the Type Indicator field contains a "0', otherwise, it will be filled with zeroes. It will be the processing year of the offset that a claim is being processed against.
28-31	Tax Period	4	PRESENT. Will contain the tax period of the offset or claim. YYMM format.
32-51	Last Name	20	PRESENT. Contains the obligor's Last Name as submitted by agency. Left justified and filled with blanks.
52-66	First Name	15	PRESENT. Contains the obligor's First Name as submitted by agency. Left justified and filled with blanks.
67-81	Agency Case Number	15	PRESENT. Contains the obligor's case number as submitted by the agency. Use is recommended when an agency does not use the SSN as the primary account/case number. If not used, fill with blanks.
82	Filing Status*	1	PRESENT. Contains the appropriate code from the table below. FILING STATUS EXPLANATION 0 Other than Joint Return 2 Joint Return
83-117	Name*	35	PRESENT. For Type 1 Offset records, contains the name of obligor as it appears on the IMF, and will be formatted Last Name, First Name. *e.g., Public, John & Mary. Blank for Type 0 claim records*
118-152	Street Address*	35	PRESENT. For Type 1 Offset records, contains the current mailing address of the obligor. Left justified and blank filled. NOTE: the street address field may be blank. Blank for Type 0 claim records.
153-177	City and State*	25	PRESENT. For Type 1 Offset records, contains the obligor's city and state of residence. Left justified and blank filled. NOTE: the City/State field may contain City/Country for foreign addresses. Blank for Type 0 claim records.

Tape Position	Field Title	Length	Description and Remarks
178-182	ZIP Code*	5	PRESENT. For Type 1 Offset records, contains the obligor's ZIP Code. Blank for Type 0 claim records.
183-186	Name Control*	4	PRESENT. For Type 1 Offset records, contains the first 4 significant characters of the obligor's last name as found on IMF. Last names of less than four characters will be left justified filling the unused positions with blanks. Embedded blanks are removed (See Definitions - Part A, Sec. 3) Blank for Type 0 claim records.
*Note : These fields will be blank filled for Claim Type records. (Type Indicator = 0)			
187-190	OFFSET CYCLE	4	PRESENT. Format is YYCC
191	FILLER	1	PRESENT. Blank Fill.
192-197	EFFECTIVE DATE OF OFFSET	6	PRESENT. FORMAT IS MMDDYY.
198-248	FILLER	51	REQUIRED. Blank Fill.
249-250	AGENCY CODE	2	PRESENT.

SEC. 21. SERVICE-WEEKLY COLLECTION (OFFSET/CLAIM) DATA CONTROL RECORD

Identifies the cumulative counts and amounts for all records on the Service-Weekly Collection (Offset/Claim) tape file. This record will appear as the last data record for each subagency on the tape file that IRS will return to the submitting agency. Also present, as the last record on the file, will be a "CUM" control record containing counts and amounts of all records for the agency.

RECORD NAME : SERVICE-WEEKLY COLLECTION (OFFSET/CLAIM) CONTROL RECORD

Tape Position	Field Title	Length	Description and Remarks
1-4	Record ID	4	PRESENT. The constant "CNTL". This identifies the end of processable records for a subagency.
5-7	Block ID/ Subagency Code	3	PRESENT. The constant "CUM" or the appropriate subagency code. If "CUM" is used it will be the last record; otherwise, it will be a balancing record for all preceding records of same agency and subagency. Subagency code will be left justified.
8-15	Offset Record Count	8	PRESENT. The cumulative record count for all Offset records (Type Indicator = 1, on Service-Weekly Collection (Offset/Claim) Record) current for that week. Right justified and zero filled.
16-27	Offset Amount	12	PRESENT. The cumulative total of all Offset Amounts (Type Indicator = 1, on Service-Weekly Collection (Offset/Claim) Record). The amount will be entered in dollars and cents. No dollar signs, commas, decimal points or negative amounts. The Offset Amount will be right justified and unused positions will be zero filled.
28-35	Claim Record Count	8	PRESENT. The cumulative record count for all Claim records (Type Indicator = 0, on Service-Weekly Collection (Offset/Claim) Record) current for that week. Right justified and zero filled.
36-47	Claim Amount	12	PRESENT. The cumulative total of all Claim Amounts (Type Indicator = 0, on Service-Weekly Collection (Offset/Claim) Record). The amount will be entered in dollars and cents. No dollar signs, commas, decimal points or negative amounts. The Claim Amount will be right justified and unused positions will be zero filled.

Tape Position	Field Title	Length	Description and Remarks
48-59	Net Collections*	12	PRESENT. The absolute value of the Offset Amount minus the Claim Amount. The amount will be entered in dollars and cents. No dollar signs, commas, decimal points or negative amounts. This field will be right justified and unused positions will be zero filled.
60-71	Excess Offset** amount	12	PRESENT. The amount of credits available. If the Offset Amount exceeds the Claim Amount, this field reflects Net Collections; otherwise filled with zeros.
72-83	Excess Claim** Amount	12	PRESENT. The amount of claims in excess of Offset. If the Claim Amount exceeds the Offset Amount, this field reflects Excess Claim amount; otherwise it is filled with zeros.
84-186	FILLER	103	PRESENT. Filled with blanks.
187-190	Offset Cycle	4	PRESENT. Format is YYCC
191	FILLER	1	PRESENT. Blank filled.
192-197	Effective Date of Offset	6	PRESENT. Format is MMDDYY.
198-248	FILLER	51	PRESENT. Blanked Filled.
249-250	AGENCY CODE	2	PRESENT.

*Note: If the Offset Amount exceeds the Claim Amount, the Excess Offset Amount will contain the same value as the Net Collections. If the Claim Amount exceeds the Offset Amount, the Excess Claim Amount will contain the same value as the Net Collections.

**Note : When the Net Collections field is significant, only one of these fields will also be significant. In addition, the significant field will contain the same value as the Net Collections field.

SEC. 22. TRANSMITTER HEADER RECORDS

.01 The transmitter header records must be in ANSI standard label format.

.02 The File Identifier field (data set name - DSNAME) is in the HDR1 data set label. It is located in positions 5 thru 21 and must be left justified and blank filled. The File Identifier for the appropriate Agency files must be as follows:

RECORD TYPE	FILE NAME *@	FILE IDENTIFIER @
Pre-Offset Address Request	440-PO-##	I4403APO.AG##.IRS
Annual Certification	440-AC-##	I4403AAC.AG##.IRS
Agency Address	440-AA-##	I44020AA.AG##.IRS
Agency Address Update	48O-AA-##	I48015AA.AG##.IRS
Weekly Update	445-WK-##	I44512WK.AG##.IRS

* See Part A, Sec. 4.03, for reference to File Name.

@ ## is replaced with the appropriate Agency Code assigned by IRS.

e.g., Pre-Offset Address Request File Name = 440-PO-02

File Identifier = I4403APO.AG02.IRS

SEC. 23. SERVICE HEADER RECORDS

.01 The service header records will be in ANSI standard label format.

.02 The file identifier (data set name - DSNAME) in the HDR1 data set label for the appropriate files will be as follows:

Record Type	*File Name @*	*File Identifier @*
Pre-Offset Unprocessable Address Request	440-03-PO	O44003PO.AG##.IRS
Pre-Offset Address Request	440-14-PO	O44014PO.AG##.IRS
Annual Unprocessable Certification	440-03-AC	O44003AC.AG##.IRS
Annual Nomatch Certification	440-08-AC	O44008AC.AG##.IRS
Weekly Unprocessable Update	445-12-WK	O44512WK.AG##.IRS
Weekly Collection	445-17-WK	O44517WK.AG##.IRS

@ - ## is replaced with the appropriate Agency Code assigned by IRS.

e.g., Weekly Collection File Name = 445-17-WK

File Identifier = O44517WK.AG01.IRS

26 CFR 601.102: Rulings and determination letters.

Rev. Proc. 89-26

SECTION 1. BACKGROUND

Rev. Proc. 89-3, page 761, this Bulletin, sets forth areas in which the Internal Revenue Service will not issue advance rulings or determination letters. Section 5 of Rev. Proc. 89-3 is entitled "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 5.27 concerns the classification of equipment leasing trusts for federal income tax purposes.

SEC. 2. PROCEDURE

Rev. Proc. 89-3 is modified by deleting section 5.27.

SEC. 3. EFFECT ON OTHER REVENUE PROCEDURES

Rev. Proc. 89-3 is modified.

SEC. 4. EFFECTIVE DATE

This revenue procedure is effective as of April 3, 1989, the date of publication of this revenue procedure in the Internal Revenue Bulletin.

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26 CFR 601.201: Rulings and determination letters.
(Also Part I, Sections 25, 103, 143; 1.25-1T, 1.103-1, 6a.103A-2.)

Rev. Proc. 89-27

SECTION 1. PURPOSE

This revenue procedure supplements Rev. Proc. 88-48, 1988-2 C.B. 635, by adding "average area purchase price" safe harbor limitations for Guam and Puerto Rico.

SEC. 2. BACKGROUND

.01 Issuers of qualified mortgage bonds, as defined in section 143(a) of the Internal Revenue Code, and mortgage credit certificates, as defined in section 25(c), must satisfy several requirements if the interest on the bonds is to be excludable from gross income under section 103(a) or the credit attributable to the certificates is to be allowable against federal income tax. One of the requirements is that the cost of each residence financed must not exceed a certain percentage of the average area purchase price applicable to such residence. The average area purchase price with respect to any residence is the average purchase price of single-family residences in the statistical area in which the residence is located that were purchased during the most recent 12-month period for which sufficient statistical information is available.

.02 Prior to the enactment of the Tax Reform Act of 1986 (Act), section 1301, 1986-3 (Vol. 1) C.B. 519, former section 103A(f) of the Code provided that the acquisition cost of each residence could not exceed 110 percent (120 percent for a targeted area residence) of the average area purchase price. The Act repealed section 103A(f) and replaced it with section 143(e), which provides that the acquisition cost can not exceed 90 percent (110 percent for a targeted area residence) of the average area purchase price. The Act generally is effective with respect to bonds issued after August 15, 1986. The Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, section 4005(a), 102 Stat. 3342, extended the qualified mortgage bond provisions under section 143(a) and the mortgage credit certificate provisions under section 25(c) through December 31, 1989.

.03 Rev. Proc. 85-42, 1985-2 C.B. 496, as originally published, contained a list of the average area purchase price safe harbor limitations for areas within each state and the District of Columbia. Rev. Proc. 87-19, 1987-1 C.B. 712, supplemented Rev. Proc. 85-42 by adding safe harbor limitations for Guam, Puerto Rico, and the Commonwealth of the Northern Mariana Islands. The portion of Rev. Proc. 85-42 concerning safe harbor limitations for the states and the District of Columbia was obsoleted by Rev. Proc. 87-20, 1987-1 C.B. 713. Rev. Proc. 87-20 was obsoleted by Rev. Proc. 88-48. Section 3 of Rev. Proc. 87-19 provides that the safe harbor limitations for Guam, Puerto Rico, and the Commonwealth of the Northern Mariana Islands published in Rev. Proc. 87-19 may be relied on until new safe harbor limitations are published.

SEC. 3. APPLICATION AND EFFECTIVE DATE

.01 The average area purchase price safe harbor limitations for Guam and Puerto Rico are contained in this revenue procedure. Issuers may continue to rely on these safe harbor limitations until they are rendered obsolete by a new revenue procedure.

.02 Issuers of qualified mortgage bonds and mortgage credit certificates for residences in Guam and Puerto Rico may rely on the average area purchase price safe harbor limitations contained in this revenue procedure for the period beginning April 10, 1989, the date of publication of this revenue procedure in the Internal Revenue Bulletin, and ending on the date that such safe harbor limitations are rendered obsolete by a new revenue procedure.

.03 Issuers may continue to rely on the average area purchase price safe harbor limitations for new residences in Puerto Rico added to Rev. Proc. 85-42 by Rev. Proc. 87-19 for mortgages financed with the proceeds of qualified mortgage bonds sold before May 10, 1989, 30 days after publication of this revenue procedure in the Internal Revenue Bulletin, if the commitments to provide financing for the mortgages are made before July 9, 1989, 90 days after publication of this revenue procedure in the Internal Revenue Bulletin.

.04 Issuers of mortgage credit certificates may continue to rely on the average area purchase price safe harbor limitations for new residences in Puerto Rico added to Rev. Proc. 85-42 by Rev. Proc. 87-19 for certificates issued with respect to bond authority exchanged before May 10, 1989, 30 days after publication of this revenue procedure in the Internal Revenue Bulletin, if commitments to issue the certificates are made before July 9, 1989, 90 days after publication of this revenue procedure in the Internal Revenue Bulletin.

.05 The issuers of qualified mortgage bonds and mortgage credit certificates in the Commonwealth of the Northern Mariana Islands may continue to rely on the average area purchase price safe harbor limitations added to Rev. Proc. 85-42 by Rev. Proc. 87-19 until new safe harbor limitations are published for that jurisdiction.

.06 The average area purchase price safe harbor limitations, which are set forth below, have not been adjusted to reflect either the 90 percent of the average area purchase price described in section 143(e)(1) of the Code or the 110 percent of the average area purchase price described in section 143 (e)(5).

STATE AND AREA DESIGNATION	AVERAGE AREA PURCHASE PRICE SAFE HARBOR LIMITATIONS FOR SINGLE-FAMILY RESIDENCES NEW	EXISTING
Guam		
All Areas	$59,200	$59,200
Puerto Rico		
All Areas	$43,800	$44,800

SEC. 4. EFFECT ON OTHER REVENUE PROCEDURES

Rev. Proc. 88-48 is supplemented, and Rev. Proc. 85-42, as supplemented by Rev. Proc. 87-19, is obsoleted except as provided in section 3.05 of this revenue procedure.

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26 CFR 601.201: Rulings and determination letters.

Rev. Proc. 89-28

SECTION 1. PURPOSE

The purpose of this revenue procedure is to amplify Rev. Proc. 86-41, 1986-2 C.B. 716, which sets forth the information that must be included in a request for a ruling under section 355 of the Internal Revenue Code.

SEC. 2. BACKGROUND

Section 355(a)(1)(D)(ii) of the Code requires that it be established to the satisfaction of the Secretary that a retention by the distributing corporation (Distributing) of stock in the controlled corporation (Controlled) was not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax. This revenue procedure amplifies Rev. Proc. 86-41 by adding to section 4.02 4. guidelines which the Service uses in making a determination under section 355(a)(1)(D)(ii) of the Code and section 1.355-2(e) of the Regulations (formerly section 1.355-2(d)).

SEC. 3. PROCEDURE

Rev. Proc. 86-41 is amplified by adding after section 4.02 4.(a)(3) the following:

The Service will issue favorable rulings regarding the application of section 355(a)(1)(D)(ii), relating to the retention by Distributing of stock in Controlled, to transactions involving a widely held corporation that are not covered by Rev. Rul. 75-321, 1975-2 C.B. 123, if:

(1) a sufficient business purpose exists for the stock retention;

(2) none of Distributing's directors or officers will serve as a director or officer of Controlled as long as Distributing continues to hold Controlled stock;

(3) the retained stock will be disposed of as soon as a disposition is warranted consistent with the business purpose in (1) above but in no event later than 5 years after the distribution and;

(4) Distributing votes the retained stock in proportion to the votes cast by Controlled's other shareholders. For example, if subsequent to the distribution the other shareholders of Controlled vote 70 per cent in favor of a matter and 30 per cent against, then Distributing would be required to vote the retained stock 70 per cent in favor and 30 per cent against the matter.

SEC. 4. COMMENTS OR INQUIRIES

Comments or inquiries regarding this revenue procedure should be addressed to the Assistant Chief Counsel (Corporate), Internal Revenue Service, 1111 Constitution Ave., N.W., Washington, D.C. 20224.

SEC. 5. EFFECT ON OTHER REVENUE PROCEDURES

Rev. Proc. 86-41 is amplified.

SEC. 6. EFFECTIVE DATE

This revenue procedure will apply to all ruling requests on hand in the National Office on April 10, 1989, the date of publication of this revenue procedure in the Internal Revenue Bulletin, as well as to requests received thereafter.

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26 CFR 601.201: Rulings and determination letters. (Also Part I, Sections 401, 411.)

Rev. Proc. 89-29

SECTION 1. PURPOSE

This revenue procedure provides final guidelines resulting from the reconsideration of Rev. Proc. 75-49, 1975-2 C.B. 584.

SEC. 2. CHANGE

This revenue procedure provides that, effective for plan years beginning after December 31, 1988, the tests described in Rev. Proc. 75-49, as modified by Rev. Proc. 76-11, 1976-1 C.B. 550, will no longer apply.

SEC. 3. BACKGROUND

.01 Rev. Proc. 75-49, as modified by Rev. Proc. 76-11, provides guidelines that are followed by the Internal Revenue Service in determining, for purposes of an advance determination letter under section 601.201(o) of the regulations (Statement of Procedural Rules), whether the vesting schedule of an employee plan discriminates, or is likely to discriminate, in favor of employees who are officers, shareholders, or highly compensated (the "prohibited group"). Those guidelines are concerned only with the circumstances in which a faster rate of vesting than would otherwise be required is appropriate for advance determination purposes due to actual or potential discrimination in the accrual of benefits or forfeitures in favor of the prohibited group.

.02 Rev. Proc. 75-49 established tests (the "key employee test" and the "turnover test") by which such discrimination would be ascertained in connection with an advance determination letter. If an employer could not satisfy these tests (when applicable), an advance determination letter would in no event be issued if the plan provided vesting at a rate less rapid than 40 percent after four years of employment, an additional 5 percent for each of the next two years, and an additional 10 percent for each of the following five years ("four forty vesting"). A plan which satisfied the requirements of this test would not be required to satisfy the key employee test or the turnover test for purposes of an advance determination as to its qualified status.

.03 Comments received by the Service suggested that a large number of employers might not be able to show compliance with Rev Proc. 75-49 without the 4-40 vesting rate set forth therein. It was decided that Rev. Proc. 75-49 would be reconsidered by the Service.

.04 Pending completion of the reconsideration of Rev. Proc. 75-49, the Service has, for purposes of issuing favorable determination letters, treated the vesting schedule of a plan as satisfying the nondiscrimination requirements of section 401(a)(4) of the Code if the plan satisfies the minimum vesting requirements of section 411(a)(2) (if applicable) and, in addition, any one of three conditions set forth in section 3.01 of Rev. Proc. 76-11. Those conditions are as follows:

(1) the plan complies with the tests contained in Rev. Proc. 75-49, either by (i) adoption of 4-40 vesting, or (ii) satisfaction of the key employee test or the turnover test (whichever test or tests may be applicable); or

(2) in the case of any plan which had previously been the subject of a favorable advance determination letter that has not been revoked, the percentage of vesting of each participant provided under the plan, as amended, is not less (at every point) than that provided under the vesting schedule of the plan upon which such most recent prior determination letter was based; or

(3) there is a demonstration, to the satisfaction of the Service, on the basis of all the facts and circumstances, that there has not been, and there is no reason to believe there will be, an accrual of benefits or forfeitures tending to discriminate in favor of the prohibited group.

.05 Section 4 of Rev. Proc. 76-11 provides that, pending completion of the reconsideration of Rev. Proc. 75-49, an applicant may request in writing that its application be processed without regard to whether the vesting provisions of the plan satisfy the nondiscrimination requirement of section 401(a)(4) of the Code. However, a determination letter issued to such an applicant will contain a caveat to the effect that such letter is not a determination as to whether the vesting provisions of the plan satisfy the nondiscrimination requirements of section 401(a)(4). Upon publication of final guidelines resulting from the reconsideration of Rev. Proc. 75-49, an applicant that had been issued a determination letter containing such a caveat may request, upon satisfying such guidelines, to have the caveat deleted. Such a request will be considered a continuation of the previous request for a determination letter and will therefore not require either the filing of a new application or additional notification of interested parties.

.06 With regard to the situation in which a plan fails to satisfy any of the three conditions described in subsection .04 above and in which the alternative described in subsection .05 has not been requested, section 3.04 of Rev. Proc. 76-11 states that such plan shall not be required by the Service to provide a vesting schedule more rapid than 4-40 vesting as a condition to the issuance of a favorable advance determination letter, except, however, that, pursuant to section 411(d)(1) of the Code, the Service may require vesting more rapid than 4-40 vesting if there has been a pattern of abuse under the plan or actual misuse of the plan in operation which affects the qualified status of the plan or trust.

SEC. 4. SCOPE

This revenue procedure applies solely for purposes of advance determination letters, and therefore does not apply in cases where the qualified status of a plan or trust under section 401(a) or 403(a) of the Code is determined upon examination of its operations. This revenue procedure also does not apply in determining whether there has been a pattern of abuse under a plan (such as the intentional dismissal of employees to prevent vesting) or actual misuse in the operation of a plan which affects the qualified status of the plan or trust.

SEC. 5. LEGISLATIVE CHANGES AFFECTING VESTING

.01 *The Tax Reform Act of 1986 (TRA '86)*

(1) Section 1113(a) of TRA '86, 1986-3 (Vol. 1) C.B. 1, 363, changed the minimum vesting standards under section 411 of the Code. The changed standards provide that a plan is not a qualified plan unless a participant's employer-provided benefit vests at least as rapidly as under one of two alternative vesting schedules or, in the case of an employee covered by a multiemployer plan pursuant to a collective bargaining agreement, the employee has a nonforfeitable right to 100 percent of the employee's accrued benefit derived from employer contributions upon completion of 10 years of service. A plan satisfies the first alternative vesting schedule if a participant has a nonforfeitable right to 100 percent of the participant's accrued benefit derived from employer contributions upon completion of 5 years of service. A plan satisfies the second schedule if a participant has a nonforfeitable right to at least 20 percent of the participant's accrued benefit derived from employer contributions after 3 years of service, 40 percent at the end of 4 years of service, 60 percent at the end of 5 years of service, 80 percent at the end of 6 years of service, and 100 percent at the end of 7 years of service. This change is effective generally for plan years beginning after December 31, 1988.

(2) Section 1114(b)(10) of TRA '86 changed section 411(d)(1) of the Code, effective generally for years beginning after December 31, 1988, by substituting "employees who are highly compensated employees (within the meaning of section 414(q))" for "employees who are officers, shareholders, or highly compensated."

.02 *Special Rules for Top-Heavy Plans.* The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), Pub. L. 97-248, 1982-2 C.B. 462, established requirements that must be met by a top-heavy plan as defined in section 416(g) of the Code. Such a plan must meet the vesting requirements of section 416(b) and the minimum benefit requirements of section 416(c). In order to meet the vesting requirements of section 416(b), a top-heavy plan must provide either "3-year vesting" or "6-year vesting."

(1) A top-heavy plan satisfies the 3-year vesting requirement under section 416(b)(1)(A) if an employee who has completed at least three years of service with the employer or employers maintaining the plan has a nonforfeitable right to 100 percent of the employee's accrued benefit derived from employer contributions.

(2) A top-heavy plan satisfies the 6-year vesting requirement under section 416(b)(1)(B) if an employee has a nonforfeitable right to a percentage of the employee's accrued benefit derived from employer contributions determined under the following table:

Years of Service	*Nonforfeitable percentage*
2	20
3	40
4	60
5	80
6	100

SEC. 6. FINAL GUIDELINES CONCERNING ISSUANCE OF DETERMINATION LETTERS

As the result of its reconsideration of Rev. Proc. 75-49, and in light of the legislative changes described in section 5 above, the Service has concluded that, for purposes of an advance determination as to whether a plan's vesting rate is rapid enough, the key employee test, the turnover test and the four-forty vesting test will not be applied with respect to plan years beginning after December 31, 1988. Instead, a plan that satisfies the minimum vesting standards under section 411(a)(2) as amended by TRA '86 or, in the case of a top-heavy plan, the requirements of section 416(b), will be deemed to provide a rapid enough rate of vesting for purposes of an advance determination letter unless there has been a pattern of abuse or actual misuse in the operation of the plan. The interim tests set forth in Rev. Proc. 76-11 will continue to apply until the effective date of this change.

SEC. 7. EFFECT ON OTHER DOCUMENTS

Rev. Procs. 75-49 and 76-11 are superseded for plan years beginning after December 31, 1988.

SEC. 8. EFFECTIVE DATE

This revenue procedure applies to determination letters issued with respect to plan years beginning after December 31, 1988.

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26 CFR 601.201: Ruling and determination letters.

Rev. Proc. 89-30

SECTION 1. PURPOSE

This revenue procedure revokes section 5 of Rev. Proc. 77-37, 1977-2 C.B. 568, superseded in part by Rev. Proc. 79-14, 1979-1 C.B. 496, and amplified by Rev. Proc. 77-41, 1977-2 C.B. 574, Rev. Proc. 82-23, 1982-1 C.B. 474, Rev. Proc. 83-81, 1983-2 C.B. 598, Rev. Proc. 84-42, 1984-1 C.B. 521, and Rev. Proc. 86-42, 1986-2 C.B. 722. Rev. Proc. 77-37 contains operating rules for the issuance of advance rulings as to matters within the jurisdiction of the Assistant Chief Counsel (Corporate) of the Internal Revenue Service.

SEC. 2. BACKGROUND

.01 Section 306(a) of the Internal Revenue Code concerns the treatment of the amount realized on the disposition or redemption of section 306 stock, as defined in section 306(c). Section 306(b)(4) provides in part that section 306(a) shall not apply if it is established to the satisfaction of the Secretary that the distribution and the disposition or redemption of the section 306 stock wasnot in pursuance of a plan having as one of its principal purposes the avoidance of federal income tax.

.02 See Rev. Rul. 89-63, page 90, this Bulletin, for a clarification of the application of section 306(b)(4).

SEC. 3. PROCEDURE

Section 5 of Rev. Proc. 77-37 provides the usual requirements for obtaining a favorable ruling under section 306(b)(4) of the Code. The proper scope and function of section 306(b)(4) has been under extensive study and it has been determined that the requirements listed in section 5 do not adequately identify those cases which warrant the relief provided by section 306(b)(4). Therefore, section 5 is hereby revoked. The Service will continue to consider requests for rulings concerning the application of section 306(b)(4) pending completion of its study.

SEC. 4. EFFECT ON OTHER REVENUE PROCEDURES

Rev. Proc. 77-37 is modified.

SEC. 5. EFFECTIVE DATE

The modification of Rev. Proc. 77-37 is effective May 1, 1989, the date of publication of this revenue procedure.

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26 CFR 601.104: Collection functions.

Rev. Proc. 89-31

SECTION 1. PURPOSE AND SCOPE

This revenue procedure provides general guidance necessary to comply with section 1446 of the Internal Revenue Code, as amended by section 1012(s) of the Technical and Miscellaneous Revenue Act of 1988, P.L. 100-647, concerning certain withholding requirements applicable to partnerships with foreign partners. This revenue procedure is organized in the following manner:

Section 1 — PURPOSE AND SCOPE;

Section 2 — BACKGROUND (History of section 1446);

Section 3 — REQUIREMENT OF WITHHOLDING (Description of withholding requirements under section 1446);

Section 4 — WITHHOLDING AGENTS (Who is responsible for withholding under section 1446);

Section 5 — DETERMINATION OF WHETHER A PARTNER IS A FOREIGN PERSON (How to determine whether a partner is a foreign person subject to withholding);

Section 6 — EFFECTIVELY CONNECTED TAXABLE INCOME (Determination of amount of effectively connected taxable income allocable to foreign partners);

Section 7 — AMOUNT OF WITHHOLDING TAX (Determining the amount of withholding tax (including the applicable percentage) and the time for payment of that tax);

Section 8 — REPORTING AND PAYING OVER WITHHELD TAX (How to report and pay over withheld amounts);

Section 9 — TREATMENT OF PARTNERS (Effect of section 1446 withholding on partners);

Section 10 — PUBLICLY TRADED PARTNERSHIPS (Special rules for publicly traded partnerships); and

Section 11 — TIERED PARTNERSHIPS (Special rules for tiered partnerships).

SEC. 2. BACKGROUND

Section 1012(s)(1)(D) of the Technical and Miscellaneous Revenue Act of 1988 (the "1988 Act"), P.L. 100-647, retroactively amends section 1446 of the Internal Revenue Code of 1986, and provides that no amount of tax shall be required to be deducted and withheld under section 1446 of the 1986 Code as in effect prior to its amendment by the 1988 Act. Prior to its amendment, section 1446 of the 1986 Code, as enacted by section 1246 of the Tax Reform Act of 1986, P.L. 99-514, had required partnerships with a U.S. trade or business to withhold a 20 percent tax from certain distributions made after December 31, 1987 to their foreign partners. Rev. Proc. 88-21, 1988-1 C.B. 777 (declared obsolete by this revenue procedure).

As amended by the 1988 Act, section 1446 of the Code generally applies to U.S. and foreign partnerships in any taxable year beginning after December 31, 1987, in which they have effectively connected taxable income that is allocable to foreign partners. Under this revenue procedure, a partnership may have effectively connected taxable income with respect to some of its foreign partners but not others. Affected partnerships are no longer to withhold on distributions to foreign partners. These partnerships are now required to pay a withholding tax in the time and manner specified in this procedure, equal to the applicable percentage of the effectively connected taxable income allocable to its foreign partners. A publicly traded partnership is subject to the rules in Section 10 of this revenue procedure. Section 10 provides rules by which a publicly traded partnership is to determine the non-foreign status of partners, and for withholding, reporting, and paying over tax on distributions. Section 10 of this revenue procedure also provides an election under which a publicly traded partnership can pay a withholding tax based upon effectively connected taxable income allocable to its foreign partners under the general rules of this revenue procedure, instead of withholding on distributions.

SEC. 3. REQUIREMENT OF WITHHOLDING

If in any taxable year beginning after December 31, 1987, a foreign or domestic partnership (as defined in section 7701 of the Code, but excluding a partnership treated as a corporation under the general rule of section 7704(a) of the Code) has effectively connected taxable income allocable under section 704 to a foreign partner, then the partnership must pay a withholding tax equal to the applicable percentage (defined in Section 7.013 of this revenue procedure) of the effectively connected taxable income that is allocable to its foreign partners. A publicly traded partnership (excluding a partnership treated as a corporation under the general rule of section 7704(a) of the Code) is required to withhold on distributions in accordance with the rules set forth in Section 10 of this revenue procedure, unless it makes the election in Section 10 to pay a withholding tax under the general rules of this revenue procedure that apply to non-publicly traded partnerships.

SEC. 4. WITHHOLDING AGENTS

.01 *In general.* Section 1446, as amended by the 1988 Act, generally requires a partnership to pay a withholding tax with respect to effectively connected taxable income allocable to its foreign partners. The general partners of a partnership shall be jointly and severally liable as withholding agents for the partnership. For ease of reference, this revenue procedure refers to various requirements applicable to withholding agents as requirements applicable to partnerships themselves. This does not affect the legal incidence of liability. Additional rules applicable to publicly traded partnerships are provided in Section 10 of this revenue procedure.

.02 *Penalty for failure to withhold and pay over tax under section 1446.* A partnership (including a publicly traded partnership) that is required to pay a withholding tax under section 1446 of the Code is made liable for that tax under section 1461. Therefore, a partnership that is required to pay such tax, but fails to do so, may be held liable for the payment of the tax, any applicable penalties, and interest. A person that is required, but fails, to pay the withholding tax required by section 1446 may also be subject to civil and criminal penalties. Officers or other responsible persons of either a corporation that is a general partner or any other withholding agent may be subject to a civil penalty under section 6672 equal to the amount that should have been withheld and paid over.

SEC. 5. DETERMINATION OF WHETHER A PARTNER IS A FOREIGN PERSON

.01 *In general.* Section 1446 of the Code requires a partnership (including a publicly traded partnership) with effectively connected taxable income allocable to any partner that is a foreign person to pay a withholding tax with respect to that partner. Accordingly, a partnership must determine under the rules of this Section whether any partner is a foreign person subject to section 1446. For purposes of section 1446, a foreign person is a nonresident alien individual, foreign corporation, foreign partnership, or foreign trust or estate. A partnership may determine a partner's status by relying upon a certification of non-foreign status, under the rules of Section 5.02 of this revenue procedure, or any other means, under the rules of Section 5.03. Additional rules applicable to publicly traded partnerships are provided in Section 10 of this revenue procedure.

.02 *Certification of non-foreign status.*

1 *In general.* This Section provides rules pursuant to which a partnership can determine that a partner is not a foreign person by obtaining a certification of non-foreign status from the partner. A partnership that has obtained such a certification may rely upon it to establish the non-foreign status of a partner, as provided in paragraph 2, below.

2 *Effect of certification.* A partnership that has obtained a certification of non-foreign status in accordance with the rules of this Section may rely upon the certification to determine that the partner is not subject to withholding, but only if the partnership does not have actual knowledge that the certification is false. If a partnership relies in good faith upon a certification, but it is subsequently determined that the certification was false, the partnership shall not be subject to the liability described in Section 4.02 of this revenue procedure for a failure to pay the withholding tax under section 1446 of the Code. A certification that satisfies the requirements of this revenue procedure will also satisfy the requirements for a certificate of non-foreign status under section 1445. If a partnership has actual knowledge that a certification of non-foreign status is false, however, it shall not be entitled to rely on that certification at any time after obtaining that knowledge. For this purpose, the knowledge of any general partner will be imputed to the partnership to give rise to a withholding liability under section 4.01 of this revenue procedure. The knowledge of one of its limited partners will not be imputed to a partnership based solely upon that partner's status as a limited partner. A partnership shall be fully liable under section 1461 for any failure to pay the withholding tax under section 1446 for the taxable year in which it obtained knowledge that a certification of non-foreign status is false. However, a partnership will not be liable for penalties for failure to make timely payments of installments of the section 1446 withholding tax that were due prior to the time it obtained knowledge that a certification was false. The liability of a publicly traded partnership is set forth in Section 10 of this revenue procedure.

3 *Duration of certification.* A partnership may rely on a partner's certification of non-foreign status until the earliest of:

(a) the end of the third year after the taxable year of the partnership during which the certification was obtained;

(b) the date the partnership receives notice from the partner that it has become a foreign person; or

(c) the date the partnership has actual knowledge that the partner is, or has become, a foreign person.

4 *Form of certification.* No particular form is required for a certification of non-foreign status, nor is any particular language required. The certification must:

(a) State that the partner is not a foreign person,

(b) Set forth the partner's name, U.S. identifying number, and home address (in the case of an individual) or office address (in the case of an entity),

(c) Provide that the partner will notify the partnership within sixty (60) days of a change to foreign status, and

(d) Be signed under penalties of perjury. An individual's U.S. identifying number is the individual's social security number (or such other taxpayer identification number as may have been assigned to a foreign individual by the Internal Revenue Service), and any other person's U.S. identifying number is its U.S. employer identification number. A certification of non-foreign status must be verified as true and signed under penalties of perjury by a responsible corporate officer in the case of a corporation, by a general partner in the case of a partnership, and by a trustee, executor, or equivalent fiduciary in the case of a trust or estate. A certification of non-foreign status may also be signed by a person authorized under a power of attorney in proper form executed by the partner, provided the power of attorney accompanies the certification. Examples of acceptable certifications of non-foreign status are provided in Section 5.04 of this revenue procedure.

5 *Certifications under section 1445.* During a partnership's taxable years beginning before July 1, 1989, but not thereafter, the partnership may, except as provided in this section, rely on a certification of non-foreign status provided by a partner under section 1445 of the Code and section 1.1445-2 or 1.1445-5 of the regulations.

For purposes of section 1446 a partnership may not rely upon a certification of non-foreign status given by a foreign corporation that has based the certification on an election under section 897(i). A foreign corporation that has made an election under section 897(i) continues to be treated as a foreign person for all U.S. tax purposes other than sections 897, 1445, and 6039C. Thus, a partnership must withhold with respect to a foreign corporate partner without regard to whether that foreign corporation has made an election under section 897(i).

6 *Retention of certifications.* A partnership must retain a certification of non-foreign status until the end of the fifth taxable year after the last taxable year in which the partnership relied upon the certification.

7 *Special rule for widely held partnerships.* In addition to a certification of non-foreign status, a widely held partnership (a partnership which has more than 200 partners, including a publicly traded partnership that has elected to pay a withholding tax based on effectively connected taxable income allocable to its foreign partners instead of withholding on distributions), that seeks to determine whether or not any of its partners are foreign persons may rely on the information provided to it by partners on a Form 1001, Form W-8, or Form W-9. In addition, a widely held partnership may rely on a certification under penalties of perjury from a nominee about the non-foreign status of partners owning partnership interests through the nominee. No particular form is required for a certification from a nominee, but the certification should identify the partner for whom the certification is made, and indicate the basis for the certification. In making such a certification a nominee may also rely on a certification of non-foreign status provided by a foreign partner under the rules of Section 5.02, or may rely on information provided to it on Form 1001, Form W-8, or Form W-9 in determining whether a partner is a foreign person. Neither a partnership nor a nominee may directly or indirectly rely on information on a Form 1001, Form W-8, or Form W-9 after the date that such form must be re-executed, nor on a certification of non-foreign status based upon an election under section 897(i) of the Code.

A partnership that is permitted to rely on a certification of non-foreign status and the alternative forms of information (Forms 1001, W-8, or W-9) in determining non-foreign status, and that relies in good faith on any of those shall not be subject to the liability imposed by Section 4.02 of this revenue procedure for a failure to withhold under section 1446 of the Code. However, a partnership that has actual knowledge of the falsity of any of these forms of information shall not be entitled to rely on that form of information any time after obtaining that knowledge, and the partnership shall be fully liable under section 1461 for any failure to pay the withholding tax under section 1446 for the taxable year in which it obtained that knowledge. The partnership will not be liable for penalties for failure to make timely payments of installments of the section 1446 withholding tax that were due prior to the time it obtained knowledge that the information upon which it was entitled to rely was false.

In the case of a widely held partnership, the documentation used to determine the non-foreign status of a partner must be retained until the end of the fifth taxable year following the last taxable year in which the partnership properly relied upon the documentation as provided in this revenue procedure.

.03 *Use of means other than certification.* A partnership is not required to obtain a certification of non-foreign status under the rules of Section 5.02 of this revenue procedure, but may instead rely upon other means to ascertain the non-foreign status of the partner. If, however, the partnership relies upon other means not specified in Section 5.02 of this revenue procedure, and erroneously determines that the partner was not a foreign person, then the partnership is subject to the liability described in Section 4.02. A partnership is in no event required to rely upon other means to determine the non-foreign status of a partner and may demand a certification of non-foreign status. If a certification is not provided, the partnership may withhold tax under section 1446 of the Code and will be considered, for purposes of sections 1461 through 1463, to have been required to withhold such tax.

.04 *Sample certifications.* The following are examples of acceptable certifications under the rules of this revenue procedure.

(a) *Partners who are individuals.* "Section 1446 of the Internal Revenue Code provides that a partnership must pay a withholding tax to the Internal Revenue Service with respect to a partner's allocable share of the partnership's effectively connected taxable income, if the partner is a foreign person. To inform [name of partnership] that the provisions of section 1446 do not apply, I, [name of partner], hereby certify the following:

1. I am not a nonresident alien for purposes of U.S. income taxation;

2. My U.S. taxpayer identification number (social security number) is ______; and

3. My home address is ______.

I hereby agree that if I become a nonresident alien, I will notify the partnership within sixty (60) days of doing so. I understand that this certification may be disclosed to the Internal Revenue Service by the partnership and that any false statement I have made here could be punished by fine, imprisonment, or both.

Under penalties of perjury I declare that I have examined this certification and to the best of my knowledge and belief it is true, correct, and complete.

[Signature and Date]"

(b) *Partners that are entities*. "Section 1446 of the Internal Revenue Code provides that a partnership must pay a withholding tax to the Internal Revenue Service with respect to a partner's allocable share of the partnership's effectively connected taxable income, if the partner is a foreign person. To inform [name of partnership] that the provisions of section 1446 do not apply, the undersigned hereby certifies on behalf of [name of the entity] the following:

1. [Name of the entity] is not a foreign corporation, foreign partnership, foreign trust, or foreign estate (as those terms are defined in the Internal Revenue Code and Income Tax Regulations);

2. [Name of the entity]'s U.S. employer identification number is ______, and

3. [Name of the entity]'s office address is ______.

[Name of the entity] hereby agrees to notify the partnership within sixty (60) days of the date [name of the entity] becomes a foreign person. [Name of entity] understands that this certification may be disclosed to the Internal Revenue Service by the partnership and that any false statement contained herein could be punished by fine, imprisonment, or both.

Under penalties of perjury I declare that I have examined this certification and to the best of my knowledge and belief it is true, correct, and complete, and I further declare that I have authority to sign this document on behalf of [name of entity].

[Signature and Date]

[Title]"

SEC. 6. EFFECTIVELY CONNECTED TAXABLE INCOME

.01 *In general*. The term "effectively connected taxable income" means the excess of the gross income of the partnership that is effectively connected, under the principles of section 864 of the Code, or treated as effectively connected with the conduct of a trade or business in the United States, over the allowable deductions that are connected to such income, computed with the following adjustments:

(a) paragraph (1) of section 703 (a) of the Code shall not apply;

(b) the partnership shall be allowed a deduction for depletion with respect to oil and gas wells, but the amount of such deduction shall be determined without regard to sections 613 and 613A;

(c) there shall not be taken into account any item of income, gain, loss, or deduction to the extent allocable to any partner that is not a foreign partner, and

(d) a partnership shall not take into account net operating loss carryovers and charitable contributions.

The computation of a partnership's effectively connected taxable income includes partnership income subject to a partner's election under section 871(d) or 882(d) of the Code, any partnership income treated as effectively connected with the conduct of a U.S. trade or business pursuant to section 897, and other items of partnership income treated as effectively connected under other provisions of the Code, without regard to whether those amounts are taxable to the partner. A foreign partner that files Form 4224, which is used to claim an exemption from withholding under section 1441 and section 1442 of the Code, is deemed to have effectively connected income and is subject to withholding under section 1446.

.02 *Amount allocable to foreign partners*. The amount of withholding tax that a partnership is required to pay under section 1446 for the partnership's taxable year is based on the amount of the partnership's effectively connected taxable income allocable to the partnership's foreign partners for that taxable year. The amount of a partnership's effectively connected taxable income for the partnership's taxable year that is allocable to a foreign partner under section 704 of the Code is equal to the foreign partner's distributive share of effectively connected gross income of the partnership for the partnership's taxable year that is properly allocable to the partner under section 704, reduced by the foreign partner's distributive share of deductions of the partnership for such year that are connected with such income under section 873 or section 882(c)(1), and that are properly allocable to the partner under section 704. For purposes of the preceding sentence, a foreign partner's distributive share of effectively connected gross income and deductions connected with such income shall be computed by taking into account any adjustments to the basis of partnership property described in section 743 pursuant to the partnership's election under section 754. A partnership's effectively connected taxable income shall not be allocable to a foreign partner to the extent such amounts are exempt from U.S. tax with respect to that partner by operation of a treaty or reciprocal agreement to which the United States is a party, or a provision of the Internal Revenue Code.

SEC. 7. AMOUNT OF WITHHOLDING TAX

.01 *Calculation of payments of tax*.

1 *In general*. Under section 1446 of the Code, as amended, a partnership (other than a publicly traded partnership described in Section 10 of this revenue procedure) must make installment payments of withholding tax based on the amount of effectively connected taxable income of the partnership allocable to its foreign partners, as determined under Section 7.012 of this revenue procedure, without regard to whether distributions are made during the partnership's taxable year. Installment payments of this withholding tax are generally to be made at the times specified in Section 7.014 of this revenue procedure, and at the applicable percentage specified in Section 7.013 of this revenue procedure. A partner's liability for the tax imposed under section 884 of the Code and the partner's distributive share of the partnership's tax credits shall not be taken into account in determining the amount of a partnership's installment payments.

2 *Amount of effectively connected taxable income used to compute installment payment of withholding tax*. (i) *In general*. Installment payments of section 1446 withholding tax during the partnership's taxable year are to be based upon the effectively connected taxable income of the partnership year to which they relate. The amount of a partnership's installment payment is equal to the sum of the installment payments for each of the partnership's foreign partners. With respect to a foreign partner, the amount of an installment of the section 1446 withholding tax is to be computed by applying the principles of section 6655(e)(2) of the Code. Under these principles, the partnership's effectively connected income and deductions for each payment period are annualized, the foreign partner's allocable share of these amounts is determined, and the annualized section 1446 withholding tax is computed by applying the section 1446 applicable percentage to the partner's annualized effectively connected taxable income. The installment of section 1446 withholding tax with respect to that foreign partner equals the excess of

the section 6655(e)(2)(B)(ii) applicable percentage of this annualized section 1446 withholding tax over the aggregate of any amounts paid under section 1446 with respect to that partner in prior installments for the partnership's taxable year.

(ii) *Safeharbor.* No penalty will be imposed if (1) the amount of each installment payment equals 25 percent of the withholding tax that would be payable on the amount of its effectively connected taxable income allocable to foreign partners for the prior year, (2) the prior taxable year consisted of twelve months, (3) the partnership filed an information return under section 6031 of the Code for the prior year, and (4) the amount of effectively connected taxable income for the prior year was not less than 50 percent of the effectively connected taxable income as shown on the annual return of section 1446 withholding tax that must be filed for the current year.

3 *Applicable percentage.* In the case of partners that are taxable as corporations under the Internal Revenue Code, the section 1446 applicable percentage is the highest rate of tax specified in section 11(b) of the Code for income derived during the taxable year of the partnership described in Section 7.013 of this revenue procedure, currently 34 percent. In the case of partners that are not taxable as corporations under the Internal Revenue Code (*e.g.*, partnerships, individuals, estates), the applicable percentage is the highest rate of tax specified in section 1 for income derived during the taxable year of the partnership described in Section 7.013 of this revenue procedure, currently 28 percent.

A partnership's liability under section 1461 of the Code and the regulations thereunder includes any underpayment of tax caused by a failure to use the proper applicable percentage in computing and paying the withholding tax due under section 1446. For example, a partnership will be liable under section 1461 and the regulations thereunder if it incorrectly fails to pay any withholding tax for a foreign partner, or underpays a withholding tax for a foreign corporate partner by using the incorrect applicable percentage.

4 *Date payments are due.* Withholding under section 1446 of the Code is imposed on effectively connected taxable income derived through a partnership during a partnership's taxable year. Subject to the transition rules described in Section 8.08 of this revenue procedure, payments of the withholding tax under section 1446 must generally be made during the taxable year of the partnership in which such income is derived. A partnership must generally pay to the Internal Revenue Service a portion of its estimated annual section 1446 payment for each foreign partner on or before the 15th day of the fourth, sixth, ninth, and twelfth months of the partnership's taxable year for U.S. income tax purposes. Any additional amounts determined to be due are to be paid with the filing of the annual return of tax under section 1446, described in Section 8.03 of this revenue procedure.

.02 *Coordination with other withholding rules.*

1 *Interest, dividends, etc.* Fixed or determinable, annual or periodical income subject to tax only under section 871(a) or 881 of the Code is not included in the partnership's effectively connected taxable income under Section 6.01 of this revenue procedure. However, such amounts are independently subject to the withholding requirements of sections 1441 and 1442 and the regulations thereunder.

2 *Real property gains.* (i) *Domestic partnerships in general.* Domestic partnerships that are subject to the withholding requirements of section 1446 of the Code, shall not also be subject to the payment and reporting requirements of section 1445(e)(1) of the Code and the regulations thereunder with respect to income from the disposition of a U.S. real property interest. A domestic partnership's compliance with the requirement to pay a withholding tax under section 1446 satisfies the requirements under section 1445 with respect to dispositions of U.S. real property interests. However, a domestic partnership that would otherwise be exempt from section 1445 withholding by operation of a nonrecognition provision must continue to comply with the requirements of section 1.1445-5(b)(2) of the regulations. Rules coordinating the withholding liability of publicly traded partnerships under section 1445 of the Code and section 1446 are provided in Section 10 of this revenue procedure.

(ii) *Credit for section 1445(e)(1) withholding.* Any amounts withheld and paid over by a partnership under section 1445(e)(1) of the Code, during the partnership's taxable year with respect to transactions occurring during taxable years beginning after December 31, 1987, but prior to the filing of the annual return reporting section 1446 withholding for such years, shall be allowed as a credit against the partnership's section 1446 tax liability for that taxable year.

(iii) *Foreign partnerships.* A foreign partnership that is subject to withholding under section 1445(a) during a taxable year, shall be allowed to credit the amount withheld under section 1445(a) against its liability to pay the section 1446 withholding tax for that year.

SEC. 8. REPORTING AND PAYING OVER WITHHELD TAX

.01 *In general.* Except in the case of publicly traded partnerships that are withholding on distributions to foreign partners under the general rule of Section 10 of this revenue procedure, payments of withholding tax required to be made during a partnership's taxable year must be reported and paid over to the Internal Revenue Service by the appropriate payment date described in Section 7.014 of this revenue procedure. Until further guidance is published by the Internal Revenue Service, such payments are to be reported in the manner prescribed in this Section 8. In addition, a partnership (other than a publicly traded partnership subject to the reporting requirements in Section 10 of this revenue procedure) that has effectively connected taxable income (without regard to the amount if any allocable to foreign partners) is required to make an annual return of such tax on or before the date (including extensions) specified in section 1.6031-1(e)(2) of the regulations for filing Form 1065 and attachments. The annual return required under section 1446 is separate from Form 1065 and the attachments thereto, and is not to be filed as part of the partnership's Form 1065. Until further guidance is published by the Internal Revenue Service, an annual return under section 1446 of the Code is to be filed in accordance with Section 8.03 and Section 8.04 of this revenue procedure.

Pursuant to section 7502 of the Code and the regulations thereunder, the timely mailing of the withholding tax with the information specified in this Section shall be treated as timely filing.

.02 *Payments of tax during partnership taxable year.* Until further guidance is published by the Internal Revenue Service, the payments of withholding tax made during the partnership's taxable year shall be:

(a) made payable to the Internal Revenue Service in U.S. currency; and

(b) sent to the Internal Revenue Service, P.O. Box 21086, Philadelphia, PA 19114.

Until official Internal Revenue Service forms are available and obtained by a partnership, the payments made during the partnership's taxable year must be accompanied by a document containing the following heading and information:

Payment of Section 1446 Tax

1(a). Name of partnership:
(b). Employer identification number:
(c). Address (number and street):
(d). City, State, and ZIP code (or equivalent):
2. Due date of payment
3. Amount of payment

.03 *Annual return of Section 1446 tax*. Every partnership (except publicly traded partnerships subject to the reporting requirements in Section 10 of this revenue procedure) that has foreign partners and effectively connected gross income, without regard to the amount, if any, allocable to foreign partners for the taxable year, shall make an annual return under section 1446 containing the information prescribed in Section 8.03 and Section 8.04 of this revenue procedure. This return must be filed with attachments described in Section 8.04 identifying all foreign partners.

Any additional tax owed under section 1446 for the relevant taxable year of the partnership must be paid to the Internal Revenue Service with this annual return. Any additional tax remitted with the annual return shall be made payable to the Internal Revenue Service in U.S. currency; and sent with the annual return and attachments to the Internal Revenue Service, P.O. Box 21086, Philadelphia, PA 19114.

Until official Internal Revenue Service forms are available, the annual return must contain the following heading and information:

Section 1446 Withholding Tax on Income of Foreign Partners — PARTNERSHIP/WITHHOLDING AGENT

1(a). Name of partnership:
(b). Employer identification number:
(c). Address (number and street):
(d). City, State, and ZIP code (or equivalent):
2(a). Name of Withholding Agent (if withholding agent is also the partnership enter "SAME" and do not complete lines 2(b) — (d)):
(b). Employer identification number:
(c). Address (number and street):
(d). City, State, and ZIP code (or equivalent):
3. Partnership's taxable year end: (date)
4(a). Number of partners with respect to which the applicable rate of withholding tax is 28%:
(b). Total amount of effectively connected taxable income allocable to these partners:
(c). Tax owed at 28% (line 4(b) multiplied by 28%):
5(a). Number of partners with respect to which the applicable rate of withholding tax is 34%:
(b). Total amount of effectively connected taxable income allocable to these partners:
(c). Tax owed at 34% (line 5(b) multiplied by 34%):
6. Total Section 1446 tax owed (line 4(c) plus line 5(c)):
7(a). Amount of Section 1446 tax paid by partnership on line 1 during its taxable year on line 3:
(b). Amount of section 1446 tax withheld with respect to partnership on line 1 by another partnership in which partnership on line 1 is a direct or indirect partner during the taxable year on line 3:
(c). Amount of section 1445(a) tax withheld from partnership on line 1 during the taxable year on line 3 with respect to a disposition by that partnership:
(d). Amount of tax withheld by partnership under section 1445(e)(1):
(e). Estimated tax paid by partnership on behalf of partners without using Rev. Proc. 88-21 reporting (*e.g.*, the partnership filed a Form 1040-ES for partner):
(f). Total credits (sum of lines 7(a), 7(b), 7(c), 7(d) and 7(e)):
8. Additional tax owed and paid with this return (excess of line 6 over line 7(f)) (enter zero if line 7(f) is greater than line 6):

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true correct and complete. Declaration of preparer (other than withholding agent) is based on all information of which preparer has any knowledge.

Please Sign Here> ______ Date: _____

.04 *Information required to be reported for each foreign partner*. An attachment to the return described above in Section 8.03 of this revenue procedure must be supplied for each foreign partner. The full name (first, middle, last, without titles (*e.g.*, Dr., Mrs.)) of each individual partner must be indicated. If more than one name or U.S. tax identification number is reported on this attachment, the tax reported will be credited only to the first U.S. tax identification number shown. The partnership filing the attachment must file separate attachments for any joint owners of a partnership interest that seek to divide the credit for section 1446 tax reported. The attachment must contain the following heading and information in the format and order specified:

Section 1446 Withholding Tax on Income of Foreign Partners — FOREIGN PARTNER

1(a). Full name of partner:
(b). U.S. tax identification number of partner:
(c). Account number assigned by partnership (if any):
(d). Address (number and street):
(e). City, State, and ZIP code (or equivalent):
2(a). Type of partner (individual, corporation, partnership, other (specify)):
(b). Country code of Partner (see listing of codes in instructions for Form 1042S):
3(a). Partnership's name:
(b). Partnership's Employer Identification Number:
(c). Partnership taxable year to which section 1446 tax relates (date of year end):
4(a). Withholding agent's name (if withholding agent is the partnership enter "SAME" and do not complete line 4(b)):
(b). Withholding agent's Employer Identification Number:
5(a). Partnership effectively connected taxable income allocable to partner:
(b). Applicable tax rate (maximum rate under section 1, or section 11(b) as appropriate):
(c). Section 1446 tax liability (line 5(a) times line 5(b)):
(d). Partner's allocable share of total section 1445(a) tax withheld on partnership's disposition of U.S. real property during partnership's taxable year:
(e). Amount of tax withheld under section 1445(e)(1) with respect to foreign partner:

(f). Total section 1445 withholding with respect to partner (line 5(d) plus line 5(e)):

(g). Estimated tax payments made by partnership on behalf of partner without using Rev. Proc. 88-21 reporting (*e.g.*, the partnership filed a Form 1040-ES for partner):

(h). Total adjustments to section 1446 liability (line 5(f) plus line 5(g)):

(i). Net section 1446 liability (line 5(c) minus line 5(h)):

6(a). Dates of payment and partner's allocable amount of section 1446 tax paid by partnership during partner's taxable year beginning on or during the partnership's taxable year ending on date on line 3(c) (excluding estimated tax payments made by partnership on behalf of partner (line 5(g)):

(b). Total of amounts entered on line 6(a):

(c). Partner's allocable share of section 1446 tax withheld with respect to partnership on line 4 by another partnership in which partnership on line 4 is a partner during the taxable year on line 3(c):

(d). Partner's allocable portion of section 1446 payment made by partnership with partnership's annual return of section 1446 tax:

(e). Tax creditable by partner under section 1446 (sum of lines 6(b), 6(c), and 6(d)):

.05 *Reporting to partners*. Upon making an installment payment of withholding tax to the Internal Revenue Service under section 1446, a partnership must notify each foreign partner of its allocable share of any section 1446 tax paid to the Internal Revenue Service by the partnership. No particular form is required for this notification, but it must contain the name of the partnership and the amount being paid on behalf of the partner. The information on this statement is to be used by the partner to adjust the amount of estimated tax that the partner is otherwise required to pay to the Internal Revenue Service.

A partnership must annually provide foreign partners with a copy of the statement filed with the Service and described in Section 8.04 of this revenue procedure. This information must be supplied to foreign partners even if no withholding tax is paid by the partnership under section 1446 of the Code. This information must be delivered to the foreign partner by the date specified in section 6031(b) on which the partnership must report the partnership's tax return information to its partners.

.06 *Payment without Identifying Number*. A partnership that has not been assigned a U.S. identifying number (an Employer Identification Number ("EIN")) must obtain one, and must in any event pay a withholding tax to the Internal Revenue Service, P.O. Box 21086, Philadelphia, PA 19114, by the time provided in this revenue procedure. Accompanying any payment must be a statement containing the relevant information described above in Section 8.02 and indicating the date the EIN was applied for. Upon receipt of its EIN, the partnership must immediately provide that number to the Internal Revenue Service, P.O. Box 21086, Philadelphia, PA 19114.

.07 *Taxpayer identification numbers of partners*. To assure appropriate crediting of withheld amounts or quarterly payments, when reporting to the Internal Revenue Service, a partnership (including a publicly traded partnership described in Section 10 of this revenue procedure) must provide a U.S. taxpayer identification number or an EIN for each foreign partner. The partnership should therefore notify each of its foreign partners of the necessity of obtaining a U.S. identifying number.

A partnership must pay a withholding tax under section 1446 with respect to a foreign partner even if the partnership does not have a taxpayer identification number for that partner. Publicly traded partnerships that designate nominees to withhold tax under section 1446 as provided in Section 10 of this revenue procedure must supply this identification number to the nominee.

.08 *Transition rules for taxable years beginning in 1988*. Payments of withholding tax that would be required to have been made during 1988 for a partnership's first taxable year beginning during 1988, under section 1446 as amended by the 1988 Act and the general rules of this revenue procedure, will be considered timely paid if made on or before the later of June 15, 1989, or the date provided in Section 8.01 of this revenue procedure on which the partnership would otherwise be required to file its annual return under section 1446 for its 1988 taxable year. In the case of a partnership with a taxable year beginning and ending in 1988, such amounts are to be made and reported with the annual return required under Section 8.01 for that taxable year in 1988, and that return shall be due on the later of June 15. 1989, or the date (including extensions) by which the partnership must file the information return required under section 6031 of the Code for that year.

In the case of partnerships with taxable years beginning but not ending in 1988, and taxable years beginning in 1989, amounts that would have been required under the general rules of this section to have been paid during 1988, as well as any payment required under the general rules to have been made on or before June 15, 1989, will be considered timely if paid by June 15, 1989. These payments are to be reported under the general filing requirements contained in Section 8 of this revenue procedure. All payments due after June 15, 1989, under the general rules of this section are to be made at the time and in the manner provided in the general rules of this revenue procedure.

Any amounts withheld, under Revenue Procedure 88-21 and section 1446 as in effect prior to its amendment by the 1988 Act, on or after the first day of a partnership's first taxable year beginning during 1988, but prior to the date specified in Section 8.01 of this revenue procedure for filing any section 1446 annual return for 1988, shall be credited against the partnership's liability for the relevant taxable year.

The amount of a payment described below that is made as a payment of estimated tax under section 6654 or 6655 by a partnership on behalf of a foreign partner with respect to the partner's allocable effectively connected taxable income, instead of as a payment of tax under section 1446 and Rev. Proc. 88-21 as in effect prior to the 1988 Act, shall reduce the amount of the partnership's section 1446 withholding tax liability for the relevant taxable year of the partnership. The payments that qualify for this treatment are the payments made after the effective date of the amendment of section 1446 by the 1988 Act and prior to the date specified in Section 8.01 of this revenue procedure for the filing of the partnership's annual return under section 1446 for 1988.

SEC. 9. TREATMENT OF PARTNERS

.01 *In general*. A partnership's payment of section 1446 withholding tax on effectively connected taxable income allocable to a foreign partner relates to the partner's U.S. income tax liability for the partner's taxable year in which the partner is subject to U.S. tax on that income.

Withholding tax paid under section 1446 of the Code that is in excess of the partner's U.S. income tax liability, as established on the partner's tax return for that year, may be credited by the partner against the partner's U.S. income tax liability for other subsequent years. Amounts paid by the partnership under section 1446 of the Code with respect to effectively connected taxable income allocable to a partner shall be allowed to the partner as a credit under section 33 of the Code. The partner may not claim an early refund of these amounts under the estimated tax rules. Amounts paid by a withholding agent under section 1446 with respect to a partner are to be treated as distributions made to that partner on the last day of the partnership taxable year for which the amount was paid, or if earlier, the last day on which the partner owned an interest in the partnership during that year. The amounts paid are not refundable to the withholding agent.

.02 *Substantiation of credit.* A partner that seeks a credit against its U.S. income tax liability for amounts withheld and paid over under section 1446 of the Code must attach proof of payment to its U.S. income tax return for the taxable year in which it claims the credit. Proof of payment consists of a copy of the annual statement that the partnership is required to furnish under Section 8.05 of this revenue procedure, or copies of any official Internal Revenue Service form that may be prescribed.

In the case of partners of publicly traded partnerships that are subject to withholding on distributions under the general rules described in Section 10 of this revenue procedure, proof of payment consists of a copy of the Form 1042S supplied to them by the partnership.

SEC. 10. PUBLICLY TRADED PARTNERSHIPS

.01 *In general.* A publicly traded partnership, as described in this Section, that has effectively connected income, gain or loss must pay a tax under section 1446 of the Code by withholding from distributions to a foreign partner, unless it makes the election in Section 10.08 of this revenue procedure to instead pay a withholding tax based on effectively connected taxable income allocable to foreign partners. The amount of the withholding tax on distributions equals the applicable percentage, defined in this Section 10.01, of any distribution not excluded under this Section that is made during any partnership taxable year beginning after December 31, 1987. Publicly traded partnerships that withhold on distributions as described in this Section are to pay over and report any section 1446 withholding tax as provided in this Section 10, and are not to pay and report a withholding tax under the rules of section 7 and Section 8 of this revenue procedure.

The applicable percentage is 20 percent for all distributions made to foreign partners prior to June 16, 1989, and 28 percent for all distributions made to foreign partners on or after June 16, 1989.

.02 *Definition of publicly traded partnership.* For purposes of this revenue procedure, the term "publicly traded partnership" means a regularly traded partnership within the meaning of the regulations under section 1445(e)(1) of the Code, but not a publicly traded partnership treated as a corporation under the general rule of section 7704(a).

.03 *Time and manner of payment.* The withholding tax under section 1446 of the Code required under this Section to be paid from distributions by a publicly traded partnership, is to be paid over pursuant to the rules and procedures of section 1461, the regulations thereunder, and section 1.6302-2 of the regulations. A publicly traded partnership is to use Forms 1042 and 1042S to report withholding from distributions.

With respect to distributions made before December 31, 1989, a payment of tax under section 1446 of the Code is to be reported on Form 1042S under income code 25, which also applies to withholding under section 1445. With respect to distributions made after December 31, 1989, section 1446 withholding on distributions by publicly traded partnerships is to be reported on From 1042S under income code 27.

.04 *Rules for designation of nominees to withhold tax under section 1446.* For purposes of section 1446 of the Code, publicly traded partnerships may apply the rules of the regulations under section 1445(e)(1) that apply to regularly traded partnerships, with respect to the designation of nominees to act as withholding agents for the partnership.

.05 *Determining foreign status of partners.* In addition to a certification of non-foreign status described in Section 5 of this revenue procedure, a publicly traded partnership that seeks to determine whether or not any of its partners are foreign persons may rely on the information provided to it on Form 1001, Form W-8, or Form W-9. In addition, a publicly traded partnership may rely on a certification signed under penalties of perjury from a person about the non-foreign status of partners owning partnership interests through that person as nominee. No particular form is required for a certification from such a nominee, but the certification should identify the partner for whom the certification is made, and indicate the basis for the certification. In making such a certification a nominee may also rely on a certification of non-foreign status provided by a foreign partner under the rules of Section 5.02, or may rely on information provided to it on Form 1001, Form W-8, or Form W-9 in determining whether a partner is a foreign person. Neither a partnership nor a nominee may directly or indirectly rely on information on a Form 1001, Form W-8, or Form W-9 after the date that such form must be re-executed, nor on a certification of non-foreign status based upon an election under section 897(i) of the Code.

A publicly traded partnership that relies in good faith on a certification of non-foreign status or the alternative forms of information described in this paragraph in determining non-foreign status, shall not be subject to the liability imposed by Section 4.02 of this revenue procedure for a failure to withhold under section 1446 of the Code. However, a partnership that has actual knowledge of the falsity of any information relied upon shall not be entitled to rely on that information any time after obtaining that knowledge, and the partnership shall be fully liable under section 1461 for any failure to withhold tax as of the time it obtained that knowledge.

In the case of a publicly traded partnership, the documentation used to determine the non-foreign status of a partner must be retained until the end of the fifth taxable year following the last taxable year in which the partnership properly relied upon that documentation as provided in this revenue procedure. A publicly traded partnership is not required to obtain a certification of non-foreign status under the rules of Section 5.02 of this revenue procedure, nor, the approved alternate forms of information described in Section 10.05 of this revenue procedure, but may instead rely upon other means to ascertain the non-foreign status of the partner. If, however, the partnership relies upon other means not specified in Sections 5.02 or 10.05 of this revenue procedure, and erroneously determines that the partner was not a foreign person, then the partnership is subject to the liability described in Section 4.02. A partnership is in no event required to rely upon other means to determine the non-foreign status of a partner and may demand a certification of non-foreign status. If a certification is not provided, the partnership may withhold tax under section 1446 of the Code and will be considered, for purposes of sections 1461 through 1463, to have been required to withhold such tax.

.06 *Distributions subject to withholding.*

1 *In general.* Except as provided herein, a foreign or domestic partnership that is regularly traded within the meaning of the regulations under section 1445(e)(1) of the Code must withhold at the applicable percentage with respect to any actual distribution to a foreign partner. The amount of a distribution subject to section 1446 withholding includes the amount of any section 1446 tax required to be withheld and, in the case of a partnership that receives a partnership distribution from another partnership (a "tiered" structure described in section 11 of this revenue procedure), any section 1446 tax that was withheld from such distribution. For example, foreign publicly traded partnership A owns an interest in domestic publicly traded partnership B. Partnership B makes a section 1446 distribution of $100 to partnership A prior to June 16, 1989, and withholds 20 percent of that distribution under section 1446. Partnership A receives a net distribution of $80 which it immediately redistributes to its partners. Upon making an actual distribution of $80, partnership A is deemed to have also made a distribution of $100 to its partners for purposes of section 1446, consisting of $80 in cash and a $20 deemed distribution in the form of tax payments on behalf of all its (U.S. and foreign) partners. Partnership A has a liability to pay 20 percent of the total actual and deemed distribution to its foreign partners as a section 1446 withholding tax. Partnership A may credit the $20 withheld by partnership B against this liability. In addition, partnership A's (U.S. and foreign) partners may claim a credit against their U.S. income tax liability for their allocable share of this $20 section 1446 tax paid on their behalf.

If a distribution is made with property other than money, the partnership shall not release the property until it has funds sufficient to enable the partnership to pay over in money the tax required to be withheld under section 1446(a) of the Code on the entire amount of the section 1446 distribution to the foreign partner.

2 *Excluded amounts.* Distributions from partnerships are deemed to be paid first out of the following types of income in the order indicated, and are excluded from the term "section 1446 distribution" to the extent thereof:

(a) Amounts attributable to non-effectively connected income distributed by a partnership that have been or are subject to the withholding requirements of section 1441 or 1442 of the Code (without regard to whether any amount was or is required to be withheld because of a treaty or statutory exemption);

(b) Amounts attributable to recurring dispositions of crops and timber that are subject to withholding under section 1.1445-5(c)(3)(iv) of the regulations, which continue to be subject to the rules of section 1.1445-5(c)(3); and

(c) Amounts subject to withholding by the partnership in the manner required by section 1.1445-5(c)(1) upon the partnership's disposition of a U.S. real property interest.

3 *Coordination with section 1445.* Except as otherwise provided in this Section 10, a publicly traded partnership that complies with the requirements of withholding under section 1446 and this Section 10 will be deemed to have satisfied the requirements of section 1445(e)(1) and the regulations thereunder. Notwithstanding Section 10.062 of this revenue procedure, section 1446 distributions subject to withholding at the applicable rate described above, shall include:

(a) The fair market value of a U.S. real property interest distributed to a partner and potentially subject to withholding under section 1445(e)(4) of the Code;

(b) Amounts subject to withholding under section 1445(e)(1) upon distribution pursuant to an election under section 1.1445-5(c)(3) of the regulations; and

(c) Amounts not subject to withholding under section 1445 because the distributee is a partnership or is a foreign corporation that has made an election under section 897(i)).

.07 *Transition rules.* Any section 1446 withholding upon a distribution occurring in 1989 that is required under the general rules of this Section 10 to be made on or before June 15, 1989, will be considered timely if made by June 15, 1989. All payments due after June 15, 1989, under the general rules of this section are to be made at the time and in the manner provided in the general rules of this revenue procedure.

Any amounts withheld, under Revenue Procedure 88-21 and section 1446 as in effect prior to its amendment by the 1988 Act, on or after the first day of a partnership's first taxable year beginning during 1988, but prior to June 15, 1989, shall be credited against the partnership's section 1446 withholding tax liability for the relevant taxable year.

.08 *Election to withhold based upon effectively connected taxable income allocable to foreign partners instead of withholding on distributions.* A publicly traded partnership will not be required to withhold on distributions under the generally applicable rules of this Section 10 if it elects instead to comply with the requirements of Sections 3 through 9, and 11 of this revenue procedure (relating to withholding on the effectively connected taxable income allocable to foreign partners). This election is retroactive to the partnership's first taxable year beginning after December 31, 1987, and is revocable only with the consent of the Commissioner.

A publicly traded partnership shall make this election by complying with the payment and reporting requirements of Sections 7 and 8 of this revenue procedure, by the later of the date on which the annual return of section 1446 tax is due for the partnership's first taxable year beginning during 1989, or the date on which the annual return of section 1446 tax is due for the partnership's first taxable year. A partnership that makes this election must pay over all amounts that would have been withheld and paid over had this election been in effect on the later of June 15, 1989, or the 15th day of the fourth month of the first taxable year of the partnership (with extensions). A publicly traded partnership that makes this election must attach a statement to its first annual return of section 1446 tax indicating that the partnership is a publicly traded partnership that is electing not to withhold on distributions.

SEC. 11. TIERED PARTNERSHIPS

.01 *In general.* The term "tiered partnership" is used in this revenue procedure to describe the situation in which a partnership owns an interest in another partnership (the latter is hereafter referred to as a "subsidiary partnership"). A partnership that directly or indirectly owns a partnership interest in a subsidiary partnership shall be allowed a credit against its own section 1446 liability for any section 1446 tax paid by the subsidiary partnership with respect to that partnership interest.

.02 *Reporting requirements.*

1 *In general.* A partnership that directly or indirectly owns a partnership interest in a subsidiary partnership must comply with the reporting requirements of Section 8.02 and Section 8.04 of this revenue procedure (which applies in the absence of official Internal Revenue Service forms), with respect to its foreign partners. To the extent that a partnership is a direct or indirect partner in a subsidiary partnership and has had section 1446 payments made on its behalf, it will receive a copy of the statements required under Section 8.02 and 8.04 of this revenue procedure to be sent to partners, and must in turn file the statements required under Sections 8.02, 8.03, and 8.04 to the extent it is subject to section 1446, treating the amount withheld by the subsidiary partnership as a credit against its liability to withhold tax under section 1446. The foreign partnership must attach to the annual return it must file under Sections 8 of this revenue procedure, a copy of any statement under Section 8.04 that it receives from the subsidiary partnership in which it is a partner, and must in turn provide its partners with a copy of any statement it receives from the subsidiary partnership along with the information described in Section 8.02 and 8.04. These statements will enable the partners of the foreign partnership to obtain appropriate credit for amounts withheld by the foreign partnership and the lower tier partnership.

2 *Publicly traded partnerships.* A publicly traded partnership is required to notify its partners of the amount of section 1446 tax withheld after each distribution, and by supplying the partner with Form 1042S as required in section 1.1461-2 of the regulations.

EFFECTIVE DATE

This revenue procedure is effective for taxable years of partnerships beginning after December 31, 1987.

EFFECT ON OTHER ADMINISTRATIVE PRONOUNCEMENTS

Rev. Proc. 88-21, 1988-1 C.B. 777, is obsolete.

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26 CFR 601.201: Rulings and determination letters.
(Also Part I, Sections 25, 103, 143; 1.25-3T, 1.103-1, 6a.103A-2.)

Rev. Proc. 89-32

SECTION 1. PURPOSE

This revenue procedure provides issuers of qualified mortgage bonds, as defined in section 143(a) of the Internal Revenue Code, and issuers of mortgage credit certificates, as defined in section 25(c), with (1) the median gross income for the United States and (2) the average purchase prices for new and existing residences located in the United States.

SEC. 2. BACKGROUND

.01 Bonds issued by a state or local government to provide financing for owner-occupied residences must satisfy the requirements under section 143(a)(2) of the Code if the bonds are to be classified as "qualified mortgage bonds." The interest on qualified mortgage bonds is excludable from gross income under section 103(a) if certain additional requirements are satisfied. A state or local government may elect to exchange all or part of its qualified mortgage bond authority for authority to issue mortgage credit certificates. Recipients of mortgage credit certificates issued by a state or local government are allowed a credit against federal income tax for a portion of the interest paid or accrued on indebtedness used to finance owner-occupied residences provided that the income requirements of section 25 are satisfied. The income requirements that are imposed on the users of proceeds of qualified mortgage bonds are identical to those imposed on the recipients of mortgage credit certificates. Sections 143(f) and 25(c)(2)(A)(iii)(IV).

.02 Generally, under sections 143(f) and 25(c)(2)(A)(iii)(IV) of the Code, as amended by the Technical and Miscellaneous Revenue Act of 1988 (Act), Pub. L. No. 100-647, section 4005(b) and (c), 102 Stat. 3342, the income requirements are met if all owner financing under a qualified mortgage bond and all certified indebtedness amounts under a mortgage credit certificate program are provided to mortgagors whose family income is 115 percent or less of the applicable median family income. The income limitation is reduced to 100 percent if there are fewer than three members in the mortgagor's family.

.03 Section 143(f)(5) of the Code provides that the income requirement in certain statistical areas is adjusted based on the relation of housing costs to income. A statistical area is a "high housing cost area" if its housing cost/income ratio is greater than 1.2. The housing cost/income ratio is determined by dividing (a) the applicable housing price ratio by (b) the ratio that the area median gross income bears to the median gross income for the United States. The applicable housing price ratio is the new housing price ratio (new housing average area purchase price divided by the new housing average purchase price for the United States) or the existing housing price ratio (existing housing average area purchase price divided by existing housing average purchase price for the United States), whichever results in the housing cost/income ratio being closer to 1.

.04 Section 4005(h) of the Act provides, in general, that the amendments made by section 4005(b) and (c) will apply to bonds issued, and nonissued bond amounts elected, after December 31, 1988.

.05 The Department of Housing and Urban Development (HUD) has computed (1) the median gross income for the United States for the fiscal year ending September 30, 1989, and (2) the average purchase prices for new and existing residences located in the United States using data from calendar year 1987.

SEC. 3. APPLICATION

.01 When computing the housing cost/income ratio under section 143(f)(5) of the Code, issuers of qualified mortgage bonds and mortgage credit certificates must use as the median gross income for the United States a figure of $34,000 (estimated for the fiscal year ending September 30, 1989) and must use as the average purchase prices for residences located in the United States figures of $127,800 for new residences and $105,200 for existing residences (based on data from calendar year 1987).

.02 When computing the housing cost/income ratio under section 143(f)(5) of the Code, issuers of qualified mortgage bonds and mortgage credit certificates must use the area median gross income for the fiscal year ending September 30, 1989.

.03 When computing the housing cost/income ratio under section 143(f)(5) of the Code, an issuer of qualified mortgage bonds and mortgage credit certificates must use the average area purchase price safe harbor limitations contained in Rev. Proc. 88-48, 1988-2 C.B. 635, unless the issuer computes a different average area purchase price based on more accurate and comprehensive data. Any such computation of different average area purchase prices must use data from a 12-month period that does not begin earlier than July 1, 1986, or end later than June 30, 1988.

SEC. 4. EFFECTIVE DATES

.01 The median gross income for the United States set forth in section 3.01 is effective for (1) commitments to provide financing for mortgages with respect to bonds that are issued no sooner than January 1, 1989, and that are sold by the issuer not later than 29 days after the date the Internal Revenue Service publishes an updated figure in the Internal Revenue Bulletin, and (2) commitments to issue certificates with respect to nonissued bond amounts elected no sooner than January 1, 1989, and not later than 29 days after the date the Service publishes the updated figure in the Bulletin, but only if the commitments described in (1) and (2) are made not later than 89 days after the date the Service publishes the updated figure in the Bulletin.

.02 The average purchase prices for residences located in the United States set forth in section 3.01 are effective for bonds issued and nonissued amounts elected for the period beginning January 1, 1989, and ending on the date such average purchase prices are rendered obsolete by a new revenue procedure.

.03 Issuers of qualified mortgage bonds and mortgage credit certificates may rely on the fiscal year 1987 or 1988 national and area median gross income figures released by HUD for purposes of computing the housing cost/income ratio under section 143(f)(5) of the Code with respect to bonds sold and nonissued bond amounts elected not later than July 11, 1989, 29 days after the date of publication of this revenue procedure in the Internal Revenue Bulletin, if the commitments to provide financing for mortgages, in the case of qualified mortgage bonds or the commitments to issue certificates, in the case of mortgage credit certificate programs, are made not later than September 9, 1989, 89 days after the date of publication of this revenue procedure in the Internal Revenue Bulletin, but only if the issuer uses area median gross income figures released by HUD for the same period as those used for the median gross income for the United States.

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26 CFR 601.701: Publicity of information

Rev. Proc. 89-33

SECTION 1. PURPOSE

The purpose of this revenue procedure is to notify officers and employees of Federal, state, and local agencies administering certain programs under the Social Security Act, the Food Stamp Act of 1977, and State unemployment compensation laws of the manner, time and place by which they may obtain certain return information from the Internal Revenue Service in accordance with Section 6103(l)(7) of the Internal Revenue Code.

SEC. 2. BACKGROUND

01. Section 6103(l)(7) of the Internal Revenue Code was amended by 651 of the Deficit Reduction Act of 1984, P.L. 98-369, to enable agencies administering certain programs under the Social Security Act, the Food Stamp Act and State unemployment laws to receive from the Service current return information with respect to unearned income for the purpose of determining eligibility for, or the correct amount of, benefits under these programs.

02. The return information will be extracted from the Information Return Master File (IRMF) for the latest processing year. This file contains information returns filed by payers of income such as interest and dividends reported on Forms 1099-INT and 1099-DIV. The information will be extracted on a monthly basis using magnetic tapes submitted by the coordinating State agency or the Federal agency with oversight responsibility for the particular program. The information will likewise be on magnetic tape when it is provided to the appropriate agency.

SEC. 3. AUTHORITY

Section 6103(l)(7) of the Internal Revenue Code requires the Service, upon written request, to disclose unearned income information to Federal, state, and local agencies administering the following programs:

(i) Aid to Families with Dependent Children (AFDC) provided under a State Plan approved under Part A of Title IV of the Social Security Act;

(ii) Medical assistance provided under a State plan approved under Title XIX of the Social Security Act;

(iii) Supplemental Security Income benefits provided under Title XVI of the Social Security Act, and federally administered supplementary payments of the type described in Section 1616(a) of such Act (including payments pursuant to an agreement entered into under Section 212(a) of Public Law 93-66, 87 Stat. 155);

(iv) Any benefits provided under a State plan approved under Titles I, X, XIV, or XVI of the Social Security Act (as those titles apply to Puerto Rico, Guam, and the Virgin Islands);

(v) Unemployment Compensation provided under a State law as described in Section 3304 of the Internal Revenue Code;

(vi) Assistance provided under the Food Stamp Act of 1977; and

(vii) State-administered supplementary payments of the type described in Section 1616(a) of the Social Security Act (including payments pursuant to an agreement entered into under Section 212(a) of Public Law 93-66).

Information may be disclosed by the Service only for the purposes of, and to the extent necessary in, determining eligibility for, or the correct amount of, benefits under the aforementioned programs.

SEC. 4. DEFINITIONS

Element	Description
DM-1 File	SSA file of all validly issued SSNs and their related names.
EBCDIC	Extended Binary Coded Decimal Interchange
EIN	Employer Identification Number which has been assigned by the Internal Revenue Service to the reporting entity.
File	For the purpose of this Revenue Procedure, a file consists of all magnetic media records submitted by a requesting agency.
IRMF	Information Return Master File.
Payee	Person(s) or organization(s) receiving payments from the reporting entity.
Payer	Person or organization, including paying agent, making payments.
SSA	Social Security Administration.
SSN	Social Security Number assigned by SSA.
TIN	Taxpayer Identification Number which may be either an EIN or SSN.

SEC. 5. APPLICATION FOR INCLUSION IN PROGRAM

01. Disclosures by the Service will be made on a reimbursable basis. This will be a magnetic media project in which the return information is accessed by magnetic tape supplied by the requesting agencies and is provided on magnetic tape by the Service. Input by paper will not be accepted and no disclosures will be made on paper.

02. Agencies wishing to receive data under Section 6103(l)(7) of the Code should submit their applications to:

Internal Revenue Service
Director, Office of Disclosure
Room 1603 EX:D
1111 Constitution Ave., NW
Washington, D.C. 20224

03. The application must be made in writing and be signed by the head of the Federal, state, or local agency.

04. The application must contain the following information:

1) an overview of how the information will be used, the programs for which the information will be used, who will conduct the eligibility verification, if any counties will have access to the information, and any other relevant information as to how the receiving agency will use the tax information;

2) the authorizing statute by which the agency qualifies to receive the information;

3) the name(s) and title(s) of the official(s) who is (are) authorized to request return information;

4) the actions which will be taken by the agency to comply with the safeguard and reporting requirements of Section 6103(p)(4) of the Code (see Section 7 of this Revenue Procedure and Internal Revenue Service Publication 1075, "Tax Information Security Guidelines");

5) a statement certifying that the safeguards to be employed will be in place at the time the agency makes its initial request for return information;

6) the name(s) and title(s) of the official(s) in the agency who has (have) responsibility for safeguarding the return information, and;

7) if appropriate, whether the agency will be acting as the coordinating State agency for purposes of requesting information or if it is an agency for whom a coordinating State agency will make requests for information (see Section 8.02). The agency should identify these other State agencies which are participating in that State's consolidated effort to obtain return information.

SEC. 6. MATCHING AGREEMENTS

01. Upon receipt and approval of an application from an agency, the Service will prepare a matching agreement in accordance with the Computer Matching and Privacy Protection Act of 1988, P.L. 100-503. The agreements will specify in detail the following information:

1) the purpose and legal authority for conducting the match program;

2) justification for the match program and anticipated results;

3) description of the records to be matched;

4) projected starting and completion dates of the match program;

5) procedures for providing notice to individuals that information provided by them may be subject to verification through matching programs;

6) procedures for verifying information produced in matching programs;

7) procedures for the retention and timely destruction of identifiable records created by the recipient agency in the matching program;

8) procedures for ensuring the administrative, technical, and physical security of the records matched and the results of such programs;

9) prohibitions on duplication and redisclosure of records;

10) procedures governing the use by a recipient agency of records provided in the matching program including return or destruction of records;

11) information on assessments made regarding the accuracy of the records used in the matching program, if available; and

12) that the Comptroller General may have access to all records of a recipient agency necessary in order to monitor or verify compliance with the agreement.

02. The requesting agency will be provided an original and copy of the prepared matching agreement for signature by the agency head or other delegated official authorized to request data. Both the original and the copy of the matching agreement must have an original signature.

03. The Service will receive the signed agreement from the agency. After the signature of the Service's approving official is obtained, a copy of the agreement will be returned to the requesting agency.

04. Matches may not take place until agreements have been signed by both agencies, copies provided to the appropriate Congressional Committees and notice published in the Federal Register. In addition, all matches must be approved by the Treasury Data Integrity Board.

05. The agreement will remain in effect for a period not to exceed 12 months and shall be effective 30 days after the date a copy is provided pursuant to Section 6.04.

SEC. 7. REIMBURSEMENT

01. All work done by the Service for agencies administering programs pursuant to Section 3 of this Revenue Procedure will be performed on a reimbursable basis. Billing will be based on the number of data records processed. The cost per data record is 1 cent per record submitted. The cost per Service tape, if used, will be $12. These charges are subject to change. Billings will be made directly to each agency that requests return information.

02. In addition to the matching agreements, the Service will prepare Form 5181, Agreement Covering Reimbursable Services (Exhibit 1) upon receipt of and approval of an application from an agency. The requesting agency will be provided an original and copy of the prepared agreement.

03. The requesting agency will complete boxes 5a, 5b, and 5c and 9a, 9b, and 9c of Form 5181. Federal agencies must provide their Agency Location Code (ALC) in block 6b. The person indicated in box 5a will be the person coordinating requests and receipt of data from the Service. The signature in box 9a must be that of the agency head or other delegated official authorized to request data. Both the original and copy of Form 5181 must have an original signature.

04. The Service will receive the signed agreement from the agency. After the signature of the Service's approving official is obtained, a copy of the agreement will be returned to the requesting agency. The Service will also provide an agency code to be used when making requests.

05. Upon receipt of the signed matching and reimbursable agreements and

pursuant to Section 6.04 of this Revenue Procedure, the agency may begin requesting return information as outlined in Section 10, Tape Submissions.

SEC. 8. SAFEGUARDS AND RECORDKEEPING REQUIREMENTS

01. Return information which is obtained by an agency under Section 6103(l)(7) of the Code is subject to the safeguard, recordkeeping, and reporting requirements of Section 6103(p)(4) of the Code. If the return information becomes a part of the agency case file regarding a specific taxpayer, the case file must be segregated to the maximum extent possible and safeguarded under the terms and conditions of Section 6103(p)(4). Destruction of returns or return information is also governed by Section 6103(p)(4).

02. An agency which receives return information pursuant to Section 6103(l)-(7) of the Code must submit a Safeguard Procedures Report within 30 days of initial receipt of the return information. The report will detail the security accorded the information, the individuals who may request and have access to the information, the flow of the information once the agency has received it, as well as other information which will give a comprehensive picture of the need for, the use of, and the disposal of the return information. Publication 1075 (Rev 1-86), "Tax Information Security Guidelines", gives additional information about the Safeguard Procedures Report and may be obtained by writing to the IRS official listed in Section 5.02.

03. The Safeguard Procedures Report will be submitted to the Federal agency which has oversight responsibility for the program(s). The address of the specific office the report must be sent to will be provided by the Service upon approval of the agency's application. The report is due within 30 days from the date the agency first receives return information pursuant to Section 6103(l)(7) of the Code.

04. The agency must also submit an Annual Safeguard Activity Report giving current information on its safeguard procedures. The information required for this report is also detailed in Publication 1075. The report will be submitted annually to the same Federal agency to whom the Safeguard Procedures Report is to be sent.

05. The Federal agency which receives these reports is responsible for insuring that all information required for the reports is included. Problems or concerns which cannot be resolved between the Federal agency and the agency which has the return information will be referred to the Director, Office of Disclosure, for resolution.

06. The oversight Federal agency is responsible for monitoring safeguard procedures employed by requesting agencies and reporting to the Service on an annual basis about its oversight of safeguards employed by requesting agencies.

07. Pursuant to Section 6103(p)(4) of the Code and the regulations thereunder, the Service has the authority to conduct its own safeguard reviews at the Federal, state, and local levels.

SEC. 9. LIMITATIONS

01. Officers and employees who are entitled to access return information generally must not disclose this information to any party outside the agency other than the taxpayer to whom the information relates, the taxpayer's duly appointed representative who has the explicit authority to obtain the return information, or employees of the Federal agency charged with oversight of the particular program the State or Local agency is administering. However, to the extent such disclosure is necessary to verify the eligibility for and the correct amount of benefits, including past benefits, under the programs listed in Section 3 of this Revenue Procedure, such disclosures may be made only when there is no other means of verifying the unearned income information and only to the extent necessary to verify the unearned income information.

02. Officers and employees who are entitled to access return information must not disclose this information to any other officer or employee within the agency whose official duties do not require this information to determine eligibility for, or the correct amount of, benefits under these programs.

03. Officers and employees of Federal, state, and local agencies who disclose return information in a manner or for a purpose not authorized by Section 6103(l)(7) are subject to the criminal penalty provisions of Section 7213 of the Code. Federal agencies and officers and employees of State and Local agencies who disclose return information in a manner or for a purpose not authorized by Section 6103(l)(7) are also subject to the civil damages provisions of Section 7431 of the Code.

04. Any unauthorized disclosure of return information must be reported to the nearest Internal Revenue Service Regional Inspector. The name, address, and telephone number of this individual may be obtained from the Disclosure Officer at the Internal Revenue Service district in which the agency is located.

05. Return information may be disclosed by the Service only for the purpose of, and to the extent necessary in, determining eligibility for, or the correct amount of, benefits for the programs listed in Section 3 of this Revenue Procedure.

06. Agencies which receive return information pursuant to Section 6103(l)-(7) may not reduce, suspend, terminate or deny aid or benefits until the agency has taken steps to independently verify the information, as provided for by the Deficit Reduction Act of 1984.

SEC. 10. TAPE SUBMISSIONS

01. The Service will only accept magnetic tapes from coordinating State agencies, the Social Security Administration (which will administer the Supplemental Security Income program) and those Federal agencies charged with oversight responsibility for the eligible programs who must use the information to review those programs to insure that State and Local agencies are paying out the correct amount of benefits.

02. The coordinating State agency is the single State agency responsible for tape submissions requesting return information to be used in any of the programs covered by Section 6103(l)(7) of the Code. If there is more than one agency in the State that wishes return information, one of the agencies must be designated as the coordinating State agency. However, each agency must complete a contract to receive information.

03. If there is more than one agency administering the programs listed in Section 3 of this Revenue Procedure, the coordinating State agency will consolidate the requests from the requesting agencies within the State and submit a single tape file, on a monthly basis, to the Service. The coordinating State agency will identify those other agencies it is representing on the transmittal sheet accompanying the magnetic tape.

04. Each tape submission must have an accompanying transmittal sheet from the requesting agency specifying the

number of reels being submitted, each reel's identification number, the number of records per reel, the assigned agency code, and the name and telephone number of an individual within the agency who can aid in reconciling shipping problems. A sample transmittal format is shown in Exhibit 2.

05. The tape submission must follow the format in Section 11 of this Revenue Procedure. Tapes which do not meet the format will be returned to the submitting agency. See Section 11.05 for label format. If the tape is received after the deadline for the monthly extract, the Service will run the tape the following month.

06. The Service will initially validate all Social Security Numbers (SSNs) and names provided by the requesting agency against the SSA-DM-1 file prior to running the agency's tape against the IRMF. Names of individuals with invalid SSNs will be returned on a separate tape file. See Sections 12.02 and 12.03 for output record format and explanation of error codes.

07. If more than one State agency is to receive return information, the output tape will be sent to the coordinating State agency and the coordinating State agency will send the individual agencies their own particular data.

08. Tape submissions must be received by specific dates in order for the Service to run an agency's tape in the corresponding month. The processing schedule is listed in Exhibit 3.

09. The program to extract the information from the IRMF was operational on July 1, 1985.

10. An agency should provide at least six magnetic tapes for the initial output when making initial input shipment. An input tape will be retained for approximately 90 days. After that time, the input tape will be scratched and the tape will be used for the agency's next output.

11. If agency tapes are not supplied and Service tapes must be used to provide output, new tapes will be used. The cost of these tapes will be reflected in the agency billing.

SEC. 11. INPUT MAGNETIC TAPE SPECIFICATIONS

01. General

1) The magnetic tape specifications contained in this section of the Revenue Procedure define the required format and contents of the records to be included in the file. The specifications must be adhered to unless deviations have been specifically granted by the Service in writing.

2) In most instances, the Service will be able to process any compatible tape files. Compatible tape files must be 9 channel, Standard Label/EBCDIC (Extended Binary Coded Decimal Interchange) with:

a) Standard Label, EBCDIC;

b) A file name of "DIFSLA";

c) ODD parity; and

d) A density of 6250 BPI.

3) All compatible tape files must have the following characteristics:

a) Type of tape — 0.5 inch (12.7 mm) wide, computer grade magnetic tape on reels of up to 2400 feet (731.52 m) within the following specifications:

1. Tape thickness:
   1.0 or 1.5 mils

2. Reel diameter:
   10.5 inches (26.67 cm),
   8.5 inches (21.59 cm),
   or 7 inches (17.78 cm).

b) Interrecord Gap — ¾ inch.

02. Record Length. The tape record may be blocked or unblocked, subject to the following:

1) A FIXED RECORD OF 92 POSITIONS IS REQUIRED.

2) All records except the Header and Trailer Labels may be blocked.

3) If records are blocked, we recommend a block size of 100. The maximum block size must be 9,200 tape positions in length.

4) When the block results in a short block (less than 20 records), all remaining positions of the block may be filled with 9's. Do not pad a block with blanks.

03. Options for Filing. For the purposes of this Revenue Procedure the following conventions must be used:

1) Header Label:

a) Agencies may use standard headers provided they begin with 1HDR, HDR1, VOL1, or VOL2; and

b) Consist of a maximum of 80 positions.

2) Trailer Label:

a) Standard trailer labels may be used provided that they begin with 1EOR, 1EOF, EOR1, EOV1, or EOV2; and

b) Consist of a maximum of 80 positions.

3) Tape Mark:

a) Used to signify the physical end of the recording on tape.

b) May follow the header label and precede and/or follow the trailer label.

04. Agency Request Record

Tape Position	Field Title	Length	Description and Remarks
1-3	Agency Code	3	REQUIRED This identifies the agency which originated the request. The number is supplied by the Service when a formal application is made to the Office of Disclosure.
4	Constant	1	REQUIRED. Insert a "0" (numeric) into this position.
5-13	SSN	9	REQUIRED. Enter the SSN of the requested individual. This field must be ALL NUMERICS.
14-22	Secondary SSN	9	OPTIONAL. Enter the SSN of individual's spouse. This field must be ALL NUMERICS if present. Otherwise zero fill.
23	Constant	1	REQUIRED. Enter a "1" (numeric) into this position.
24-25	Constant	2	REQUIRED. Enter "99" into these positions.
26-32	Welfare Codes	7	REQUIRED. Enter the code(s) for the welfare program(s) requesting information. Left justify and blank fill. *Code* *Welfare Program* 1 AFDC 2 Medicaid 3 SSI Benefits 4 Cash Assistance 5 Unemployment Comp. 6 Food Stamps 7 State Supplementary Payments
33-36	Name Control 1	4	REQUIRED. Enter the first four letters of the last name. Left justify and blank fill if the name is less than four letters.
37-40	Name Control 2	4	OPTIONAL. If the Secondary SSN is present in positions 14-22, Name Control 2 is REQUIRED. Enter the first four letters of the spouse's last name. Left justify and blank fill if the name is less than four letters.
41-61	Agency Requester Information	21	OPTIONAL. Agency supplied for agency use. It is an optional field which will be returned on the IRS tape at the end of each record.
62	Program Code	1	REQUIRED. Enter a "1" (numeric) in this position.
63-92	IRS Use Only	30	Must be blank filled.

05. Invalid Agency Request Records. The agency requests must follow the format in part 04 above. The tapes are processed through a diagnostic program to assure that they meet the format requirements. Tapes which do not meet the format requirements will be returned to the submitting agency unprocessed. The external label will be 405D101-XXX, where "XXX" is the full three digits of the assigned agency request number.

SEC. 12. OUTPUT MAGNETIC TAPE SPECIFICATIONS

01. General

1) The magnetic tape specifications contained in this section of the Revenue Procedure define the format and contents of the records to be included in the files which will be returned to the coordinating agencies.

2) The output tapes will be 9 track Standard Label/EBCDIC (Extended Binary Coded Decimal Interchange) with:

a) IBM Standard Label, EBCDIC;

b) The reel label will be as follows:

1. For valid tape matches, the external label will be 405D411-XX, where "XX" is the last two digits of the assigned agency request number. The internal label will have a File-ID equal to 405D411—XXX, where "XXX" is the full three digits of the assigned agency request number.

2. For the invalid numbers tape, the external label will be 405D311-XX, where "XX" is the last two digits of the assigned agency request number. The internal label will have a File-ID equal to 405D311—XXX, where "XXX" is the full three digits of the assigned agency request number.

c) ODD Parity; and

d) A density of 6250 BPI.

3) All output tape files will have the following characteristics:

a) Type of tape — 0.5 inch (12.7 mm) wide computer grade magnetic tape of reels of up to 2400 feet (731.52 m) within the following specifications:

1. Tape thickness:
1.0 or 1.5 mils

2. Reel diameter:
10.5 inches (26.67 cm);
8.5 inches (21.50) inches;
or 7 inches (17.78 cm)

b) Interrecord Gap — ¾ inch.

02. Record Length.

1) The invalid records will be blocked 100, subject to the following:

a) A FIXED RECORD OF 92 POSITIONS WILL BE OUTPUT.

b) All records except the Header and Trailer Labels will be blocked.

c) The block will be 9,200 tape positions in length.

d) When the block results in a short block (less than 20 records), all remaining positions of the block will be filled with 9's.

2) The unearned income information records will be blocked 20, subject to the following:

a) A FIXED RECORD OF 1011 POSITIONS WILL BE OUTPUT.

b) All records except the Header and Trailer Labels will be blocked.

c) The block will be 20,220 tape positions in length.

d) When the block results in a short block (less than 20 records), all remaining positions of the block will be filled with 9's.

03. Invalid Disclosure Requests Record.

Tape Position	Field Title	Length	Description and Remarks
(All information except position 66 is duplicated from the agency request record. These records are not processed against the IRMF.)			
1-3	Agency Code	3	The agency which originated the request.
4	Constant	1	"0" (numeric).
5-13	SSN	9	SSN of the requested individual.
14-22	Secondary SSN	9	SSN of spouse if present.
23	Constant	1	"1" (numeric) .
24-25	Constant	2	"99"
26-32	Welfare Codes	7	The welfare program(s) for which the request is being made. See Section 10.04 for explanation of codes.
33-36	Name Control 1	4	The first four letters of the last name.
37-40	Name Control 2	4	First four (4) letters of spouse's last name if Secondary SSN present.
41-61	Agency Requester Information	21	Agency supplied information agency use.
62	Program Code	1	"1" (numeric).
63-65	Agency Code	3	Agency which originated the request. Duplicated from positions 1-3 for sorting purposes.
66	Error Code	1	Code explaining the type of error that was encountered when the SSN was initially validated.
67-92	Reserved	27	IRS Use Only

Code	*Explanation*
1	Invalid Agency Code
2	SSN not all numeric
3	Secondary SSN not all numeric
4	Name Control #1 missing or in error
5	Invalid Program Code
6	Invalid SSN
7	Name Control does not match SSN

04. Payee Document Record

Tape Position	Field Title	Length	Description and Remarks
1-9	Payee TIN	9	Same as request SSN.
10-13	Payee Name Control	4	Same as the request Name Control for identifying the individual.
14-16	Agency Code	3	Same as the request Agency Code.
17-18	Tax Year	2	The year in which the income was paid. For requests received July 1989 through June 1990, the Tax Year is "88".
19-20	Document Type	2	The document on which the income was reported.

Document Type	*Document Name*
32	Form W-2G
65	Form 1065 Schedule K1
66	Form 1041 Schedule K1
67	Form 1120S Schedule K1
75	Form 1099-S
79	Form 1099-B
80	Form 1099-A
86	Form 1099-G
91	Form 1099-DIV
92	Form 1099-INT
95	Form 1099-MISC
96	Form 1099-OID
97	Form 1099-PATR
98	Form 1099-R
**	No matched record on IMRMF

T[illegible] Position	Field Title	Length	Description and Remarks
[illegible]-40	Account Number for Payee	20	The number assigned by the payee's account.
41-80	Payee Name Line 1	40	The name of the payee whose TIN is contained in position 1-9. If less than 40 characters, left justified and blank filled.
81-120	Payee Name Line 2	40	If the payee name required more than 40 characters or if there are other payees, this field will contain these names, left justified and blank filled.
121-160	Payee Mailing Address	40	The mailing address of the payee, left justified and blank filled.
161-200	Payee City	40	The payee's city, left justified and blank filled.
201-202	Payee State	2	The payee's state as abbreviated by the U. S. Postal Service.
203-211	Payee ZIP Code	9	The payee's ZIP Code, left justified and blank filled if it only 5 digits.
212-220	Payer TIN	9	The Payer's EIN or SSN.
221-260	Payer Name Line 1	40	The payer's name, left justified and blank filled.
261-300	Payer Name Line 2	40	Any additional payer name(s) information, left justified and blank filled.
301-340	Payer Address	40	The payer's address, left justified and blank filled.
341-380	Payer City/ State/Zip Code	40	The payer's city, state and zip code. Left justified and blank filled.
381-382	Reserved	2	Blank (alpha) filled.
(Money fields—all amounts are in dollars only.)			
383-394	Other Taxable Income	12	Other taxable income reported on Schedule K-1 of Forms 1041, 1065 and 1120S.
395-406	Interest	12	Interest reported on Forms 1099-INT, 1099-OID and Schedule K-1 of Forms 1041, 1065 and 1120S.
407-418	Dividends	12	Dividends reported on Forms 1099-DIV and Schedule K-1 of Forms 1041, 1065 and 1120S.
419-430	Patronage Dividends	12	Patronage dividends reported on Form 1099-PATR.
431-442	Non-Patronage Dividends	12	Non-patronage dividends reported on Form 1099-PATR.
443-454	Per-Unit Retain Allocations	12	Allocations reported on Form 1099-PATR.
455-466	Redemption of Non Qualified Notices and Retain Allocations	12	Redemption amounts reported on Form 1099-PATR.
467-478	Reserved	12	0 (numeric) filled.
479-490	Reserved	12	0 (numeric) filled.
491-502	Reserved	12	0 (numeric) filled.
503-514	Unemployment Compensation	12	Unemployment compensation Compensation reported on Form 1099-G.
515-526	Prior Year Refund	12	State and local tax refunds reported on Form 1099-G.
527-538	Discharge of Indebtedness	12	Discharge amounts reported on Form 1099-G.
539-550	Reserved	12	0 (numeric) filled.
551-562	Agricultural Subsidies	12	Agricultural subsidies reported on Form 1099-G.
563-574	Capital Gain Distributions	12	Capital gains distributions on Form 1099-DIV.
575-586	Non-Taxable Distributions	12	Non-taxable distributions reported on Form 1099-DIV.
587-598	Cash Liquidation Distribution	12	Cash liquidations reported on Form 1099-DIV.
599-610	Non-Cash	12	Non-cash liquidations reported on Form 1099-DIV.
611-622	Reserved	12	0 (numeric) filled.
623-634	Gross Winnings	12	Gambling winnings reported on Form W-2G.
635-646	Additional Winnings	12	Additional winnings from identical wager reported on Form W-2G.
647-658	Savings Bonds, etc.	12	U.S. savings bond and other Treasury obligations interest reported on Form 1099-INT.
659-670	Interest Forfeiture	12	Early withdrawal penalty reported on Forms 1099-INT and 1099-OID.
671-682	Substitute Payments	12	Substitute payments reported on Form 1099-MISC.
683-694	Stocks and Bonds	12	Sales of securities reported on Bonds Form 1099-B.
695-706	Reserved	12	0 (numeric) filled.
707-718	Aggregate Profit or Loss	12	Total profit/loss reported on Loss Form 1099-B.
719-730	Profit or Loss Realized	12	Profit/loss reported for current year on Form 1099-B.

Tape Position	Field Title	Length	Description and Remarks
731-742	Unrealized Profit/Loss from Prior year	12	Unrealized profit or loss from regulated futures contracts reported on Form year 1099-B.
743-754	Unrealized Profit/Loss from Current Year	12	Unrealized profit or loss from regulated futures from contracts reported on Form Year 1099-B.
755-766	Rents	12	Rents reported on Form 1099-MISC.
767-778	Royalties	12	Royalties reported on Form 1099-MISC.
779-790	Prizes and Awards	12	Prizes and awards reported on Awards Form 1099-MISC.
791-802	Reserved	12	0 (numeric) filled.
803-814	Reserved	12	0 (numeric) filled.
815-826	Reserved	12	0 (numeric) filled.
827-838	Original Issue Discount	12	Original issue discount reported on Form 1099-OID.
839-850	Total Pension Distribution	12	Lump sum distribution from a retirement plan as reported on Form 1099-R.
851-862	Other Pension Distribution	12	Actuarial value of annuity contract or retirement bond; retirement account exchange or death benefit payment as reported on Form 1099-R.
863-874	Reserved	12	0 (numeric) filled.
875-886	Reserved	12	0 (numeric) filled.
887-898	Reserved	12	0 (numeric) filled.
899-910	Real Estate Sales	12	Proceeds from real estate reported on Form 1099-S.
911-922	Reserved	12	0 (numeric) filled.
923-934	Debt Outstanding	12	Outstanding debt reported on Form 1099-A.
935-946	Debt Satisfied	12	Amount of debt satisfied reported on Form 1099-A.
947-958	Fair Market Value	12	Fair market value reported on Form 1099-A.
959-960	Blanks	2	Blank filled.
961	Amended Return Indicator	1	1 (numeric) if the information return was amended, otherwise blank.
(Identifying information duplicated from the request record.)			
962-970	Secondary SSN	9	Same as the Request Secondary SSN.
971-977	Welfare Codes	7	Same as Request Welfare Codes.
978-981	Name Control 1	4	Same as the Request Name Control 1.
982-985	Name Control 2	4	Same as the Request Name Control 2.
986-1006	Agency Requester Information.	21	Same as the Request Agency Information
1007-1011	Blanks	5	Blank filled.

SEC. 13. INQUIRIES

01. Any questions regarding the material in this Revenue Procedure may be addressed to the Director, Office of Disclosure, at the address listed in Section 5.02 of this Revenue Procedure.

02. Questions concerning tape receipt, processing, and shipping can be addressed to:

Internal Revenue Service
Production Control Officer
Systems Operations Division
Martinsburg Computing Center
P.O. Box 1208
Martinsburg, WV 25401

SEC. 14. EFFECTIVE DATE

This Revenue Procedure is effective July 1989 through June 1990.

Form **5181** (Rev. June 1985) Department of the Treasury Internal Revenue Service	**Agreement Covering Reimbursable Services** *See "Terms and Conditions" on reverse*	Project Number 9-066-2

1. Name of organization requesting services on reimbursable basis	2. Address

3. Project title or type of service requested

Extract from the Internal Revenue Service's Information Return Master File and Payer Master File subject to the terms and conditions of this contract, Section 6103(l)(7)(B) of the Internal Revenue Code and applicable Revenue Procedures published annually.

4. Internal Revenue Project Coordinator	5. Project Coordinator of Requesting Organization
a. Name and title Gwen Collins Program Analyst	a. Name and title
b. Address Office of Disclosure 1111 Constitution Ave., NW Room 1607 EX:D:D Washington, D.C. 20224	b. Shipping Address *(No., Street, City, State, ZIP Code)*
c. Telephone (202) 535-9749	c. Telephone

6. Cost and Financing	a. Total estimated cost of services .01 per record $
	b. Method of Billing ☐ In advance ☐ Actual cost to be billed as work is completed ☒ Other *(Explain)* Charges will be billed on actual number of records submitted.

Federal Government Agencies are required to make payment by Standard Form 1081, and must ensure inclusion of their Agency Locator Code (ALC). All other organizations, i.e., municipal, state governments and corporations, will send payment by check drawn to order of Accounting Section, Internal Revenue Service, 1111 Constitution Avenue, NW.
(Address) Washington, D.C. 20224

7. Period of Agreement	This agreement shall become effective on the date approved by the Government and shall not extend beyond the end of the Government fiscal year or June 1990. For a renewal, apply to the Internal Revenue Project Coordinator.

8. For Internal Revenue Use Only		9. For Use of Requesting Organization	
a. Approved by *(signature)*		a. Accepted by *(Signature of Authorized Official)*	
b. Title	c. Date	b. Title	c. Date

Terms and Conditions

1. The authority to perform services on a cost basis is contained in Section 6103(p)(2) and Section 6108(b) of the Internal Revenue Code (IRC). The performance of services is authorized only when consistent with the basic public obligations of the Internal Revenue Service (the Service). If necessary to fulfill its public obligations, the Service may reject or terminate any part of this agreement and return the unused balance of funds advanced.

2. Although every reasonable effort is made to avoid delays and errors in the performance of its work, the Service is not responsible for delays or errors in the services performed. The cost of data recompilations or corrections must be paid for by the requesting party.

3. Direct and indirect actual costs will be charged for reimbursable work. If funds advanced to the Service are more than the actual cost of performing the work, the difference will be returned. If an estimate is less than the actual costs incurred, the requesting organization agrees to pay for the actual costs incurred.

4a. Section 6103(p)(4) of the IRC provides specific requirements for Federal, state and local organizations to safeguard Federal returns and return information as a condition for receiving the information.

b. Section 7213 of the IRC makes illegal disclosure of returns or return information a felony punishable by a fine not to exceed $5000 or imprisonment of not more than 5 years, or both, together with the costs of prosecution. IRC Section 7431 makes persons liable for civil damages who knowingly or negligently disclose returns or return information illegally.

5. The Service reserves the right to use a copy of all data provided under this agreement.

6. The requester may cancel this agreement only by giving the Service written notice 30 days before cancellation. Payment to the Service shall include actual costs to the date of cancellation. The Service will exercise due diligence to prevent incurring costs after the cancellation date. However, payment shall also be made for unavoidable commitments up to the date the agreement would have expired.

Form 5181 (Rev. 6-85)

Transmittal Sheet

State of ____________________

Department of __________________

Tape Transmittal Sheet for
Income and Eligibility Verification System (IEVS)

1. From:	2. TO: Internal Revenue Service Production Control Officer Systems Operations Division Martinsburg Computing Center P.O. Box 1208 Martinsburg, WV 25401
3. Contact Person/Telephone:	4. Agency Code: 6XX
5. Data Set (File) Name: DIFSLA	6. Date Transmitted:
7. Number of Reels:	8. Volume Serial Number (s):
9. Number of Records:	10. Label Type: SL (Standard Label)
11. Tracks: 9	12. Record Format: FB (Fixed Block)
13. Character Format: EBCDIC	14. Record Length: 92
15. Density: 6250	16. Block Size: 9200
17. Other Agency	18.

EXHIBIT 3

DIFSLA Processing Schedule - Tax Year 1988

	REQUEST DUE DATE	RUN DATE	SHIPPING DATE
JUL	07/14/89	07/16/89	07/28/89
AUG	08/11/89	08/13/89	08/25/89
SEP	09/08/89	09/10/89	09/22/89
OCT	10/06/89	10/08/89	10/20/89
NOV	11/03/89	11/05/89	11/17/89
DEC	12/22/89	12/24/89	01/05/90
FEB	02/09/90	02/11/90	02/23/90
MAR	03/09/90	03/11/90	03/23/90
APR	04/06/90	04/08/90	04/20/90
MAY	05/04/90	05/06/90	05/18/90
JUN	06/22/90	06/24/90	07/06/90

There will be no January run of the IRMF. Tapes received after the cutoff date will be processed in the next monthly run. Tapes with matching data will be shipped approximately two weeks after the Request Due Date.

26 CFR 601.201: Rulings and determination letters.

Rev. Proc. 89-34

SECTION 1. BACKGROUND AND PURPOSE

.01 Rev. Proc. 89-1, page 740, this Bulletin, provides procedures for issuing ruling letters involving substantive areas under the jurisdiction of the Associate Chief Counsel (Technical). Section 7 indicates that the issuance of a letter ruling is discretionary with the Service and lists some broad grounds on which it will not issue rulings, such as requests presenting alternative plans of a proposed transaction or hypothetical situations.

.02 In order to devote its resources more efficiently to resolving issues in need of attention by the public in general through the issuance of regulations, revenue rulings, and other published guidance, and, ultimately, in order to speed up the issuance of letter rulings not covered by this modification of the Rev. Proc. 89-1, the Office of Associate Chief Counsel (Technical) is discontinuing, except in extraordinary circumstances, the issuance of letter rulings with respect to issues that are clearly and adequately addressed by published authorities.

SEC. 2. PROCEDURE

Rev. Proc. 89-1 is hereby modified as follows:

.01 A new section 7.02 is added to provide as follows: "The National Office ordinarily will not issue a ruling with respect to an issue that is clearly and adequately addressed by a statute, regulation, decision of the Supreme Court, tax treaty, revenue ruling, revenue procedure, notice, or other authority published in the Internal Revenue Bulletin except in extraordinary circumstances (*e.g.*, a request for a ruling required by a governmental regulatory authority in order to effectuate a transaction). *See* section 8.07 for a statement to be included in a request for a ruling. However, the National Office will issue an information letter, as defined in section 4.06, if it believes that providing general information would be helpful."

.02 Present sections 7.02, 7.03, and 7.04 are renumbered, respectively, sections 7.03, 7.04, and 7.05.

.03 A new section 8.07 is added to provide as follows: "A request for a ruling must contain a statement supporting the taxpayer's judgment that the issue in the ruling request is not clearly and adequately addressed by a statute, regulation, decision of the Supreme Court, tax treaty, revenue ruling, revenue procedure, notice, or other authority published in the Internal Revenue Bulletin. *See* section 7.02."

.04 Present sections 8.07 through 8.23 are renumbered consecutively sections 8.08 through 8.24.

SEC. 3. EFFECT ON OTHER REVENUE PROCEDURES

Rev. Proc. 89-1 is modified.

SEC. 4. EFFECTIVE DATE

This revenue procedure applies to all ruling requests postmarked or, if not mailed, received 30 days or more after May 15, 1989, the date of publication of this revenue procedure in the Internal Revenue Bulletin.

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26 CFR 601.201: Rulings and determination letters.

Rev. Proc. 89-35

SECTION 1. PURPOSE AND SCOPE

.01 The purpose of this revenue procedure is to set forth a procedure by which a plan administrator or plan sponsor of a qualified defined benefit pension plan may under certain circumstances satisfy the requirement that a deduction under section 404 of the Code be disallowed by the Secretary of the Treasury, thereby fulfilling a condition under which a contribution may revert to the employer without adversely affecting the plan's qualified status.

.02 This revenue procedure applies only to employer contributions to qualified defined benefit pension plan that are made for a plan year beinning in 1988 (i.e., the 1988 plan year), or that are made to satisfy the quarterly contributions requirement of section 412(m) of the Code for the first plan year beginning after December 31, 1988 (see section 5).

.03 In general, contributions to which this revenue procedure applies must be effectively disallowed by obtaining a ruling letter, as described in subsection .06 of section 1 and in section 4 of this revenue procedure before the nondeductible contributions may be returned to the employer.

SEC. 2. BACKGROUND INFORMATION

.01 Section 401(a)(2) of the Internal Revenue Code generally requires a trust forming part of a pension, profit-sharing, or stock bonus plan to prohibit the diversion of corpus or income for purposes other than the exclusive benefit of the employees or their beneficiaries.

.02 Section 412(m) of the Code provides that for plan years beginning after December 31, 1988, quarterly estimated contributions must be made to any plan (other than a multiemployer plan) that is subject to the minimum funding requirements of section 412.

.03 Section 4072 of the Code provides that a 10 percent tax is to he imposed on nondeductible plan contributions. However, the section 4972 tax does not apply to the extent that contributions are returned to the taxpayer no later than the time prescribed by law for filing the tax return for such taxable year (including extensions filed for and granted).

. 04 In Rev. Rul. 77-200, 1977-1 C.B. 98, the Service held that plan language providing for the return of employer contributions under certain limited circumstances may be included in a plan intended to qualify under the Internal Revenue Code. One of those circumstances addresses situations in which the employer contribution is conditioned on its deductibility under section 404 of the Code and the deduction is disallowed by the Secretary of the Treasury. Under Rev. Rul 77-200, the return to the employer must take place within one year from the date of disallowance of the deduction.

.05 Rev. Proc. 83-36, 1983-1 C.B. 763; as modified by Rev. Proc. 87-40, 1987-2 C.B. 514, sets forth the general procedures of the Service relating to the issuance of rulings, determination letters. opinion letters, and notification letters on employee plans and exempt organization matters.

.06 Rev. Proc. 89-4, page 767, this Bulletin, sets forth the procedures relating to the payment of user fees for requests to the Service for rulings, opinion letters, determination letters, and similar requests.

.07 Notice 89-52, page 692, this Bulletin, provides guidance with respect to the quarterly estimated payments required by section 412(m). In addition. in light of the uncertainty asserted by taxpayers about the effective date of the change to a 5-year amortization period for experience gains and losses for calendar year plans, it provides limited relief under which an employer may apply a transitional rule.

SEC. 3. REQUESTS FOR RULING LETTERS TO DISALLOW THE DEDUCTIBILITY OF A CONTRIBUTION

.01 Who may Submit — Only a plan administrator within the meaning of section 414(g) of the Code), plan sponsor, or the authorized representative of either may make a request for a determination that the employer contribution to which this revenue procedure applies would be nondeductible if claimed as a deduction for purposes of determining whether such contribution may be returned to the employer in accordance with Rev. Rul. 77-200 without adversely affecting the qualified status of the plan.

.02 Where to Submit — Such requests with the appropriate user fee for a ruling pursuant to Rev. Proc. 89-4 shall be submitted to the Internal Revenue Service: Assistant Commissioner (Employee Plans and Exempt Organizations): Attention: E:EP:PA, P.O. Box 14071. Ben Franklin Station; Washington, DC 20044. The request must be made no later than 2½ months after the close of the plan year for which the disallowance of the deductibility of the employer contribution is requested or, if later, 120 days after publication of this procedure.

.03 Procedural Rules — The request must satisfy all of the requirements of Rev. Proc. 83-36, 1983-1 C.B. 761, including deletion instructions in compliance with section 6110 of the Code. Also, attention is called to section 7.10 of Rev. Proc. 81-16. which provides that a request for a ruling to which section 6110 of the Code applies must contain a declaration in the following form: "Under the penalties of perjury, I declare that I have examined this request, including accompanying documents, and to the best of my knowledge and belief, the facts presented in support of the request are true, correct, and complete." This declaration must be signed by the taxpayer (e.g., an authorized officer of a corporation). The signature of an individual with a power of attorney will not suffice for the declaration.

.04 Information Required — In addition to any information required by Rev. Proc. 83-36, the following information shall accompany the request:

(1) The location of the office of the District Director of Internal Revenue having jurisdiction over the plan, the employer identification number, the plan name and number, and the name and address of the plan administrator or plan sponsor.

(2) A copy of each of the last two actuarial valuation reports, and a copy of each of the last two Schedules B of Form 5500, including attachments thereto, that have been filed with the Internal Revenue Service.

(3) The plan year for which the request is made (e.g., January 1, 1988 December 31, 1988).

(4) A list of the employer contributions actually paid in each month, from the twenty-fourth month prior to the beginning of the plan year for which the disallowance is requested through the date of the request and the plan year to which the contributions were applied.

(5) A worksheet, signed by the enrolled actuary for the plan, showing how the amount of the reversion due to the employer as a result of the disallowance of the deduction of the employer contribution will be determined, and an explanation of why the contribution is not deductible. The maximum amount which may be returned to the employer is the excess of (1) the amount contributed over (2) the amount that would have been contributed had the contribution been limited to the amount that is deductible. Earnings attributable to the excess contribution may not be returned to the employer, but losses attributable thereto must reduce the amount to be so returned.

(6) A copy of the current plan document and a copy of the most recent summary plan description.

(7) Documentation must be provided that employer contributions are conditioned on deductibility. A copy of a board resolution will suffice for such documentation as will plan language providing that employer contributions are conditioned on deductibility.

(8) A reference to the appropriate section in the plan document which permits the return of employer contributions.

(9) A copy of the most recent determination letter issued to the plan.

.05 The Service may request additional information as needed.

.06 Approval Letter.

(1) If the request described in section 3.01 is approved, a form letter will be issued. A copy of this approval letter must be attached to the Schedule B of the Form 5500 that is filed for the plan year for which the disallowance is effective (see Appendix I Form Letter). The form letter will contain the caveat that the Service has considered the disallowance of employer contributions solely for the purpose of applying Rev. Rul. 77-200.

(2) The National Office will send a copy of the form letter to the Key District Director having jurisdiction over the plan.

SEC. 4. SPECIAL RULES FOR A PLAN YEAR COMMENCING IN 1988

For a ruling request for a plan year beginning in 1988, special rules of this section will apply. The National Office within 90 days from the receipt of a complete request will either contact the applicant to obtain more information or will issue a form letter approving the request with respect to employer contributions made to the plan for the plan year commencing in 1988. To expedite processing for 1988 plan years, taxpayers should specify in the upper right-hand corner of their requests the words "Rev. Proc. 89-35". If an approval letter is issued, a copy of the form letter must be attached to the next Schedule B of the Form 5500 filed (see Appendix I — Form Letter).

SEC. 5. EFFECTIVE DATE

This revenue procedure is effective for contributions made for a plan year commencing in 1988, or for contributions made to satisfy the quarterly installments requirement for a plan year commencing on or after January 1, 1989, but not after December 31, 1989.

Appendix I—Form Letter

Significant Index No. 0404.00-00

In re: Plan Name
(Plan No. __
EIN:

Dear ______.

This letter is in response to your request with respect to the above-referenced defined benefit pension plan pursuant to Revenue Procedure 89-35 for the plan year commencing ________.

Rev. Proc. 89-35 sets forth the procedure whereby, under certain circumstances, a disallowance of the deduction of employer contributions to a qualified defined benefit pension plan may be obtained, thereby fulfilling a condition under which such contributions could revert to the employer.

Based upon the information submitted, we have determined that contributions amounting to $____ which were made for the plan year commencing ______ may be considered as disallowed solely for the purpose of applying Rev. Rul. 77-200. Therefore, the return of contributions not exceeding $ ____ would not adversely affect the qualified status of the plan, provided such reversion occurs no later than one year from the date of this letter. (However, if it is not returned by your tax filing date, including extensions filed for and granted, the tax under section 4972 would apply.) In granting this approval, we are not expressing any opinion as to the accuracy or acceptability of any calculations or other material submitted with your request.

When filing Form 5500 for the plan year commencing a copy of this letter must be attached to the Schedule B (Actuarial Information). A copy of this letter should be furnished to the enrolled actuary for the plan. We have sent a copy to the Key District Director in ———.

Sincerely yours,

James E. Holland, Jr.
Chief, Pension Actuarial Branch

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26 CFR 601.201: Rulings and determination letters.
(Also Part I, Sections 101, 334, 336, 338, 419, 801, 805, 811, 815, 816, 818, 7702; 1.101-1, 1.334-1, 1.336-1, 1.815-2.)

Rev. Proc. 89-36

SECTION 1. PURPOSE

Section 5 of Rev. Proc. 89-3, page 761, this Bulletin, contains a list of those areas of the Internal Revenue Code under the jurisdiction of the Associate Chief Counsel (Technical) in which advance rulings or determination letters will not be issued because the matter is under extensive study. This revenue procedure modifies Rev. Proc. 89-3 by deleting section 5.04, 5.10, 5.11, 5.12, 5.18, 5.19, 5.20, 5.21, 5.22, and 5.23. Section 5.04 concerns the treatment of proceeds received by a beneficiary from a "self-insured" life and survivor benefit plan established through a trust qualified under section 501(c)(9) of the Code as to whether such proceeds are excludable from the beneficiary's gross income as amounts paid by reason of death of the insured under section 101(a). Section 5.10, 5.11, 5.12, 5.18, 5.19, 5.20, 5.21, 5.22, and 5.23 concern the tax treatment of stock-purchase/liquidation transactions involving life insurance companies.

SEC. 2. BACKGROUND

The following paragraphs under section 5 of Rev. Proc. 89-3 were designated as areas under extensive study in which rulings or determination letters will not be issued:

.04 Section 101—Certain Death Benefits—Whether proceeds of "self-insured" life and survivor benefit plans established through a trust qualified under section 501(c)(9) of the Code are excludable from the beneficiary's gross income as amounts paid by reason of the death of the insured under section 101(a).

.10 Section 334(b)(2) (pre-TEFRA).—Liquidation of Subsidiary.—Whether an acquiring corporation may treat the life insurance reserves received in liquidation as unsecured liabilities assumed.

.11 Section 336 (pre-TEFRA).—Distribution of Property in Liquidation.—Whether the liquidation of a life insurance subsidiary is a termination pursuant to section 815(d)(2) as in effect before the enactment of the Tax Reform Act of 1984.

.12 Section 338 (pre-TEFRA section 334(b)(2)).—Certain Stock Purchases Treated as Asset Acquisitions.—The tax consequences, under subchapter L, from the stock purchase and the deemed purchase of assets of a life insurance subsidiary.

.18 Section 801(b).—Life Insurance Company Taxable Income Defined.—Whether the liquidation of a life insurance subsidiary pursuant to either section 334(b)(2) (pre-TEFRA) or section 338 (added by TEFRA) is a termination under section 815(d)(2) (as in effect before the Tax Reform Act of 1984) causing a distribution from the subsidiary's policyholders surplus account.

.19 Section 805(a)(8).—Other Deductions.—Whether a portion of the purchase price of the stock of the life insurance subsidiary is properly allocable to insurance in force.

.20 Section 811(b)(34).—Amortization of Premium and Accrual of Discount—Exception.—Whether the difference between the face value of bonds held by a life insurance subsidiary liquidating under section 334(b)(2) (pre-TEFRA) or section 338 (added by TEFRA) and the amount allocable to such bonds pursuant to the liquidation is market discount and need not be accrued.

.21 Section 815(d)(2) as in effect before the enactment of the Tax Reform Act of 1984—Termination as Life Insurance Company.—Whether the liquidation of a life insurance subsidiary pursuant to section 334(b)(2) (pre-TEFRA) or section 338 (added by TEFRA) is a termination requiring the application of section 801(c) or section 802(b)(3) as in effect before the enactment of the Tax Reform Act of 1984.

.22 Section 816(b).—Life Insurance Reserves Defined.—Whether the life insurance reserves acquired in the liquidation of a life insurance subsidiary qualify as unsecured liabilities assumed by the acquiring corporation for purposes of section 334(b)(2) (pre-TEFRA) and section 338 (added by TEFRA).

.23 Section 818(b).—Treatment of Capital Gains and Losses, etc.—Whether the purchase of the stock of a life insurance subsidiary and its subsequent liquidation under section 334(b)(2) (pre-TEFRA) or section 338 (added by TEFRA) is, in fact, a purchase of the subsidiary's insurance contracts.

SEC. 3. PROCEDURE

Because the above-cited areas are no longer under study, the Internal Revenue Service will now rule on issues involving these areas.

Rev. Proc. 89-3 is modified by deleting section 5.04, 5.10, 5.11, 5.12, 5.18, 5.19, 5.20, 5.21, 5.22, and 5.23.

SEC. 4. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 89-3 is modified.

SEC. 5. EFFECTIVE DATE

This revenue procedure is effective May 30, 1989, the date of its publication in the Internal Revenue Bulletin.

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26 CFR 601.602: Forms and instructions.
(Also Part I, Section 6109; 301.6109-1.)

Rev. Proc. 89-37

SECTION 1. PURPOSE

Rev. Proc. 70-22, 1970-1 C.B. 503, establishes procedures to permit certain fiduciaries or other persons to file consolidated applications to obtain employer identification numbers (EINs). This revenue procedure updates those procedures and provides guidance to fiduciaries or other persons who are authorized to represent ten or more estates or trusts in federal tax matters or to execute and file tax returns in their behalf, and who wish to file a consolidated application to request a block of EINs for such estates or trusts in advance of filing returns.

SEC. 2. BACKGROUND

.01 Under section 6109 of the Internal Revenue Code, any person required to make a return, statement, or other document must furnish an identifying number as required by the forms and related instructions.

.02 Under section 301.6109-1 of the Regulations on Procedure and Administration, EINs identify corporations, partnerships, nonprofit associations, trusts, and similar nonindividual persons. Under Rev. Rul. 64-99, 1964-1 (Part I) C.B. 482, and Rev. Rul. 64-113, 1964-1 (Part I) C.B. 483, an EIN is prescribed for use by an estate in filing any federal income tax return. Any person required to furnish an EIN must apply for one on Form SS-4, Application for Employer Identification Number.

.03 Except for cases under Chapter 13 of the Bankruptcy Code (adjustment of debts of an individual with regular income), a bankrupt individual's estate is treated as a separate entity for federal income tax purposes. *See* section 1398 of the Code; *see also*, S. Rep. No. 1035, 96th Cong., 2d. Sess. 4, 1980-2 C.B. 620, 622. A receiver or trustee of a bankrupt individual's estate must request a separate EIN for each such estate. Pursuant to section 1399 of the Code, however, separate taxable entities are not created for a bankrupt corporation or partnership. A receiver or trustee of a bankrupt corporation or partnership must use the EIN of the corporation or partnership. However, if a trust is established in connection with the liquidation of a bankrupt corporation or partnership, an EIN is needed for the trust unless the corporation or partnership is the trustee and can revoke the trust. *See* section 301.6109-1(a)(2) of the regulations.

.04 A fiduciary or other person serving in a representative capacity, such as a bank, trust company, attorney, or agent, may be authorized to act for numerous estates or trusts. In order to minimize the burden of filing a separate application on Form SS-4 for each estate or trust, a fiduciary or other person who is authorized to represent ten or more estates or trusts needing EINs may request a series or block of EINs by following the procedures outlined in section 3 of this revenue procedure.

.05 A financial institution may request blocks of numbers for newly created mortgage pools (such as pools created under the mortgage-backed security programs administered by the Federal National Mortgage Association (''Fannie Mae'') or the Government National Mortgage Association (''Ginnie Mae'')), if the pools qualify as trusts for federal income tax purposes. However, when a pool is traded from one financial institution to another, a new entity is not created; therefore, a new EIN should not be requested. The EIN is transferred with the pool.

.06 A person applying for an EIN for estates or trusts that are subject to employment or excise taxes must file a separate application on Form SS-4 for each estate or trust and may not use the procedures outlined in this revenue procedure.

SEC. 3. PROCEDURE

.01 The fiduciary or other authorized representative must request the EINs from the Entity Control Section of the Internal Revenue Service Center for the region in which the fiduciary or other authorized representative has his or her legal residence or principal place of business. The request must be in writing and may be for an approximate number of EINs. EINs will only be supplied by the service center in consecutive series, or blocks, of 10, 25, 50, 75, or 100.

.02 Within 30 days of receipt of the block of EINs, the fiduciary or other authorized representative must assign the EINs to specific estates or trusts and must submit a list of the estates or trusts with the assigned pre-supplied numbers. The following information must be provided with the list:

(1). The name of the party submitting the request, and the capacity in which the party is acting. If there is a co-fiduciary, or if the submitting party is merely acting for or on behalf of an actual fiduciary, that party's name and title should also be included;

(2). Whether the EIN is for an estate or a trust, and if it is for a trust, the type of trust;

(3). The exact name of the estate or trust;

(4). The name of the grantor or decedent;

(5). The name of the beneficiary, if applicable;

(6). The date the estate or trust was established; and

(7). A statement indicating that none of the named entities have previously applied for or been assigned an EIN and that none are subject to employment or excise taxes.

.03 The list must be submitted in duplicate to the service center specified in section 3.01. The service center will acknowledge its receipt of the list and will return a copy of the list to the submitting fiduciary. Unassigned pre-supplied numbers outstanding 45 days after issuance by the service center will be cancelled by the service center.

SEC. 4. EFFECT ON OTHER REVENUE PROCEDURES

Rev. Proc. 70-22 is modified and, as modified, is superseded.

SEC. 5. EFFECTIVE DATE

This revenue procedure is effective for consolidated applications that request a block of EINs for trusts or estates filed after May 30, 1989.

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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 469, 7805; 1.469-4T, 301.7805-1.)

Rev. Proc. 89-38

SECTION 1. PURPOSE

01. This revenue procedure sets forth lines of business for purposes of applying section 1.469-4T(f)(4) of the Temporary Income Tax Regulations. This revenue procedure is promulgated pursuant to the authority granted in section 7805 of the Internal Revenue Code, section 469(l)(1) of the Code, and section 1.469-4T(f)(4)(iv) of the regulations. For the text of section 1.469-4T, see 54 FR 20527, T.D. 8253, beginning on page 121 of this Bulletin.

SEC. 2. BACKGROUND

01. Section 1.469-4T of the regulations provides rules under which a taxpayer's business and rental operations are treated as one or more separate activities for purposes of section 469 of the Code and the regulations thereunder.

02. Section 1.469-4T(f) of the regulations provides rules under which a taxpayer's interests in two or more trade or business undertakings (within the meaning of section 1.469-4T(f)(1)(ii)) that are similar (within the meaning of section 1.469-4T(f)(4)) and controlled by the same interests (within the meaning of section 1.469-4T(j)) are treated as part of the same activity of the taxpayer.

03. Section 1.469-4T(f)(4)(i) of the regulations provides that two trade or business undertakings are similar for purposes of section 1.469-4T(f) if and only

if (A) there are predominant operations in each such undertaking, and (B) the predominant operations of both undertakings are in the same line of business. For purposes of this rule, there are predominant operations in an undertaking if more than 50 percent of the undertaking's gross income is attributable to operations in a single line of business.

04. Section 1.469-4T(f)(4)(iv) of the regulations provides that the Commissioner shall establish, by revenue procedure, lines of business for purposes of applying section 1.469-4T(f)(4).

SEC. 3. SCOPE

This revenue procedure applies to all persons to whom the rules in section 1.469-4T of the regulations apply.

SEC. 4. APPLICATION

The lines of business listed in this revenue procedure are derived from the Standard Industrial Classification codes (the "SIC" codes) set forth in Executive Office of the President, Office of Management and Budget, *Standard Industrial Classification Manual* (1987). The SIC codes are arranged by divisions, two-digit major groups of industries, three-digit industry groups, and four-digit industries. The SIC code or codes to which a particular line of business corresponds are set forth in parentheses following the name of the line of business. Except as otherwise indicated, each line of business is intended to have the same content as the SIC code or codes from which it is derived.

The Internal Revenue Service anticipates that these lines of business may be modified from time to time to reflect technological, institutional, and other changes in the economy, taxpayers' and the Service's experiences in working with the lines of business, and changes in the SIC codes from which they are derived. In addition, section 1.469-4T(f)(4)(iv) of the regulations provides that business and rental operations that are not included in the lines of business established by the Commissioner shall nonetheless be included in a single line of business or multiple lines of business on a basis that reasonably reflects (A) similarities and differences in the property or services provided pursuant to such operations and in the markets to which such property or services are offered, and (B) the treatment within the lines of business established by the Commissioner of operations that are comparable in their similarities and differences.

Lines of business for purposes of applying section 1.469-4T(f)(4) of the regulations are set forth below.

01. Agricultural (including production of crops and livestock, services, and forestry) (01, 02, 07, and 08).

02. Fishing, hunting, and trapping (09).

03. Metal mining (10).

04. Coal mining (12).

05. Oil and gas extraction (13).

06. Mining—nonmetallic minerals, except fuels (14).

07. Real estate development and services (15, 65).

08. Heavy construction (except buildings) (16).

09. Manufacturing—food and kindred products (20).

10. Manufacturing—tobacco products (21).

11. Manufacturing—textile mill products (22).

12. Manufacturing—apparel (23).

13. Manufacturing—lumber and wood products (24).

14. Manufacturing—furniture and fixtures (25).

15. Manufacturing—paper and allied products (26).

16. Printing and publishing (27).

17. Manufacturing—chemicals and allied products (28).

18. Manufacturing—petroleum and coal products (29).

19. Manufacturing—rubber and miscellaneous plastics products (30).

20. Manufacturing—leather and leather products (31).

21. Manufacturing—stone, clay, and glass products (32).

22. Manufacturing—primary metals (33).

23. Manufacturing—fabricated metal products (34).

24. Manufacturing—industrial machinery and equipment (35).

25. Manufacturing—electronic and other electric equipment (36).

26. Manufacturing—transportation equipment (37).

27. Manufacturing—instruments and related products (38).

28. Railroad transportation (40).

29. Local and interurban passenger transit (41).

30. Trucking and warehousing (42).

31. Water transportation (44).

32. Air transportation (45).

33. Transportation pipelines (except natural gas) (46).

34. Transportation services (47).

35. Communications (48).

36. Electric, gas, and sanitary services (49).

37. Wholesale trade—durable goods (50).

38. Wholesale trade—nondurable goods (51).

39. Retailing—building materials and garden supplies (52).

40. General merchandise stores (53).

41. Food stores (54).

42. Automotive dealers and service stations (55).

43. Apparel and accessory stores (56).

44. Furniture and homefurnishings stores (57).

45. Eating and drinking places (58).

46. Drug stores and proprietary stores (591).

47. Liquor stores (592).

48. Used merchandise stores (593).

49. Miscellaneous shopping goods stores (594).

50. Nonstore retailers (596).

51. Fuel dealers (598).

52. Depository financial institutions (60).

53. Nondepository financial institutions (61).

54. Security and commodity brokers (62).

55. Insurance carriers (63).

56. Insurance agents, brokers, and service (64).

57. Holding and other investment offices (67).

58. Hotels and other lodging places (70).

59. Laundry, cleaning, and garment services (721).

60. Photographic studios (including portrait)(722).

61. Beauty and barber shops (723, 724).

62. Shoe repair and shoeshine parlors (725).

63. Funeral service and crematories (726).

64. Advertising (731).

65. Credit reporting and collection (732).

66. Mailing, reproduction, and stenographic services (733).

67. Services to buildings (734).

68. Miscellaneous equipment rental and leasing (735).

69. Personnel supply services (736).

70. Computer and data processing services (737).

71. Auto repair, services, and parking (75).

72. Electrical repair shops (762).

73. Watch, clock, and jewelry repair (763).

74. Reupholstery and furniture repair (764).

75. Motion picture services (78).

76. Amusement and recreation facilities (793, 799).

77. Commercial sports (794).

78. Educational services (82).

79. Social services (83).

SEC. 5. INQUIRIES

Taxpayers may send inquiries and comments about this revenue procedure to the following address: Office of Chief Counsel, 1111 Constitution Avenue, N.W., Room 4429, Washington, D.C. 20224 (Attn: CC:CORP:T:R (PS-001-89)).

SEC. 6. EFFECTIVE DATE

This revenue procedure is effective for taxable years to which section 1.469-4T of the regulations applies. See sections 1.469-4T(p) and 1.469-11T.

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26 CFR 601.201: Rulings and determination letters.

Rev. Proc. 89-39

SECTION 1. BACKGROUND

Rev. Proc. 89-3, page 761, this Bulletin, sets forth areas in which advance rulings will not be issued by the Internal Revenue Service. Section 3 of Rev. Proc. 89-3 is entitled, AREAS IN WHICH RULINGS OR DETERMINATION LETTERS WILL NOT BE ISSUED.

SEC. 2. PROCEDURE

Rev. Proc. 89-3 is amplified by adding to section 3.01 the following new subsection.

Section 355.—Distribution of Stock and Securities of a Controlled Corporation.—The determination of whether the corporate business requirement of section 1.355-2(b) of the Income Tax Regulations is satisfied in the following situations:

1. Whether the reduction of non Federal taxes is substantially coextensive with the reduction of Federal taxes.

2. If a transaction has the potential of avoiding Federal taxes but has another corporate business purpose, whether the non-avoidance purpose is the "substantial" motivation for the transaction.

3. If a transaction has the potential of avoiding Federal taxes but the stated purpose is to reduce foreign taxes.

SEC. 3. EFFECTIVE DATE

This revenue procedure will apply to all ruling requests received in the National Office after June 19, 1989, the date of publication of this revenue procedure.

SEC. 4. EFFECT ON OTHER REVENUE PROCEDURES

Rev. Proc. 89-3 is amplified.

Social Security Contribution and Benefit Base

Under authority contained in the Social Security Act, the Secretary, Department of Health and Human Services, has determined and announced (53 F.R. 43934, dated October 31, 1988) that the contribution and benefit base for remuneration paid in 1989 and self-employment income earned in taxable years beginning in 1989 is $48,000.

Notice of Proposed Rulemaking

CONTENTS

The "Proposed regulations" heading in the index contains a list of Code sections affected, the subject matter and the number and page.

Notice of Proposed Rulemaking

Consolidated Return Regulations—Distributions After the Sale of Stock of a Subsidiary

CO-5-89

AGENCY: Internal Revenue Service, Treasury.

ACTION: Notice of proposed rulemaking by cross-reference to temporary and final regulations.

SUMMARY: In * * * [T.D. 8245, page 270, this Bulletin] the Internal Revenue Service is issuing temporary and final regulations to provide rules relating to a dividend or other distribution subject to section 301 that is declared with respect to stock of a subsidiary member of an affiliated group filing consolidated federal income tax returns if the stock of that subsidiary member is disposed of before the distribution is made, but after the selling member becomes entitled to the distribution. The text of the temporary and final regulations also serves as the comment document for this notice of proposed rulemaking.

DATES: The regulations are proposed to apply to a distribution subject to section 301 that is declared in a taxable year for which the due date (without extensions) of the federal income tax return is after March 14, 1989. Written comments and requests for public hearing must be delivered or mailed by May 15, 1989.

ADDRESS: Send comments and requests for a public hearing to: Internal Revenue Service, Attn: CC:CORP:T:R (CC:CO-5-89), Room 4429, 1111 Constitution Avenue, N.W., Washington, D.C. 20224.

SUPPLEMENTARY INFORMATION:

Background

The temporary regulations published in * * * [T.D. 8245, page 270, this Bulletin] amend temporary regulations §1.1502-32T and add cross-references to §§1.1502-14(a) and 1.1502-32(b) and (c) of Part 1 of Title 26 of the Code of Federal Regulations (CFR). The final regulations that are proposed to be based on these temporary regulations would be added to Part 1 of Title 26 of the CFR. Those final regulations would provide rules relating to a dividend or other distribution subject to section 301 that is declared with respect to stock of a subsidiary member of an affiliated group filing consolidated federal income tax returns if the stock of that subsidiary member is disposed of before the distribution is made, but after the selling member becomes entitled to the distribution. For the text of the new temporary regulations, see T.D. 8245 * * * [page 270, this Bulletin]. The preamble to the temporary regulations explains the regulations.

Special Analyses

These proposed rules are not major rules as defined in Executive Order 12291. Therefore, a Regulatory Impact Analysis is not required. These rules, if issued, will not have a significant economic impact on a substantial number of small entities. These rules apply only to affiliated groups of corporations that have elected to file consolidated returns, which tend to be larger businesses. These rules would not significantly alter the reporting or record keeping duties of small entities. Therefore, an initial Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. Chapter 6) is not required.

Comments and Requests for a Public Hearing

Before these proposed regulations are adopted, consideration will be given to any written comments that are submitted (preferably nine copies) to the Internal Revenue Service. All comments will be available for public inspection and copying. A public hearing will be held upon written request to the Internal Revenue Service by any person who also submits written comments. If a public hearing is held, notice of the time and place will be published in the Federal Register.

Lawrence B. Gibbs,
Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on March 14, 1989, 8:45 a.m., and published in the issue of the Federal Register for March 16, 1989, 54 F.R. 11007)

Notice of Proposed Regulations

Disclosure of Information

D-1398-88

AGENCY: Internal Revenue Service, Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed amendments to the Income Tax Regulations relating to the disclosure, under section 6103(n) of the Internal Revenue Code, of returns and return information, in connection with the procurement of property and services for purposes of tax administration. These proposed amendments give to the Tax Division, Department of Justice, the authority to make these disclosures under section 6103(n) for federal tax administration purposes. These proposed amendments affect all disclosures by the Tax Division, Department of Justice, made to any person(s) described in section 6103(n). These proposed amendments apply to all disclosures made after the effective date of this amended regulation.

DATES: These proposed amendments to the regulations are proposed to be effective March 6, 1989. Written comments and requests for a public hearing must be delivered or mailed by February 2, 1989.

ADDRESS; Send comments and requests for a public hearing to: Internal Revenue Service, Attention: CC:CORP:T:R, Room 4429, 1111 Constitution Avenue, N.W., Washington, D.C. 20224.

SUPPLEMENTARY INFORMATION:

Background

This document contains proposed amendments to the Income Tax Regulations relating to the disclosure of returns and return information under section 6103(n) of the Internal Revenue Code (26 CFR §301.6103(n)-1).

Explanation of Provisions

Section 6103(n) of the Code authorizes the disclosure, pursuant to Treasury Regulations, of returns and return information to the extent necessary and in connection with the processing, storage, transmission, and reproduction of returns and return information, and the programming, maintenance, repair, testing, and procurement of equipment, for purposes of tax administration. Section 6103(b)(4) of the Code defines "tax administration" to include litigation arising under the Internal Revenue laws.

Existing §301.6103(n)-1 of the regulations authorizes disclosures to third parties under section 6103(n) only by officers or employees of the Treasury Department, a State tax agency, or the Social Security Administration, for tax administration purposes. Under the current regulations, the Tax Division, Department of Justice, cannot make disclosures to third parties. These proposed amendments would give disclosure authority to the Tax Division, Department of Justice, in order to allow the Tax Division to disclose tax returns and return information for purposes of obtaining litigation support services during the course of litigation arising under the Code. This authority is deemed necessary to enable the Tax Division to procure services from outside contractors in connection with Tax Division's tax litigation responsibilities.

Special Analyses

The proposed rules are not major rules as defined in Executive Order 12291. Therefore, a Regulatory Impact Analysis is not required. Although this document is a notice of proposed rulemaking that solicits public comments, the notice and public procedure requirements of 5 U.S.C. §553 do not apply because the regulations proposed herein are interpretative. Therefore, an initial Regulatory Flexibility Analysis is not required by the Regulatory Flexibility Act (5 U.S.C. chapter 6).

Comments and Request for a Public Hearing

Before adopting the proposed amendments to the regulations, consideration will be given to any written comments that are submitted (preferably a signed original and eight copies) to the Internal Revenue Service. All comments will be available for public inspection and copying in their entirety. A public hearing may be scheduled and held upon written request by any person who submits written comments. If a public hearing is scheduled, notice of the time and place will be published in the Federal Register.

* * * * * *

Accordingly, Title 26, Part 301 of the Code of Federal Regulations, is proposed to be amended as follows:

PART 301, Procedure and Administration.

Paragraph 1. The authority for Part 301 is amended by adding the following citation:

Authority; 26 U.S.C 7805; * * * Section 301.6103(n)-1 also issued under 26 U.S.C. 6103(n).

Paragraph 2. Section 301. 6103(n)-1(a) is amended as follows:

In §301.6103(n)-1, the first sentence of paragraph (a) is amended by removing the language "or" immediately following the phrase "State tax agency", and by adding, immediately following the phrase "the Social Security Administration", the language, "or the Tax Division, Department of Justice".

Also in paragraph (a), the first full sentence of the flush language following paragraph (a)(2) is amended by removing the language "or" immediately following the phrase "State tax agency", and by adding, immediately following the phrase "the Social Security Administration", the language, "or the Tax Division, Department of Justice".

Paragraph 3. Section 301.6103(n)-1(d) is amended as follows:

In §301.6103(n)-1, the second sentence of paragraph (d) is amended by removing the language "or" immediately following the phrase "State tax agency", and by adding, immediately following the phrase "the Social Security Administration", the language, "or the Tax Division, Department of Justice".

Paragraph 4. Section 301.6103(n)-1(d) is further amended as follows:

In §301.6103(n)-1, paragraph (d)(2) is amended by adding, immediately following the phrase "State tax agency", the language "or to the Tax Division, Department of Justice".

Lawrence B. Gibbs,
Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on December 30, 1988, 8:45 a.m., and published in the issue of the Federal Register for January 3, 1989, 54 F.R. 39)

Notice of Proposed Rulemaking

Lobby by Public Charities; Lobbying by Private Foundations; Amendment of Notices of Proposed Rulemaking

EE-154-78

AGENCY: Internal Revenue Service, Treasury.

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

SUMMARY: This document revises proposed regulations published in 1986 and also supersedes portions of proposed regulations published in 1980. The proposed regulations relate to lobbying expenditures by certain tax-exempt public charities and by private foundations. Changes to the tax laws governing lobbying by public charities were made by the Tax Reform Act of 1976 (the "Act") [Pub. L. 99-514, 1986-3 C.B. (Vol. 1)]. The proposed regulations will provide organizations the guidance needed to comply with the Act, and will affect public charities electing the expenditure test under section 501(h) of the Internal Revenue Code of 1986 ("electing public charities"). The proposed regulations will also provide organizations with clearer guidance needed to comply with the requirements of section 4945 (relating to lobbying expenditures by private foundations). Finally, in light of the unique charitable and educational purposes shared by all organizations described in section 501(c)(3) as well as the similarity of the statutory schemes governing lobbying by private foundations and by electing public charities, the regulations ensure that the rules regarding lobbying by private foundations are consistent with the rules regarding lobbying by electing public charities. However, these proposed regulations are not applicable to lobbying by ineligible or nonelecting public charities, which continue to be covered by the "substantial part" test regarding lobbying activities.

DATES: Written comments and/or requests to appear (with an outline of the oral comments to be presented) at a public hearing scheduled for Monday, April 3, 1989, at 10:00 a.m., and continuing, if necessary, at the same time on Tuesday, April, 4, 1989, must be delivered or mailed by March 23, 1989. The proposed regulations published in the Federal Register on November 5, 1986 (51 FR 40211), as amended by this document, are proposed to be effective for tax years beginning after the publication of final regulations.

ADDRESS: Send comments, requests to appear at the public hearing, and outlines of oral comments to be presented at the public hearing to: Commissioner of Internal Revenue, Attention: CC:CORP: T:R (EE-154-78), Washington, D.C. 20224. The public hearing will be held in the I.R.S. Auditorium, Seventh Floor, 7400 Corridor, Internal Revenue Building, 1111 Constitution Avenue, N.W., Washington, D.C.

SUPPLEMENTARY INFORMATION:

PRIOR LAW

A publicly supported charity is not an organization described in section 501(c)(3) ("a section 501(c)(3) organization") if its lobbying activities are more than an insubstantial part of its activities. If it is determined that a substantial part of a publicly supported section 501(c)(3) organization's activities consists of attempts to influence legislation, the organization will lose its tax-exempt status as a charity. Before the passage of the Tax Reform Act of 1976, there was uncertainty about what constituted a "substantial part" of an organization's activities. Congress was aware both of the severity of loss of tax exemption as a sanction and of the belief that the vague standards of the substantial part test tended to create uncertainty and allow subjective and selective enforcement.

EXPENDITURE TEST

Under sections 501(h) and 4911, which were added by section 1307 of the Tax Reform Act of 1976, certain publicly supported section 501(c)(3) organizations may elect to spend up to a certain percentage of their "exempt purpose expenditures" to influence legislation without incurring tax or losing qualification for tax-exempt status. Thus, if an eligible organization elects the "expenditure test" of sections 501(h) and 4911, specific statutory dollar limits on the organization's lobbying expenditures apply. Under the expenditure test, there are limits both upon the amount of the organization's grass roots lobbying expenditures and upon the total amount of the organization's direct and grass roots lobbying expenditures. In contrast to the substantial part test, however, the expenditure test imposes no limit on lobbying activities that do not require expenditures, such as certain unreimbursed lobbying activities conducted by bona fide volunteers. In general, if either or both of the expenditure test limits are exceeded, a 25 percent excise tax is imposed upon the greater of: (1) the amount by which the organization's grass roots lobbying expenditures exceed its grass roots lobbying limit, or (2) the amount by which an organization's total direct and grass roots lobbying expenditures exceed its total lobbying limit. Additionally, if an organization's grass roots expenditures or total lobbying expenditures normally exceed 150 percent of the applicable limitation on its lobbying expenditures, the organization will cease to be described in section 501(c)(3), and, therefore, will cease to be exempt from income tax and will no longer be eligible to receive tax deductible charitable contributions.

BACKGROUND

On November 25, 1980, the Federal Register published proposed amendments to the Income Tax Regulations (26 CFR Part 1) under sections 162, 6001, and 6033 of the Internal Revenue Code of 1954 (relating to grass roots lobbying expenditures by business corporations) and to the Foundation and Similar Excise Taxes (26 CFR Part 53) under section 4945 of the Internal Revenue Code of 1954 (relating to lobbying expenditures by private foundations) (45 FR 78167) ("the 1980 NPRM").

On November 5, 1986, the Federal Register published proposed amendments to the Income Tax Regulations (26 CFR Part 1), Temporary Income Tax Regulations under the Tax Reform Act of 1976 (26 CFR Part 7), Estate Tax Regulations (26 CFR Part 20), Gift Tax Regulations (26 CFR Part 25), and Foundation and Similar Excise Taxes (26 CFR Part 53), and also proposed regulations on Public Charity Excise Taxes (26 CFR Part 56), under sections 170, 501(c)(3), 501(c)(4), 501(h), 504, 2055, 2522, 4911, 4945, 6001, 6011, and 6033 of the Internal Revenue Code of 1954 (51 FR 40211) ("the 1986 NPRM") [EE-154-78, 1986-2 C.B. 750].

This document supersedes a portion of the 1980 NPRM and revises portions of the 1986 NPRM. Specifically, it supersedes that portion of the 1980 NPRM that proposed amendments to the regulations under section 4945 of the Internal Revenue Code (relating to lobbying expenditures by private foundations). It revises portions of the 1986 NPRM relating to proposed regulations on Public Charity Excise Taxes (26 CFR Part 56) under section 4911 of the Internal Revenue Code. In addition, it revises portions of the 1986 NPRM that proposed amendments to the regulations under sections 501(h) and 4945. Thus, where this document proposes to amend any portion of the regulations under section 501(h) or section 4945, the proposed amendment in this document supersedes any proposed amendment of that portion of the regulations that was published in the 1986 NPRM.

The amendments to the Foundation and Similar Excise Taxes are necessary to provide guidance to organizations that must comply with the requirements of section 4945 and will also ensure that the regulations regarding lobbying by private foundations are consistent with the regulations regarding lobbying by electing public charities. The amendments proposed on November 5, 1986, as amended in this document, are proposed to conform the regulations to section 1307 of the Tax Reform Act of 1976 (90 Stat. 1720) as well as to ensure consistency between the similar schemes governing lobbying expenditures by electing public charities and by private foundations. The proposed regulations are to be issued under the authority in sections 501(h)(6), 504(b), 4911(f)(3) and 7805 of the Internal Revenue Code of 1986 (26 U.S.C. 501(h)(6). 504(b), 4911(f)(3), 7805).

PUBLIC COMMENT PROCESS OF PREVIOUS NOTICES OF PROPOSED RULEMAKING

Several thousand written comments were received concerning the 1986 NPRM. Numerous written comments were also received concerning the 1980 NPRM. In addition, on May 11 and 12, 1987, the Internal Revenue Service ("Service") held public hearings concerning the 1986 NPRM.

The numerous public comments and the two days of public hearings have been helpful in formulating this revised notice of proposed rulemaking. In addition, possible revisions of the controversial sections of the proposed regulations have been discussed at length with the Commissioner's Exempt Organizations Advisory Group (comprised of legal and other representatives of exempt organizations as well as academics) at public meetings held on September 17, 1987, and February 26, 1988.

Every effort has been made in the drafting of this revised notice of proposed rulemaking to be as responsive as possible to the many comments received from the public. This effort required a careful balancing of the statutory mandate limiting the amount of lobbying expenditures by section 501(c)(3) organizations with the desire of the affected organizations and individuals to involve themselves in the public policymaking process to the greatest extent consistent with that statutory mandate. Extensive revisions have been made to the prior notices of proposed rulemaking in an effort to achieve this difficult balance. For example, the proposed regulations contain a definition of grass roots lobbying that is less inclusive than is permitted by the broad statutory language defining grass roots lobbying.

Numerous portions of the 1986 NPRM were not controversial, however, and gave rise to little or no public comment. Those portions of the proposed regulations have been retained and are, in general, not affected by the revisions proposed in this document. For example, proposed §§1.501(h)-1 and 1.501(h)-3, proposed in the 1986 NPRM, describe the application of the expenditure test to electing public charities, including that an electing public charity may undertake a certain amount of lobbying expenditures without being subject to tax or having its tax-exempt status revoked. With minor exceptions, these portions of the proposed regulations are not affected by the revisions proposed in this document.

SUMMARY OF COMMENTS RECEIVED ON THE PREVIOUS NOTICES OF PROPOSED RULEMAKING AND EXPLANATION OF PROVISIONS

1. *Proposed Effective Date*

Many of the comments on the 1986 NPRM's proposed regulations regarding lobbying expenditures by electing public charities opposed the proposed effective date of the proposed regulations (generally for tax years beginning after December 31, 1976). On April 9, 1987, the Service issued an information release, IR-87-49, stating that final regulations will be effective only prospectively from the date of publication of final regulations. Accordingly, the amendments proposed in this document and in the 1986 NPRM, as revised by this document, are hereby proposed to be effective on a prospective-only basis for tax years beginning after the date of publication of final regulations.

2. *Definition of Grass Roots Lobbying*

The 1986 NPRM proposed to define grass roots lobbying as a communication that:

(i) Pertains to legislation being considered by a legislative body, or seeks or opposes legislation,

(ii) Reflects a view with respect to the desirability of the legislation (for this purpose, a communication that pertains to legislation but expresses no explicit view on the legislation shall be deemed to reflect a view on legislation if the communication is selectively disseminated to persons reasonably expected to share a common view of the legislation), and

(iii) Is communicated in a form and distributed in a manner so as to reach individuals as members of the general public, that is, as voters or constituents, as opposed to a communication designed for academic, scientific, or similar purposes. A communication may meet this test even if it reaches the public only indirectly, as in a news release submitted to the media.

Most commentators expressed opposition to the breadth of the definition of grass roots lobbying contained in the 1986 NPRM. The primary objections were that the definition did not require a communication to have a "call to action" or some other encouragement to action on the part of the communication's recipients; that the definition considered an otherwise balanced discussion of a piece of legislation to reflect a view on that legislation based on the persons to whom the discussion was disseminated; and that the definition did not require the legislation to be pending or imminently to be introduced. Several commentators also expressed concern that the third part of the proposed definition of grass roots lobbying, regarding communications that reach the public only indirectly, could include testimony on a bill before a legislative committee if the press was in attendance.

In response to the numerous comments on the 1986 NPRM, this document substantially revises the proposed definition of grass roots lobbying. The modifications include the removal of the phrases "pertains to," "seeks or opposes legislation," and "selectively disseminated to persons reasonably expected to share a common view of the legislation."

In place of the definition contained in the 1986 NPRM, this document proposes to define the term "grass roots lobbying communication" (except with regard to a limited number of mass media communications discussed below) to include only those communications that: (1) refer to specific legislation; (2) reflect a view on such legislation; and (3) encourage the recipient of the communication to take action with respect to such legislation.

Thus, under the rules proposed in this document, a communication is not a grass roots lobbying communication unless the communication's reference to legislation is to "specific legislation." As indicated in this document, this term includes both legislation that has already been introduced in a legislative body and a specific legislative proposal that the organization either supports or opposes.

The rules proposed in this document also indicate that a communication is not a grass roots lobbying communication unless it encourages its recipients to take action with respect to the specific legislation. As indicated in this document, a communication encourages its recipients to take action only if the communication:

(1) states that the recipient should contact a legislator or an employee of a legislative body, or should contact any other government official or employee who may participate in the formulation of legislation (but only if the principal purpose of urging contact with the government official or employee is to influence legislation);

(2) states the address, telephone number, or similar information of a legislator or an employee of a legislative body;

(3) provides a petition, tear-off postcard or similar material for the recipient to communicate his or her views to a legislator or an employee of a legislative body, or to any other government official or employee who may participate in the formulation of legislation (but only if the principal purpose of so facilitating contact with the government official or employee is to influence legislation); or

(4) specifically identifies one or more legislators who will vote on the legislation as: (a) opposing the communication's view with respect to the legislation; (b) being undecided with respect to the legislation; (c) being the recipient's representative in the legislature; or (d) being a member of the legislative committee that will consider the legislation. Encouraging the recipient to take action under this fourth category does not include naming the main sponsor(s) of the legislation for purposes of identifying the legislation.

Communications that are described in categories (1) through (3) above are deemed not only to encourage action with respect to legislation, but also to "directly encourage" action with respect to legislation. This distinction is important because only communications in category (4), which encourage the recipient to take action with respect to legislation without "directly encouraging" such action, may be within the exception for nonpartisan analysis, study or research and, as a result, not be grass roots lobbying communications.

This revised definition is a major modification to the definition proposed in the 1986 NPRM. The lobbying definition contained in this document (with an exception for a limited number of mass media communications discussed below) not only requires that the communication contain a reference to specific legislation, but also requires that the communication both reflect a view with respect to such legislation and encourage the recipient to take action. Under such a definition, communications could advocate or oppose specific legislation and not be considered lobbying, so long as the communications do not encourage the recipients to take action with respect to the legislation. The 1986 NPRM, in contrast, included within the definition of lobbying certain communications that did not encourage the recipient to take action with respect to legislation. Also in contrast to this document's definition, the definition proposed in 1986 provided that a communication not directly taking a position on legislation could be lobbying based upon the selective dissemination of the communication.

The one exception to the above three-part definition of lobbying is a special rule for certain mass media communications. If within two weeks before a vote by a legislative body, or committee thereof, on a highly publicized piece of legislation, an organization makes a communication in the mass media that reflects a view on the general subject of such legislation and either (1) refers to the highly publicized legislation or (2) encourages the public to communicate with their legislators on the general subject of such legislation, then the communication will be presumed to be a grass roots lobbying communication. An organization can rebut this presumption by demonstrating that the communication is a type of communication regularly made by the organization in the mass media without regard to the timing of legislation (that is, a customary course of business exception) or that the timing of the communication was for reasons unrelated to the upcoming legislative action. For purposes of this special rule, the term "mass media" means television, radio, and certain general circulation newspapers and magazines. Any mass media communication that is not made within two weeks before a legislative vote on a highly publicized piece of legislation will be tested by the general three-part test for grass roots lobbying.

Under the proposed regulations, testimony on a bill before a legislative committee, which is often a direct lobbying communication, is not grass roots lobbying merely because the testimony indirectly reached the public through press coverage of the organization's testimony.

In addition to the rules discussed above, numerous examples are provided to assist organizations in evaluating the facts and circumstances of each individual case. In general, those examples amplify the rule that a communication that advocates or opposes specific legislation is generally not a grass roots lobbying communication unless it encourages the recipient to take action with respect to the legislation, such as by requesting recipients to contact legislators or by providing the names of undecided legislators.

As noted above, under the proposed regulations, a communication will be considered to encourage recipients to take action with respect to legislation only if the communication is described in one of the four listed categories. The Service will, however, continue to study communications and, if other methods of encouraging recipients to take action are identified, will propose amendments to the regulations.

In order to achieve the balance between the statutory mandate limiting expenditures for grass roots lobbying and the desire of many charitable organizations to participate in the public policy process, the definition of grass roots lobbying proposed in this document is a less inclusive definition than is permitted by the broad statutory language defining grass roots lobbying. The Service believes that any definition of grass roots lobbying less inclusive than that proposed in this document could, in effect, eliminate the statutory limitation Congress has placed on grass roots lobbying expenditures by electing public charities.

3. *Definition of Direct Lobbying*

Some commentators criticized the definition of direct lobbying contained in the 1986 NPRM in that the definition was based on the grass roots lobbying definition. The primary objections were that the definition considered an otherwise balanced discussion of a piece of legislation to reflect a view on legislation based on the dissemination of the communication, and that the definition did not require the legislation to be pending or imminently to be introduced.

This document proposes to modify the definition of direct lobbying by removing the phrases "pertains to," "seeks or opposes legislation," and "selectively disseminated to persons reasonably expected to share a common view of the legislation." In place of the definition contained in the 1986 NPRM, this document proposes to define the term "direct lobbying communication" to include only those communications to legislators or certain other government officials that (1) refer to specific legislation, and (2) reflect a view on such legislation.

4. *Allocation Rules*

Many commentators expressed concern about the allocation rules proposed in the 1986 NPRM, particularly the special rules relating to advertising, fundraising, and mixed lobbying purposes.

This document revises the proposed allocation rules. Under the allocation rule proposed in this document, a mixed grass roots and direct lobbying expenditure is to be treated as a grass roots expenditure, except to the extent that the organization demonstrates that the expenditure was incurred *primarily* (rather than the *solely* standard contained in the 1986 NPRM) for direct lobbying purposes, in which case a reasonable allocation shall be made between the direct and grass roots lobbying purposes served by the communication.

This document removes the two special rules with respect to fundraising and advertising contained in the 1986 NPRM. For lobbying communications that also serve a bona fide nonlobbying purpose, this document proposes two different allocation rules. Which rule is used depends upon whether the communication is sent primarily to members or nonmembers.

For communications that are sent primarily to bona fide members (that is, for communications sent to more members than nonmembers), an organization must make a reasonable allocation between the amount expended for the lobbying purpose and the amount spent for the nonlobbying purpose. Including as a lobbying expenditure only the amount expended for the specific sentence or sentences that encourage the recipient to action is not considered a reasonable allocation.

For lobbying communications that are not sent primarily to bona fide members, all costs attributable to those parts of the communication that are on the same specific subject as the lobbying message must be included as lobbying expenditures for allocation purposes. Under the rules proposed in this document, however, the costs attributable to parts of a lobbying communication that are not on the same specific subject as the lobbying message are not considered lobbying expenditures. Whether or not a portion of a communication is on the same specific subject as the lobbying message will depend on the surrounding facts and circumstances. In general, a portion of a communication will be on the same specific subject as the lobbying message if that portion discusses an activity that would be directly affected by the proposed legislation that is the subject of the lobbying message. Moreover, discussion of the background or consequences of either the proposed legislation or of an activity directly affected by the proposed legislation will also be considered to be on the same specific subject as the lobbying communication.

5. *Research and Preparation Costs*

Some commentators expressed concern that, under the 1986 NPRM, the research and preparation costs incurred in producing a nonlobbying communication could be treated as a lobbying expenditure because of subsequent use of the communication in a lobbying campaign by that organization, a related organization, or an unrelated organization.

This document attempts to make clear that the costs of researching and preparing nonlobbying communications would be treated as lobbying expenditures only in cases of abuse. Except in such cases, the regulations proposed in this document would not treat as lobbying expenditures the research and preparation costs of a communication that is not itself a lobbying communication merely because the communication was also used in a lobbying campaign.

A communication that reflects a view on specific legislation but that is not a lobbying communication will be treated as a lobbying communication because of subsequent use of the communication in a lobbying effort only if the primary purpose of the organization in preparing the communication was for use in lobbying. The primary purpose of an organization in preparing a document is not lobbying if, prior to or contemporaneously with the use of the communication in lobbying, the organization makes a substantial nonlobbying distribution of the communication.

Where a communication's nonlobbying distribution is not substantial, all of the facts and circumstances must be weighed to determine the organization's primary purpose in preparing the communication. Two factors of particular importance are (1) the relative scope of the nonlobbying and subsequent lobbying distributions, and (2) whether the subsequent lobbying distribution is made by the organization itself, a related organization or an unrelated organization. Where the subsequent distribution is made by an unrelated organization, clear and convincing evidence will be required to establish that the primary purpose for preparing the communication was for use in lobbying.

6. *Communications with Members*

With respect to the exception for an organization's communications with its members, many commentators stated that their organizations have only a mailing list of supporters, without a formal membership, or have a single mailing list that includes both formal members and nonmember supporters.

This document does not revise the proposed definition of membership because the statutory use of the term "bona fide member', combined with the legislative history, indicates Congress intended that the exception for communications with members not include persons simply included on a mailing list or those whose financial support of the organization is in the distant past. However, the proposed regulations relating to communications with members have been slightly modified to reflect the revisions to the definition of direct and grass roots lobbying.

7. *Exception for Nonpartisan Analysis, Study or Research*

Some commentators expressed concern that the statutory exception for nonpartisan analysis should apply to some of the examples under the 1986 NPRM's general definition section for grass roots lobbying.

The section 4945 regulations currently provide that engaging in and making available nonpartisan analysis, study or research does not constitute lobbying. This same exception was included in the 1986 NPRM's proposed section 4911 regulations by cross-reference to the section 4945 regulations. This document proposes to include in the section 4911 regulations the full text of the section 4945 regulations' exception for nonpartisan analysis, study or research, rather than merely a cross-reference to the section 4945 regulations. As requested by the comments, the examples proposed in this document note where the nonpartisan analysis exception clearly applies. As a result of the narrow definition of grass roots lobbying proposed in this document, many communications addressing legislation will not be grass roots lobbying communications. Because fewer communications will be lobbying communications, organizations will not have to depend on the nonpartisan analysis exception to the extent necessary under the 1986 NPRM. That is to say, under the rules proposed in this document, many communications that address legislation will fail to be lobbying communications as a result of the narrow definition of lobbying rather than because of the nonpartisan analysis exception.

The comments received by the Service indicated some confusion regarding the scope of the nonpartisan analysis exception. To remove this confusion, this document proposes to clarify in both the section 4945 and section 4911 regulations that a communication is not within the nonpartisan analysis exception if the communication *directly* encourages recipients of the communication to contact legislators or certain other governmental officials in favor of or in opposition to specific legislation. As stated above, a communication would encourage the recipient to take action with respect to legislation, but not *directly* encourage such action, if the communication does no more than specifically identify legislators as: opposing the communication's view with respect to the legislation; being undecided with respect to the legislation; being the recipient's representative in the legislature; or being a member of the legislative committee that will consider the legislation.

This document proposes an additional amendment to the regulations regarding the nonpartisan analysis, study or research exception. Under the rules proposed in this document, analysis, study or research that reflects a view on specific legislation is not nonpartisan if an organization's primary purpose for undertaking the analysis, study or research is for use in lobbying *and* the analysis, study or research is subsequently used as, or with, a lobbying communication that directly encourages recipients to take action with respect to specific legislation. However, the primary purpose of the organization in undertaking analysis, study or research will not be considered to be lobbying if, prior to or contemporaneously with the use of the analysis, study or research in lobbying, the organization makes a substantial distribution of the analysis, study or research (without an accompanying lobbying message). Whether a distribution is substantial will be determined by reference to all of the facts and circumstances, including the normal distribution pattern of similar nonpartisan analyses, studies, or research.

8. *Exception for Discussion of Broad Social, Economic and Similar Problems*

Some commentators requested that the "discussion of broad social, economic and similar problems" exception to the definition of lobbying be included in the text of the section 4911 regulations (relating to lobbying expenditures by electing public charities). The section 4945 regulations currently provide that discussions of broad social, economic and similar problems are not lobbying activities. This document proposes that the full text of the exception be included in the section 4911 regulations. In response to confusion about the scope of the exception, this document proposes that the exception, for purposes of both section 4945 and section 4911, does not apply where a communication directly encourages recipients of the communication to contact legislators or certain other government officials in favor of or in opposition to specific legislation. Because of the revised definition of grass roots lobbying proposed in this document, many communications will not be grass roots lobbying, and thus very few, if any, communications that actually constitute grass roots lobbying communications will be within the exception for discussion of broad social, economic and similar problems. That is, the revised definition of grass roots lobbying will reduce or eliminate the need for organizations to depend upon the exception for discussion of broad social, economic and similar problems.

9. *Grants by Private Foundations to Electing Public Charities*

Some commentators noted that the 1986 NPRM would expand certain rules relating to restrictions on grants by private foundations to electing public charities beyond the scope of a private letter ruling issued by the Service in 1977. These commentators suggested that the additions to the Service's 1977 private ruling are inappropriate and unnecessary.

With respect to grants by private foundations to electing public charities, this document revises the 1986 NPRM to conform to the Service's 1977 private letter ruling by removing the additional restrictions. Additionally, this document states that a private foundation can rely on the assertions of the grantee regarding the nonlobbying nature of the funded activities, unless the private foundation doubts or, in light of all the facts and circumstances, reasonably should doubt the accuracy or reliability of the documents provided by the grantee.

10. *Effect on 1980 Notice of Proposed Rulemaking*

In the 1980 NPRM, the Service proposed amendments to the regulations on Foundations and Similar Excise Taxes in order to provide clearer guidance to organizations that must comply with the requirements of section 4945, relating to the making of lobbying expenditures by private foundations. Regulations under section 162(e)(2) were also proposed to be amended in that same notice of proposed rulemaking. This document proposes to revise the regulations regarding lobbying by private foundations by conforming them to the regulations governing lobbying by electing public charities. It does not propose any revisions to the regulations under section 162(e)(2).

11. *Rules Regarding Affiliated Organizations*

Several commentators objected to the 1986 NPRM's standard that organizations are affiliated where the governing instruments of the "controlled" organization require that the "controlled" organization "take into account" the position of the "controlling" organization on a legislative issue.

In response to those comments, this document slightly modifies the affiliation rules by removing the "take into account" language and directly tracking the statutory language.

12. *Definition of Term "Separate Fundraising Units."*

Several commentators objected to the use of the term "substantial" in the 1986 NPRM's definition of the term "separate fundraising units." Their objections were with regard to both the term's lack of precision and its expansive scope.

In response to such objections, this document slightly modifies the proposed rule to include only those persons who spend a majority, rather than a substantial part, of their time on fundraising for the organization.

13. *Miscellaneous Technical Revisions*

Finally, some commentators suggested that, for a variety of reasons, certain portions of the proposed regulations needed minor technical changes. In response to those comments, this document proposes several minor technical revisions to the 1986 NPRM. The Service specifically welcomes further comments suggesting any additional technical revisions necessary for proper implementation of the underlying statutes.

Several sections in the regulations have been reserved. This is simply for the convenience of the FEDERAL REGISTER reader.

RULINGS REGARDING APPLICATION OF THE REGULATIONS

Under its ruling program (see Rev. Proc. 83-36, 1983-1 C.B. 763 and Rev. Proc. 88-8, 1988-1 C.B. 628), the Service will consider requests for private letter rulings to clarify the application of these regulations to particular fact patterns.

COMMENTS, REQUESTS TO APPEAR AT THE PUBLIC HEARING, AND OUTLINE OF ORAL COMMENTS TO BE PRESENTED AT THE PUBLIC HEARING

Before adopting these proposed regulations, consideration will be given to any written comments that are submitted (preferably nine copies) to the Commissioner of Internal Revenue. All comments, requests to appear at, and outlines of oral comments to be presented at the public hearing will be available for public inspection and copying. In light of the extensive comments upon and full discussion of the issues in this document since the enactment of the Tax Reform Act of 1976 and the publication of the 1986 NPRM, the Service has scheduled a public hearing to be held on Monday, April 3, 1989, at 10:00 a.m., and continuing, if necessary, at the same time on Tuesday, April, 4, 1989, in the I.R.S. Auditorium, Seventh Floor, 7400 Corridor, Internal Revenue Building, 1111 Constitution Avenue, N.W., Washington, D.C.

SPECIAL ANALYSES

The Commissioner of Internal Revenue has determined that this proposed rule is not a major rule as defined in Executive Order 12291 and that a regulatory impact analysis is therefore not required. Although this document is a notice of proposed rulemaking that solicits public comment, the Internal Revenue Service has concluded that the regulations proposed herein are interpretative and that the notice and public procedure requirements of 5 U.S.C. 553 do not apply. Accordingly, these proposed regulations do not constitute regulations subject to the Regulatory Flexibility Act (5 U.S.C. chapter 6).

SUPERSESSION

These regulations, when published in final form in the Federal Register, will supersede §7.0(c)(4) of the Temporary Income Tax Regulations under the Tax Reform Act of 1976. This document supersedes that portion of the notice of proposed rulemaking published in the Federal Register on November 25, 1980 (45 FR 78167) that proposed amendments to the regulations on Foundations and Similar Excise Taxes (26 CFR Part 53). Where this document proposes to amend any portion of the regulations under Title 26 of the Code of Federal Regulations, the proposed amendment in this document supersedes any proposed amendment of that portion of the regulations that was previously published in the Federal Register on November 5, 1986 (51 FR 40211).

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Proposed Amendments to the Regulations

Accordingly, (I) the proposed amendments to 26 CFR Part 53 that were published on November25, 1980 (45 FR 78167) are withdrawn, and (II) the notice of proposed rulemaking (to amend 26 CFR Parts 1 and 53 and add a new Part 56) that was published on November 5, 1986 (51 FR 40211), is amended, and additional amendments of Part 53 are proposed, as follows:

INCOME TAX REGULATIONS (26 CFR Part 1)

Paragraph 1. The authority citation for Part 1 is amended by adding the following citation:

Authority: 26 U.S.C. 7805. * * * Sections 1.504-1 and 1.504-2 also issued under 26 U.S.C. 504(b).

Par. 2. Proposed §1.501(h)-2 is amended by revising paragraph (b)(2)(vi) to read:

§1.501(h)-2 Electing the expenditure test.

* * * * * *

(b) *Organizations eligible to elect the expenditure test.* * * *

(2) *Certain organizations listed.* * * *

(vi) Section 509(a)(3) (relating to organizations supporting public charities), except that for purposes of this paragraph (b)(2), section 509(a)(3) shall be applied without regard to the last sentence of section 509(a).

* * * * * *

Par. 3. Proposed §1.501(h)-3 is amended by revising paragraph (c)(4) and adding new Examples (4) and (5) to paragraph (e), to read:

§1.501(h)-3 Lobbying or grass roots expenditures normally in excess of ceiling amount.

* * * * * *

(c) *Definitions.* * * *

(4) The term "grass roots expenditures" means expenditures for grass roots lobbying communications as defined in section 4911(c)(3) or section 4911(f)(4)(A) and §§56.4911-2 and 3.

* * * * * *

(e) *Examples.* * * *

Example (4). Organization M made the expenditure test election under section 501(h) effective for taxable years beginning with 1977 and has not revoked the election. M has $500,000 of exempt purpose expenditures during each of the years 1981 through 1984. In addition, during each of those years, M spends $75,000 for direct lobbying and $25,000 for grass roots lobbying. Since the amount expended for M's lobbying (both total lobbying and grass roots lobbying) is within the respective nontaxable expenditure limitations, M is not liable for the 25 percent excise tax imposed under section 4911(a) upon excess lobbying expenditures, nor is M denied tax-exempt status by reason of section 501(h).

Example (5). Assume the same facts as in Example (4), except that, on behalf of M, numerous unpaid volunteers conduct substantial lobbying activities with no reimbursement. Since the substantial lobbying activities of the unpaid volunteers are not counted towards the expenditure limitations and the amount expended for M's lobbying is within the respective nontaxable expenditure limitations, M is not liable for the 25 percent excise tax under section 4911, nor is M denied tax-exempt status by reason of section 501(h).

FOUNDATION AND SIMILAR EXCISE TAXES(26 CFR Part 53)

Par. 4. The authority citation for Part 53 continues to read in part:

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

Par. 5. Section 53.4945-2 is amended as follows:

1. Paragraph (a)(1) is revised, paragraph (a)(2) is removed and reserved, proposed paragraph (a)(6) is revised, and, in proposed paragraph (a)(7)(ii), Examples (1), (2), and (3) are revised and new Examples(10) through (13) are added, and the introductory text is republished to read as set forth below.

2. Paragraphs (b) and (c) are removed and reserved.

3. Paragraph (d)(1)(i) is revised to read as set forth below.

4. In paragraph (d)(1)(iv), the last sentence is revised to read as set forth below.

5. Paragraph (d)(1)(v), *Examples*, is redesignated as paragraph (d)(1)(vii), Examples (4) and (5) are revised, and new Examples (8) through (11) are added, to read as set forth below.

6. New paragraphs (d)(1)(v) and (d)(1)(vi) are added, to read as set forth below.

7. Paragraph (d)(4) is revised to read as set forth below.

§53.4945-2 Propaganda influencing legislation.

(a) *Propaganda influencing legislation, etc.*—(1) *In general.* Under section 4945(d)(1) the term "taxable expenditure" includes any amount paid or incurred by a private foundation to carry on propaganda, or otherwise to attempt, to influence legislation. An expenditure is an attempt to influence legislation if it is for a direct or grass roots lobbying communication, as defined in §56.4911-2 (without reference to §§56.4911-2(b)(3) and 56.4911-2(c)) and §56.4911-3. See, however, paragraph (d) of this section for exceptions to the general rule of this paragraph (a)(1).

(2) [Reserved]

* * * * * *

(6) *Grants to public organizations that attempt to influence legislation*—(i) *General Support Grant.* A general support grant by a private foundation to an organization described in section 509(a)(1), (2), or (3) (a "public charity" for purposes of paragraphs (a)(6) and (7) of this section) does not constitute a taxable expenditure under section 4945(d)(1) to the extent that the grant is not earmarked, within the meaning of §53.4945-2(a)(5)(i), to be used in an attempt to influence legislation. The preceding sentence applies without regard to whether the public charity has made the election under section 501(h).

(ii) *Specific Project Grant.* A grant by a private foundation to fund a specific project of a public charity is not a taxable expenditure by the foundation under section 4945(d)(1) to the extent that—

(A) The grant is not earmarked, within the meaning of §53.4945-2(a)(5)(i), to be used in an attempt to influence legislation, and

(B) The amount of the grant, together with other grants by the same private foundation for the same project for the same year, does not exceed the amount budgeted, for the year of the grant, by the grantee organization for activities of the project that are not attempts to influence legislation. If the grant is for more than one year, the preceding sentence applies to each year of the grant with the amount of the grant divided equally between years, or as otherwise actually disbursed by the private foundation. This paragraph (a)(6)(ii) applies without regard to whether the public charity has made the election under section 501(h).

(iii) *Reliance upon grantee's budget.* For purposes of determining the amount budgeted by a prospective grantee for specific project activities that are not attempts to influence legislation under paragraph (a)(6)(ii) of this section, a private foundation may rely on budget documents or other sufficient evidence supplied by the grantee organization (such as a signed statement by an authorized officer, director or trustee of such grantee organization) showing the proposed budget of the specific project, unless the private foundation doubts or, in light of all the facts and circumstances, reasonably should doubt the accuracy or reliability of the documents.

(7) *Grants to organizations that cease to be described in 501(c)(3)*— * * *

(ii) *Examples.* The provisions of paragraphs (a)(6) and (a)(7) of this section are illustrated by the following examples:

Example (1). W, a private foundation, makes a general support grant to Z, a public charity described in section 509(a)(1). Z informs W that, as an insubstantial portion of its activities, Z attempts to influence the State legislature with regard to changes in the mental health laws. The use of the grant is not earmarked by W to be used in a manner that would violate section 4945(d)(1). Even if the grant is subsequently devoted by Z to its legislative activities, the grant by W is not a taxable expenditure under section 4945(d).

Example (2). X, a private foundation, makes a specific project grant to Y University for the purpose of conducting research on the potential environmental effects of certain pesticides. X does not earmark the grant for any purpose that would violate section 4945(d)(1) and there is no oral or written agreement or understanding whereby X may cause Y to engage in any activity described in section 4945(d)(1), (2), or (5), or to select any recipient to which the grant may be devoted. Further, X determines, based on budget information supplied by Y, that Y's budget for the project does not contain any amount for attempts to influence legislation. X has no reason to doubt the accuracy or reliability of the budget information. Y uses most of the funds for the research project; however, Y expends a portion of the grant funds to send a representative to testify at Congressional hearings on a specific bill proposing certain pesticide control measures. The portion of the grant funds expended with respect to the Congressional hearings is not treated as a taxable expenditure by X under section 4945(d)(1).

Example (3). M, a private foundation, makes a specific project grant of $150,000 to P, a public charity described in section 509(a)(1). In requesting the grant from M, P stated that the total budgeted cost of the project is $200,000, and that of this amount $20,000 is allocated to attempts to influence legislation related to the project. M relies on the budget figures provided by P in determining the amount P will spend on influencing legislation and M has no reason to doubt the accuracy or reliability of P's budget figures. In making the grant, M did not earmark any of the funds from the grant to be used for attempts to influence legislation. M's grant of $150,000 to P will not constitute a taxable expenditure under section 4945(d)(1) because M did not earmark any of the funds for attempts to influence legislation and because the amount of its grant ($150,000) does not exceed the amount allocated to specific project activities that are not attempts to influence legislation ($200,000 − $20,000 = $180,000).

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Example (10). X, a private foundation, makes a specific project grant to Y, a public charity described in section 509(a). In requesting the grant, Y stated that it planned to use the funds to purchase a computer for purposes of computerizing its research files and that the grant will not be used to influence legislation. Two years after X makes the grant, X discovers that Y has also used the computer for purposes of maintaining and updating the mailing list for Y's lobbying newsletter. Because X did not earmark any of the grant funds to be used for attempts to influence legislation and because X had no reason to doubt the accuracy or reliability of Y's documents representing that the grant would not be used to influence legislation, X's grant is not treated as a taxable expenditure.

Example (11). G, a private foundation, makes a specific project grant of $300,000 to L, a public charity described in section 509(a)(1) for a three-year specific project studying child care problems. L provides budget material indicating that the specific project will expend $200,000 in each of three years. L's budget materials indicate that attempts to influence legislation will amount to $10,000 in the first year, $20,000 in the second year and $100,000 in the third year. G intends to pay its $300,000 grant over three years as follows: $200,000 in the first year, $50,000 in the second year and $50,000 in the third year. Since the amount of the grant in each of the three years, when divided equally between the three years ($100,000 for each year), is not more than the nonlobbying expenditures of L on the specific project for any of the three years, none of the grant is treated as a taxable expenditure under section 4945(d)(1).

Example (12). P, a private foundation, makes a $120,000 specific project grant to C, a public charity described in section 509(a) for a three-year project. P intends to pay its grant to C in three equal annual installments of $40,000. C provides budget material indicating that the specific project will expend $100,000 in each of three years. C's budget materials, which P reasonably does not doubt, indicate that the project's attempts to influence legislation will amount to $50,000 in each of the three years. After P pays the first annual installment to C, but before P pays the second installment to C, reliable information comes to P's attention that C has spent $90,000 of the project's $100,000 first-year budget on attempts to influence legislation. This information causes P to doubt the accuracy and reliability of C's budget materials. Because of the information, P does not pay the second-year installment to C. P's payment of the first installment of $40,000 is not a taxable expenditure under section 4945(d)(1) because the grant in the first year is not more than the nonlobbying expenditures C projected in its lobbying materials that P reasonably did not doubt.

Example (13). Assume the same facts as in Example (12), except that P pays the second-year installment of $40,000 to C. In the project's second year, C once again spends $90,000 of the project's $100,000 annual budget in attempts to influence legislation. Because P doubts or reasonably should doubt the accuracy or reliability of C's budget materials when P makes the second-year grant payment, P may not rely upon C's budget documents at that time. Accordingly, although none of the $40,000 paid in the first installment is a taxable expenditure, only $10,000 ($100,000 minus $90,000) of the second-year grant payment is not a taxable expenditure. The remaining $30,000 of the second installment is a taxable expenditure within the meaning of section 4945(d)(1).

* * * * * *

(b) [Reserved]

(c) [Reserved]

(d) * * *

(1) * * *

(i) *In general.* A communication is not a direct lobbying communication described in §56.4911-2(b)(1) or a grass roots lobbying communication described in §56.4911-2(b)(2) if the communication constitutes engaging in nonpartisan analysis, study or research and making available to the general public or a segment or members thereof or to governmental bodies, officials, or employees the results of such work. Accordingly, an expenditure for such a communication does not constitute a taxable expenditure under section 4945(d)(1) and §53.4945-2(a)(1).

(ii) * * *

(iii) * * *

(iv) *Making available results of nonpartisan analysis, study, or research.* * * * For purposes of this paragraph (d)(1)(iv), such communications may not be limited to, or be directed toward, persons who are interested solely in one side of a particular issue.

(v) *Subsequent lobbying use of nonpartisan analysis, study or research.* For purposes of this paragraph, a nonlobbying communication is any communication that reflects a view on specific legislation but that is not a lobbying communication as described in §56.4911-2(b). This §56.4945-2(d)(1)(v) governs any nonlobbying communication that is nonpartisan analysis, study or research (within the meaning of §56.4945-2(d)(1)) *and* that is: subsequently used with an accompanying lobbying communication that directly encourages recipients to take action with respect to legislation; or subsequently altered so that it is itself a lobbying communication that directly encourages recipients to take action with respect to legislation. In such a case, the communication is not within the exception for nonpartisan analysis, study or research and will be treated as a lobbying communication if the organization's primary purpose in preparing the communication was for use in lobbying; consequently, the expenses of preparing and distributing the communication will be treated as lobbying expenditures. The primary purpose of the organization in undertaking analysis, study, or research will not be considered to be for use in lobbying if, prior to or contemporaneously with the use of the analysis, study, or research in lobbying, the organization makes a substantial distribution of the analysis, study, or research (without an accompanying lobbying message). Whether a distribution is substantial will be determined by reference to all of the facts and circumstances, including the normal distribution pattern of similar nonpartisan analyses, studies, or research. Where the nonlobbying distribution of a communication governed by this paragraph is not substantial, all of the facts and circumstances must be weighed to determine whether the organization's primary purpose in preparing the communication was for use in lobbying. While not the only factor, the extent of the organization's nonlobbying distribution of the communication is particularly relevant, especially when compared to the extent of the communication's distribution with the lobbying message. Another particularly relevant factor is whether the subsequent lobbying use of a communication is by the organization that prepared the document, a related organization, or an unrelated organization. Where the subsequent lobbying distribution is made by an unrelated organization, clear and convincing evidence will be required to establish that the primary purpose for preparing the communication was for use in lobbying.

(vi) *Directly encouraging action by recipients of a communication.* A communication that reflects a view on specific legislation is not within the nonpartisan analysis, study or research exception of this §53.4945-2(d)(1) if the communication directly encourages the recipient to take action with respect to such legislation. For purposes of this section, a communication directly encourages the recipient to take action with respect to legislation if the communication is described in §56.4911-2(b)(2)(iii)-(A) through (C). As described in §56.4911-2(b)(2)(iv), a communication would encourage the recipient to take action with respect to legislation, but not *directly* encourage such action, if the communication does no more than specifically identify one or more legislators who will vote on the legislation as: opposing the communication's view with respect to the legislation; being undecided with respect to the legislation; being the recipient's representative in the legislature; or being a member of the legislative committee that will consider the legislation.

(vii) *Examples.* * * *

Example (4). P publishes a bi-monthly newsletter to collect and report all published materials, ongoing research, and new developments with regard to the use of pesticides in raising crops. The newsletter also includes notices of proposed pesticide legislation with impartial summaries of the provisions and debates on such legislation. The newsletter does not encourage recipients to take action with respect to such legislation, but is designed to present information on both sides of the legislative controversy and does present such information fully and fairly. It is within the exception for nonpartisan analysis, study, or research.

Example (5). X is satisfied that A, a member of the faculty of Y University, is exceptionally well qualified to undertake a project involving a comprehensive study of the effects of pesticides on crop yields. Consequently, X makes a grant to A to underwrite the cost of the study and of the preparation of a book on the effect of pesticides on crop yields. X does not take any position on the issues or control the content of A's output. A produces a book which concludes that the use of pesticides often has a favorable effect on crop yields, and on that basis argues against pending bills which would ban the use of pesticides. A's book contains a sufficiently full and fair exposition of the pertinent facts, including known or potential disadvantages of the use of pesticides, to enable the public or an individual to form an independent opinion or conclusion as to whether pesticides should be banned as provided in the pending bills. The book does not directly encourage readers to take action with respect to the pending bills. Consequently, the book is within the exception for nonpartisan analysis, study, or research.

Example (6). * * *

Example (7). * * *

Example (8). Organization Z researches, writes, prints and distributes a study on the use and effects of pesticide X. A bill is pending in the U.S. Senate to ban the use of pesticide X. Z's study leads to the conclusion that pesticide X is extremely harmful and that the bill pending in the U.S. Senate is an appropriate and much needed remedy to solve the problems caused by pesticide X. The study contains a sufficiently full and fair exposition of the pertinent facts, including known or potential advantages of the use of pesticide X, to enable the public or an individual to form an independent opinion or conclusion as to whether pesticides should be banned as provided in the pending bills. In its analysis of the pending bill, the study names certain undecided Senators on the Senate committee considering the bill. Although the study meets the three part test for determining whether a communication is a grass roots lobbying communication, the study is within the exception for nonpartisan analysis, study or research, because it does not directly encourage recipients of the communication to urge a legislator to oppose the bill.

Example (9). Assume the same facts as in Example (8), except that, after stating support for the pending bill, the study concludes: "You should write to the undecided committee members to support this crucial bill." The study is not within the exception for nonpartisan analysis, study or research because it directly encourages the recipients to urge a legislator to support a specific piece of legislation.

Example (10). Organization X plans to conduct a lobbying campaign with respect to illegal drug use in the United States. It incurs $5,000 in expenses to conduct research and prepare an extensive report primarily for use in the lobbying campaign. Although the detailed report discusses specific pending legislation and reaches the conclusion that the legislation would reduce illegal drug use, the report contains a sufficiently full and fair exposition of the pertinent facts to enable the public or an individual to form an independent conclusion regarding the effect of the legislation. The report does not encourage readers to contact legislators regarding the legislation. Accordingly, the report does not, in and of itself, constitute a lobbying communication.

Copies of the report are available to the public at X's office, but X does not actively distribute the report or otherwise seek to make the contents of the report available to the general public. Whether or not X's distribution is sufficient to meet the requirement in §53.4945-2(d)(1)(iv) that a nonpartisan communication be made available, X's distribution is not substantial (for purposes of §53.4945-2(d)(1)(v)) in light of all of the facts and circumstances, including the normal distribution pattern of similar nonpartisan reports. X then mails copies of the report, along with a letter, to 10,000 individuals on X's mailing list. In the letter, X requests that individuals contact legislators urging passage of the legislation discussed in the report. Because X's research and report were primarily undertaken by X for lobbying purposes and X did not make a substantial distribution of the report (without an accompanying lobbying message) prior to or contemporaneously with the use of the report in lobbying, the report is a grass roots lobbying communication that is not within the exception for nonpartisan analysis, study or research. Thus, the expenditures for preparing and mailing both the report and the letter are taxable expenditures under section 4945.

Example (11). Assume the same facts as in Example (10), except that before using the report in the lobbying campaign, X sends the research and report (without an accompanying lobbying message) to universities and newspapers. At the same time, X also advertises the availability of the report in its newsletter. This distribution is similar in scope to the normal distribution pattern of similar nonpartisan reports. In light of all of the facts and circumstances, X's distribution of the report is substantial. Because of X's substantial distribution of the report, X's primary purpose will be considered to be other than for use in lobbying and the report will not be considered a grass roots lobbying communication. Accordingly, only the expenditures for copying and mailing the report to the 10,000 individuals on X's mailing list, as well as for preparing and mailing the letter, are expenditures for grass roots lobbying communications, and are thus taxable expenditures under section 4945.

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(4) *Examinations and discussions of broad social, economic, and similar problems.* Examinations and discussions of broad social, economic, and similar problems are neither direct lobbying communications under §56.4911-2(b)(1) nor grass roots lobbying communications under §56.4911-2(b)(2) even if the problems are of the type with which government would be expected to deal ultimately. Thus, under §§56.4911-2(b)(1) and (2), lobbying communications do not include public discussion, or communications with members of legislative bodies or governmental employees, the general subject of which is also the subject of legislation before a legislative body, so long as such discussion does not address itself to the merits of a specific legislative proposal and so long as such discussion does not directly encourage recipients to take action with respect to legislation. For example, this paragraph excludes from grass roots lobbying under §56.4911-2(b)(2) an organization's discussions of problems such as environmental pollution or population growth that are being considered by Congress and various State legislatures, but only where the discussions are not directly addressed to specific legislation being considered, and only where the discussions do not directly encourage recipients of the communication to contact a legislator, an employee of a legislative body, or a government official or employee who may participate in the formulation of legislation.

PUBLIC CHARITY EXCISE TAXES (Proposed 26 CFR Part 56)

Par. 6. Proposed §§56.4911-1 through 56.4911-3 are revised to read:

§56.4911-1 Tax on excess lobbying expenditures.

(a) *In general.* Section 4911(a) imposes an excise tax of 25 percent on the excess lobbying expenditures (as defined in paragraph (b) of this section) for a taxable year of an organization for which the expenditure test election under section 501(h) is in effect. The limit on expenditures for influencing legislation on which no tax is due from an organization for a taxable year is the lobbying nontaxable amount, or, on expenditures for influencing legislation through grass roots lobbying, the grass roots nontaxable amount (see paragraph (c) of this section). For rules concerning the application of the excise tax imposed by section 4911(a) to the members of an affiliated group of organizations (as defined in §56.4911-7(e)), see §56.4911-8.

(b) *Excess lobbying expenditures.* For any taxable year for which the expenditure test election under section 501(h) is in effect, the amount of an organization's excess lobbying expenditures is the greater of—

(1) The amount by which the organization's lobbying expenditures (within the meaning of §56.4911-2(a)) exceed the organization's lobbying nontaxable amount, or

(2) The amount by which the organization's expenditures for grass roots lobbying communications (within the meaning of §§56.4911-2 and -3)) exceed the organization's grass roots nontaxable amount.

(c) *Nontaxable amounts*—(1) *Lobbying nontaxable amount.* Under section 4911(c)(2), the lobbying nontaxable amount for any taxable year for which the expenditure test election is in effect is the lesser of—

(i) $1,000,000, or

(ii) To the extent of the organization's exempt purpose expenditures (within the meaning of §56.4911-4) for that year, the sum of 20 percent of the first $500,000 of such expenditures, plus 15 percent of the second $500,000 of such expenditures, plus 10 percent of the third $500,000 of such expenditures, plus 5 percent of the remainder of such expenditures.

(2) *Grass roots nontaxable amount.* Under section 4911(c)(4), an organization's grass roots nontaxable amount for any taxable year is 25 percent of its lobbying nontaxable amount for that year.

(d) *Examples.* The provisions of this section are illustrated by the examples in §1.501(h)-3.

§56.4911-2 Lobbying expenditures, direct lobbying communications, and grass roots lobbying communications.

(a) *Lobbying expenditures.* If an organization has in effect for any year the expenditure test election under section 501(h), its lobbying expenditures for that year are the sum of its expenditures during that year for direct lobbying communications ("direct lobbying expenditures") plus its expenditures during that year for grass roots lobbying communications ("grass roots expenditures").

(b) *Influencing legislation: direct and grass roots lobbying communications defined*—(1) *Direct lobbying communication*—(i) *Definition.* A direct lobbying communication is any attempt to influence any legislation through communication with:

(A) any member or employee of a legislative body; or

(B) any government official or employee (other than a member or employee of a legislative body) who may participate in the formulation of the legislation, but only if the principal purpose of the communication is to influence legislation.

(ii) *Required elements.* A communication with a legislator or government official will be treated as a direct lobbying communication under this §56.4911-2(b)(1) only if the communication:

(A) refers to specific legislation; and

(B) reflects a view on such legislation.

(iii) *Definition of specific legislation.* For purposes of paragraphs (b)(1) and (b)(2) of this section, specific legislation includes both legislation that has already been introduced in a legislative body and a specific legislative proposal that the organization either supports or opposes.

(2) *Grass roots lobbying communication*—(i) *Definition.* A grass roots lobbying communication is any attempt to influence any legislation through an attempt to affect the opinions of the general public or any segment thereof.

(ii) *Required elements.* A communication will be treated as a grass roots lobbying communication under this §56.4911-2(b)(2) only if the communication:

(A) Refers to specific legislation;

(B) Reflects a view on such legislation; and

(C) Encourages the recipient of the communication to take action with respect to such legislation.

(For special rules regarding certain mass media communications, see §56.4911-2(b)(5)).

(iii) *Definition of encouraging recipient to take action.* For purposes of this section, encouraging a recipient to take action with respect to legislation means that the communication:

(A) States that the recipient should contact a legislator or an employee of a legislative body, or should contact any other government official or employee who may participate in the formulation of legislation (but only if the principal purpose of urging contact with the government official or employee is to influence legislation);

(B) States the address, telephone number, or similar information of a legislator or an employee of a legislative body;

(C) Provides a petition, tear-off postcard or similar material for the recipient to communicate his or her views to a legislator or an employee of a legislative body, or to any other government official or employee who may participate in the formulation of legislation (but only if the principal purpose of so facilitating contact with the government official or employee is to influence legislation); or

(D) Specifically identifies one or more legislators who will vote on the legislation as: opposing the communication's view with respect to the legislation; being undecided with respect to the legislation; being the recipient's representative in the legislature; or being a member of the legislative committee that will consider the legislation. Encouraging the recipient to take action under this paragraph (D) does not include naming the main sponsor(s) of the legislation for purposes of identifying the legislation.

(iv) *Definition of directly encouraging recipient to take action.* Communications described in §§56.4911-2(b)(2)(iii)(A) through (C) not only "encourage," but also "directly encourage" the recipient to take action with respect to legislation. Communications described in §56.4911-2(b)(2)(iii)(D), however, do not directly encourage the recipient to take action with respect to legislation. Thus, a communication would encourage the recipient to take action with respect to legislation, but not *directly* encourage such action, if the communication does no more than identify one or more legislators who will vote on the legislation as: opposing the communication's view with respect to the legislation; being undecided with respect to the legislation; being the recipient's representative in the legislature; or being a member of the legislative committee that will consider the legislation. Communications that encourage the recipient to take action with respect to legislation but that do not *directly* encourage the recipient to take action with respect to legislation may be within the exception for nonpartisan analysis, study or research (see §56.4911-2(c)(1)) and thus not be grass roots lobbying communications.

(v) *Subsequent lobbying use of nonlobbying communication that is not nonpartisan analysis, study or research.* For purposes of this paragraph, a nonlobbying communication is any communication that reflects a view on specific legislation but that is not a lobbying communication as described in §56.4911-2(b). This §56.4911-2(b)(2)(v) governs any nonlobbying communication that is not nonpartisan analysis, study or research (within the meaning of §56.4911-2(c)(1)) *and* that is subsequently used with an accompanying lobbying communication or is altered so that it is itself a lobbying communication. In such a case, the communication will be treated as a lobbying communication if the organization's primary purpose in preparing the communication was for use in lobbying, and the expenses of preparing and distributing the communication will be treated as lobbying expenditures. The primary purpose of the organization in preparing a communication governed by this paragraph will not be considered to be for use in lobbying if, prior to or contemporaneously with the use of the communication in lobbying, the organization makes a substantial distribution of the communication (without an accompanying lobbying message). Whether a distribution is substantial will be determined by reference to all of the facts and circumstances. Solely for purposes of this paragraph (v), the nonlobbying distribution of a communication will not be considered "substantial" unless that distribution is at least as extensive as the lobbying distribution of the communication. Where the nonlobbying distribution of a communication governed by this paragraph is not substantial, all of the facts and circumstances must be weighed to determine whether the organization's primary purpose in preparing the communication was for use in lobbying. While not the only factor, the extent of the organization's nonlobbying distribution of the communication is particularly relevant, especially when compared to the extent of the communication's distribution with the lobbying message. Another particularly relevant factor is whether the lobbying use of a communication is by the organization that prepared the document, a related organization, or an unrelated organization. Where the subsequent lobbying distribution is made by an unrelated organization, clear and convincing evidence will be required to establish that the primary purpose for preparing the communication was for use in lobbying. To illustrate this paragraph, assume a nonlobbying "report" (that is not nonpartisan analysis, study or research) is prepared by an organization, but distributed to only 50 people. The organization then sends the report to 10,000 people along with a letter urging recipients to write their Senators about the legislation discussed in the report. Because the report's nonlobbying distribution is not as extensive as its lobbying distribution, the report's nonlobbying distribution is not substantial for purposes of this paragraph. Accordingly, the organization's primary purpose in preparing the report must be determined by weighing all of the facts and circumstances. In light of the relatively minimal nonlobbying distribution and the fact that the lobbying distribution is by the preparing organization rather than by an unrelated organization, and in the absence of evidence to the contrary, both the report and the letter are grass roots lobbying communications. Accordingly, the organization's expenditures for preparing and mailing the two documents are grass roots lobbying expenditures.

(3) *Exceptions to the definition of influencing legislation.* A communication is not a direct or grass roots lobbying communication under §56.4911-2(b)(1) or (2) if it falls within one of the exceptions listed in paragraph (c) of this section. See paragraph (c)(1), Nonpartisan analysis, study or research; paragraph (c)(2), Examinations and discussions of broad social, economic and similar problems; paragraph (c)(3), Requests for technical advice; and paragraph (c)(4), Communications pertaining to self-defense by the organization. In addition, see §56.4911-5, which provides special rules regarding the treatment of certain lobbying communications directed in whole or in part to members of an electing public charity.

(4) *Examples.* This paragraph (b)(4) provides examples to illustrate the rules set forth in this section regarding direct and grass roots lobbying. Except where otherwise explicitly stated, the expenditure test election under section 501(h) is assumed to be in effect for all organizations discussed in the examples in this paragraph (b)(4). In addition, it is assumed that the special rules of §56.4911-5, regarding certain of a public charity's communications with its members, do not apply to any of the examples in this paragraph (b)(4).

(i) *Direct lobbying.* The provisions of this section regarding direct lobbying communications are illustrated by the following examples:

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

Example (2). Organization M's president writes a letter to the Congresswoman representing the district in which M is headquartered, requesting that the Congresswoman write an administrative agency regarding proposed regulations recently published by that agency. M's president also requests that the Congresswoman's letter to the agency state the Congresswoman's support of M's application for a particular type of permit granted by the agency. The letter written by M's president is not a direct lobbying communication.

Example (3). Organization Z prepares a paper on a particular state's environmental problems. The paper does not reflect a view on any specific pending legislation or on any specific legislative proposal that Z either supports or opposes. Z's representatives give the paper to a state legislator. Z's paper is not a direct lobbying communication.

Example (4). State X enacts a statute that requires the licensing of all day care providers. Agency B in State X is charged with preparing rules to implement the bill enacted by State X. One week after enactment of the bill, organization C sends a letter to Agency B providing detailed proposed rules that organization C suggests to Agency B as the appropriate standards to follow in implementing the statute on licensing of day care providers. Organization C's letter to Agency B is not a lobbying communication.

Example (5). Organization B researches, prepares and prints a code of standards of minimum safety requirements in an area of common electrical wiring. Organization B sells the code of standards booklet to the public and it is widely used by professionals in the subject area. A number of states have codified all, or part, of the code of standards as mandatory safety standards. On occasion, B lobbies state legislators for passage of the code of standards for safety reasons. The research, preparation, printing and public distribution of the code of standards is not an expenditure for a direct (or grass roots) lobbying communication. Costs incurred in lobbying state legislators for passage of the code of standards into law are expenditures for direct lobbying communications.

Example (6). On the organization's own initiative, representatives of organization F present written testimony to a Congressional committee. The news media reports on the testimony of organization F, detailing F's opposition to a pending bill. The testimony is a direct lobbying communication but is not a grass roots lobbying communication.

(ii) *Grass roots lobbying.* The provisions of this section regarding grass roots lobbying communications are illustrated in paragraph (b)(4)(ii)(A) of this section by examples of communications that are not grass roots lobbying communications and in paragraph (b)(4)(ii)(B) by examples of communications that are grass roots lobbying communications. The provisions of this section are further illustrated in paragraph (b)(4)(ii)(C), with particular regard to the exception for nonpartisan analysis, study, or research:

(A) *Communications that are not grass roots lobbying communications.*

Example (1). Organization L places in its newsletter an article that asserts that lack of new capital is hurting State W's economy. The article recommends that State W residents either invest more in local businesses or increase their savings so that funds will be available to others interested in making investments. The article is an attempt to influence opinions with respect to a general problem that might receive legislative attention and is distributed in a manner so as to reach and influence many individuals. However, the article does not refer to specific legislation that is pending in a legislative body, nor does the article refer to a specific legislative proposal the organization either supports or opposes.

Example (2). Assume the same facts as Example (1), except that the article refers to a bill pending in State W's legislature that is intended to provide tax incentives for private savings. The article praises the pending bill and recommends that it be enacted. However, the article does not encourage readers to take action with respect to the legislation.

Example (3). Organization B sends a letter to all persons on its mailing list. The letter includes an update on numerous environmental issues with a discussion of general concerns regarding pollution, proposed federal regulations affecting the area, and several pending legislative proposals. The letter endorses two pending bills and opposes another pending bill, but does not name any legislator involved (other than the sponsor of one bill, for purposes of identifying the bill), nor does it otherwise encourage the reader to take action with respect to the legislation.

Example (4). A pamphlet distributed by organization Z discusses the dangers of drugs and encourages the public to send their legislators a coupon, printed with the statement "I support a drug-free America." The term "drug-free America" is not widely identified with any of the many specific pending legislative proposals regarding drug issues. The pamphlet does not refer to any of the numerous pending legislative proposals, nor does the organization support or oppose a specific legislative proposal.

Example (5). A pamphlet distributed by organization B encourages readers to join an organization and "get involved in the fight against drugs." The text states, in the course of a discussion of several current drug issues, that organization B supports a specific bill before Congress that would establish an expanded drug control program. The pamphlet does not encourage readers to communicate with legislators about the bill (such as by including the names of undecided or opposed legislators).

Example (6). Organization E, an environmental organization, routinely summarizes in each edition of its newsletter the new environment-related bills that have been introduced in Congress since the last edition of the newsletter. The newsletter identifies each bill by a bill number and the name of the legislation's sponsor. The newsletter also reports on the status of previously introduced environment-related bills. The summaries and status reports do not encourage recipients of the newsletter to take action with respect to legislation, as described in paragraphs (b)(2)(iii)(A) through (D) of this section. Although the summaries and status reports refer to specific legislation and often reflect a view on such legislation, they do not encourage the newsletter recipients to take action with respect to such legislation.

(B) *Communications that are grass roots lobbying communications.*

Example (1). A pamphlet distributed by organization Y states that the "President's plan for a drug-free America," which will establish a drug control program, should be passed. The pamphlet encourages readers to "write or call your senators and representatives and tell them to vote for the President's plan." No legislative proposal formally bears the name "President's plan for a drug-free America," but that and similar terms have been widely used in connection with specific legislation pending in Congress that was initially proposed by the President. Thus, the pamphlet refers to specific legislation, reflects a view on the legislation, and encourages readers to take action with respect to the legislation.

Example (2). Assume the same facts as in Example (1), except that the pamphlet does not encourage the public to write or call representatives, but does list the members of the committee that will consider the bill.

Example (3). Assume the same facts as in Example (1), except that the pamphlet encourages readers to "write the President to urge him to make the bill a top legislative priority" rather than encouraging readers to communicate with members of Congress.

Example (4). Organization B, a nonmembership organization, includes in one of three sections of its newsletter an endorsement of two pending bills and opposition to another pending bill and also identifies several legislators as undecided on the three bills. The section of the newsletter devoted to the three pending bills is a grass roots lobbying communication.

Example (5). Organization D, a nonmembership organization, sends a letter to all persons on its mailing list. The letter includes an extensive discussion concluding that a significant increase in spending for the Air Force is essential in order to provide an adequate defense of the nation. Prior to a concluding fundraising request, the letter encourages readers to write their Congressional representatives urging increased appropriations to build the B-1 bomber.

Example (6). State Y plans to conduct a binding voter referendum on a proposition to permit gambling in the state. Organization Z places an advertisement in a general circulation newspaper encouraging voters to vote against the proposition.

Example (7). Organization F mails letters requesting that each recipient contribute money to or join F. In addition, the letters express F's opposition to a pending bill that is to be voted upon by the U.S. House of Representatives. Although the letters are form letters sent as a mass mailing, each letter is individualized to report to the recipient the name of the recipient's congressional representative.

(C) *Additional examples.*

Example (1). The newsletter of an organization concerned with drug issues is circulated primarily to individuals who are not members of the organization. A story in the newsletter reports on the prospects for passage of a specifically identified bill, stating that the organization supports the bill. The newsletter story identifies certain legislators as undecided, but does not state that readers should contact the undecided legislators. The story does not provide a full and fair exposition sufficient to qualify as nonpartisan analysis, study or research. The newsletter story is a grass roots lobbying communication.

Example (2). Assume the same facts as in Example (1), except that the newsletter story provides a full and fair exposition sufficient to qualify as nonpartisan analysis, study or research. The newsletter story is *not* a grass roots lobbying communication because it is within the exception for nonpartisan analysis, study or research.

Example (3). Assume the same facts as in Example (2), except that the newsletter story explicitly asks readers to contact the undecided legislators. Because the newsletter story directly encourages readers to take action with respect to the legislation, the newsletter story is not within the exception for nonpartisan analysis, study or research. Accordingly, the newsletter story is a grass roots lobbying communication.

Example (4). Assume the same facts as in Example (1), except that the story does not identify any undecided legislators. The story is not a grass roots lobbying communication.

Example (5). X organization places an advertisement that specifically identifies and opposes a bill that X asserts would harm the farm economy. The advertisement is not a mass media communication described in §56.4911-2(b)(5)(ii) and does not directly encourage readers to take action with respect to the bill. However, the advertisement does state that Senator Y favors the legislation. Because the advertisement refers to and reflects a view on specific legislation, and also encourages the readers to take action with respect to the legislation by specifically identifying a legislator who opposes X's views on the legislation, the advertisement is a grass roots lobbying communication.

Example (6). Assume the same facts as in Example (5), except that instead of identifying Senator Y as favoring the legislation, the advertisement identifies the "junior Senator from State Z" as favoring the legislation. The advertisement is a grass roots lobbying communication.

Example (7). Assume the same facts as in Example (5), except that instead of identifying Senator Y as favoring the legislation, the advertisement states: "Even though this bill will have a devastating effect upon the farm economy, most of the Senators from the Farm Belt states are inexplicably in favor of the bill." The advertisement does not specifically identify one or more legislators as opposing the advertisement's view on the bill in question. Accordingly, the advertisement is not a grass roots lobbying communication because it does not encourage readers to take action with respect to the legislation.

(5) *Mass media communications*—(i) *In general.* All mass media communications, other than those described in paragraph (b)(5)(ii) of this section, are evaluated by the three-part grass roots lobbying definition contained in paragraph (b)(2) of this section.

(ii) *Special rule for certain mass media communications.* If within two weeks before a vote by a legislative body, or committee thereof, on a highly publicized piece of legislation, an organization makes a communication in the mass media that reflects a view on the general subject of such legislation and either: refers to the highly publicized legislation; or encourages the public to communicate with legislators on the general subject of such legislation, then the communication will be presumed to be a grass roots lobbying communication. An organization can rebut this presumption by demonstrating that the communication is a type of communication regularly made by the organization in the mass media without regard to the timing of legislation (that is, a customary course of business exception) or that the timing of the communication was unrelated to the upcoming legislative action. Notwithstanding the fact that an organization successfully rebuts the presumption, a mass media communication described in this paragraph (b)(5)(ii) is a grass roots lobbying communication if the communication would be a grass roots lobbying communication under the rules contained in paragraph (b)(2) of this section.

(iii) *Definitions*—(A) *Mass media.* For purposes of this paragraph (b)(5), "mass media" means television, radio, and general circulation newspapers and magazines. General circulation newspapers and magazines do not include newspapers or magazines published by an organization for which the expenditure test election under section 501(h) is in effect, except where both: the total circulation of the newspaper or magazine is greater than 100,000; and fewer than one-half of the recipients are members of the organization (as defined in §56.4911-5(f)).

(B) *Highly publicized.* For purposes of this paragraph (b)(5), "highly publicized" means frequent coverage on television, radio, and general circulation newspapers and magazines during the two weeks preceding the vote by the legislative body.

(iv) *Examples.* The special rule of this paragraph (b)(5) is illustrated by the following examples. The expenditure test election under section 501(h) is assumed to be in effect for all organizations discussed in the examples in this paragraph (b)(5)(iv):

Example (1). Organization X places a television advertisement advocating one of the President's major foreign policy initiatives, as outlined by the President in a series of speeches. The initiative is popularly known as "the President's World Peace Plan," and is voted upon by the Senate four days after X's advertisement. The advertisement concludes: "SUPPORT THE PRESIDENT'S WORLD PEACE PLAN!" The President's plan and position are highly publicized during the two weeks before the Senate vote, as evidenced by: coverage of the plan on several nightly television network news program; more than one article about the plan on the front page of a majority of the country's ten largest daily general circulation newspapers; and an editorial about the plan in four of the country's ten largest daily general circulation newspapers. Although the advertisement does not encourage readers to contact legislators or other government officials, the advertisement does refer to specific legislation and reflect a view on the general subject of the legislation. The communication is presumed to be a grass roots lobbying communication.

Example (2). Assume the same facts as in Example (1), except that the advertisement appears three weeks before the Senate's vote on the plan. Because the advertisement appears more than two weeks before the legislative vote, the advertisement is *not* within the scope of the special rule for mass media communications on highly publicized legislation. Accordingly, the advertisement is a grass roots lobbying communication only if it is described in the general definition contained in paragraph (b)(2) of this section. Because the advertisement does not encourage recipients to take action with respect to the legislation in question, the advertisement is not a grass roots lobbying communication.

Example (3). Organization Y places a newspaper advertisement advocating increased government funding for certain public works projects the President has proposed and that are being considered by a legislative committee. The advertisement explains the President's proposals and concludes: "SUPPORT FUNDING FOR THESE VITAL PROJECTS!" The advertisement does not encourage readers to contact legislators or other government officials nor does it name any undecided legislators, but it does name the legislation being considered by the committee. The issue of funding public works, however, is not highly publicized during the two weeks before the vote: there has been little coverage of the issue on nightly television network news programs, only one front-page article on the issue in the country's ten largest daily general circulation newspapers, and only one editorial about the issue in the country's ten largest daily general circulation newspapers. Two days after the advertisement appears, the committee votes to approve funding of the projects. Although the advertisement appears less than two weeks before the legislative vote, the advertisement is *not* within the scope of the special rule for mass media communications on highly publicized legislation because the issue of funding for public works projects is not highly publicized. Thus, the advertisement is a grass roots lobbying communication only if it is described in the general definition contained in paragraph (b)(2) of this section. Because the advertisement does not encourage recipients to take action with respect to the legislation in question, the advertisement is not a grass roots lobbying communication.

Example (4). A binding referendum is held in State X. At issue is Proposition 1, a citizen initiated proposition that, if enacted, would ban the manufacture and sale of handguns in State X. The proposition is controversial and highly publicized during the two weeks preceding the vote, as evidenced by numerous front-page articles, editorials, and letters to the editor published in the state's general circulation daily newspapers, as well as frequent coverage of the proposition by the television and radio stations serving the state. During the two weeks before the election, Organization Y places advertisements on radio stations serving the state. The advertisements do not encourage listeners to vote against the proposition, but do attack the legislation as being unconstitutional and ineffective.

Because the advertisements are mass media communications made within two weeks of a vote on highly publicized legislation and because the advertisements refer to that highly publicized legislation and reflect a view on the general subject of such legislation, the advertisements are presumed to be grass roots lobbying communications.

(c) *Exceptions to the definitions of direct lobbying communication and grass roots lobbying communication*—(1) *Nonpartisan analysis, study, or research exception*—(i) *In general.* Engaging in nonpartisan analysis, study, or research and making available to the general public or a segment or members thereof or to governmental bodies, officials, or employees the results of such work constitute neither a direct lobbying communication under §56.4911-2(b)(1) nor a grass roots lobbying communication under §56.4911-2(b)(2).

(ii) *Nonpartisan analysis, study, or research.* For purposes of this section, "nonpartisan analysis, study, or research" means an independent and objective exposition of a particular subject matter, including any activity that is "educational" within the meaning of §1.501(c)(3)-1(d)(3). Thus, "nonpartisan analysis, study, or research" may advocate a particular position or viewpoint so long as there is a sufficiently full and fair exposition of the pertinent facts to enable the public or an individual to form an independent opinion or conclusion. The mere presentation of unsupported opinion, however, does not qualify as "nonpartisan analysis, study, or research." Activities of a noncommercial educational broadcasting station or network (television or radio) constitute "nonpartisan analysis, study, or research" if the station or network adheres to the Federal Communications Commission regulations and its "fairness doctrine," interpreted as in effect on January 1, 1987 (requiring balanced, fair, and objective presentation of issues).

(iii) *Presentation as part of a series.* Normally, whether a publication or broadcast qualifies as "nonpartisan analysis, study, or research" will be determined on a presentation-by-presentation basis. However, if a publication or broadcast is one of a series prepared or supported by an electing organization and the series as a whole meets the standards of paragraph (c)(1)(ii) of this section, then any individual publication or broadcast within the series is not a direct or grass roots lobbying communication even though such individual broadcast or publication does not, by itself, meet the standards of paragraph (c)(1)(ii) of this section. Whether a broadcast or publication is considered part of a series will ordinarily depend upon all the facts and circumstances of each particular situation. However, with respect to broadcast activities, all broadcasts within any period of six consecutive months will ordinarily be eligible to be considered as part of a series. If an electing organization times or channels a part of a series which is described in this paragraph (c)(1)(iii) in a manner designed to influence the general public or the action of a legislative body with respect to a specific legislative proposal, the expenses of preparing and distributing such part of the analysis, study, or research will be expenditures for a direct or grass roots lobbying communication, as the case may be.

(iv) *Making available results of nonpartisan analysis, study, or research.* An organization may choose any suitable means, including oral or written presentations, to distribute the results of its nonpartisan analysis, study, or research, with or without charge. Such means include distribution of reprints of speeches, articles and reports; presentation of information through conferences, meetings and discussions; and dissemination to the news media, including radio, television and newspapers, and to other public forums. For purposes of this paragraph (c)(1)(iv), such communications may not be limited to, or be directed toward, persons who are interested solely in one side of a particular issue.

(v) *Subsequent lobbying use of nonpartisan analysis, study or research.* For purposes of this paragraph, a nonlobbying communication is any communication that reflects a view on specific legislation but that is not a lobbying communication as described in §56.4911-2(b). This §56.4911-2(c)(1)(v) governs any nonlobbying communication that is nonpartisan analysis, study or research (within the meaning of §56.4911-2(c)(1)) *and* that is: subsequently used with an accompanying lobbying communication that directly encourages recipients to take action with respect to legislation; or subsequently altered so that it is itself a lobbying communication that directly encourages recipients to take action with respect to legislation. In such a case, the communication is not within the exception for nonpartisan analysis, study or research and will be treated as a lobbying communication if the organization's primary purpose in preparing the communication was for use in lobbying; consequently, the expenses of preparing and distributing the communication will be treated as lobbying expenditures. The primary purpose of the organization in undertaking analysis, study, or research will not be considered to be for use in lobbying if, prior to or contemporaneously with the use of the analysis, study, or research in lobbying, the organization makes a substantial distribution of the analysis, study, or research (without an accompanying lobbying message). Whether a distribution is substantial will be determined by reference to all of the facts and circumstances, including the normal distribution pattern of similar nonpartisan analyses, studies, or research. Where the nonlobbying distribution of a communication governed by this paragraph is not substantial, all of the facts and circumstances must be weighed to determine whether the organization's primary purpose in preparing the communication was for use in lobbying. While not the only factor, the extent of the organization's nonlobbying distribution of the communication is particularly relevant, especially when compared to the extent of the communication's distribution with the lobbying message. Another particularly relevant factor is whether the lobbying use of a communication is by the organization that prepared the document, a related organization, or an unrelated organization. Where the subsequent lobbying distribution is made by an unrelated organization, clear and convincing evidence will be required to establish that the primary purpose for preparing the communication was for use in lobbying.

(vi) *Directly encouraging action by recipients of a communication.* A communication that reflects a view on specific legislation is not within the nonpartisan analysis, study, or research exception of this paragraph (c)(1) if the communication directly encourages the recipient to take action with respect to such legislation. For purposes of this section, a communication directly encourages the recipient to take action with respect to legislation if the communication is described in §56.4911-2(b)(2)(iii)(A) through (C). As described in §56.4911-2(b)(2)(iv), a communication would encourage the recipient to take action with respect to legislation, but not *directly* encourage such action, if the communication does no more than specifically identify one or more legislators who will vote on the legislation as: opposing the communication's view with respect to the legislation; being undecided with respect to the legislation; being the recipient's representative in the legislature; or being a member of the legislative committee that will consider the legislation.

(vii) *Examples*. The provisions of this paragraph (c)(1) may be illustrated by the following examples:

Example (1). Organization M establishes a research project to collect information for the purpose of showing the dangers of the use of pesticides in raising crops. The information collected includes data with respect to proposed legislation, pending before several State legislatures, which would ban the use of pesticides. The project takes favorable positions on such legislation without producing a sufficiently full and fair exposition of the pertinent facts to enable the public or an individual to form an independent opinion or conclusion on the pros and cons of the use of pesticides. This project is not within the exception for nonpartisan analysis, study, or research because it is designed to present information merely on one side of the legislative controversy.

Example (2). Organization N establishes a research project to collect information concerning the dangers of the use of pesticides in raising crops for the ostensible purpose of examining and reporting information as to the pros and cons of the use of pesticides in raising crops. The information is collected and distributed in the form of a published report which analyzed the effects and costs of the use and nonuse of various pesticides under various conditions on humans, animals and crops. The report also presents the advantages, disadvantages, and economic cost of allowing the continued use of pesticides unabated, of controlling the use of pesticides, and of developing alternatives to pesticides. Even if the report sets forth conclusions that the disadvantages as a result of using pesticides are greater than the advantages of using pesticides and that prompt legislative regulation of the use of pesticides is needed, the project is within the exception for nonpartisan analysis, study, or research since it is designed to present information on both sides of the legislative controversy and presents a sufficiently full and fair exposition of the pertinent facts to enable the public or an individual to form an independent opinion or conclusion.

Example (3). Organization O establishes a research project to collect information on the presence or absence of disease in humans from eating food grown with pesticides and the presence or absence of disease in humans from eating food not grown with pesticides. As part of the research project, O hires a consultant who prepares a "fact sheet" which calls for the curtailment of the use of pesticides and which addresses itself to the merits of several specific legislative proposals to curtail the use of pesticides in raising crops which are currently pending before State Legislatures. The "fact sheet" presents reports of experimental evidence tending to support its conclusions but omits any reference to reports of experimental evidence tending to dispute its conclusions. O distributes ten thousand copies to citizens' groups. Expenditures by O in connection with this work of the consultant are not within the exception for nonpartisan analysis, study, or research.

Example (4). P publishes a bi-monthly newsletter to collect and report all published materials, ongoing research, and new developments with regard to the use of pesticides in raising crops. The newsletter also includes notices of proposed pesticide legislation with impartial summaries of the provisions and debates on such legislation. The newsletter does not encourage recipients to take action with respect to such legislation, but is designed to present information on both sides of the legislative controversy and does present such information fully and fairly. It is within the exception for nonpartisan analysis, study, or research.

Example (5). X is satisfied that A, a member of the faculty of Y University, is exceptionally well qualified to undertake a project involving a comprehensive study of the effects of pesticides on crop yields. Consequently, X makes a grant to A to underwrite the cost of the study and of the preparation of a book on the effect of pesticides on crop yields. X does not take any position on the issues or control the content of A's output. A produces a book which concludes that the use of pesticides often has a favorable effect on crop yields, and on that basis argues against pending bills which would ban the use of pesticides. A's book contains a sufficiently full and fair exposition of the pertinent facts, including known or potential disadvantages of the use of pesticides, to enable the public or an individual to form an independent opinion or conclusion as to whether pesticides should be banned as provided in the pending bills. The book does not directly encourage readers to take action with respect to the pending bills. Consequently, the book is within the exception for nonpartisan analysis, study, or research.

Example (6). Assume the same facts as Example (2), except that, instead of issuing a report, X presents within a period of 6 consecutive months a two-program television series relating to the pesticide issue. The first program contains information, arguments, and conclusions favoring legislation to restrict the use of pesticides. The second program contains information, arguments, and conclusions opposing legislation to restrict the use of pesticides. The programs are broadcast within 6 months of each other during commensurate periods of prime time. X's programs are within the exception for nonpartisan analysis, study, or research. Although neither program individually could be regarded as nonpartisan, the series of two programs constitutes a balanced presentation.

Example (7). Assume the same facts as in Example (6), except that X arranged for televising the program favoring legislation to restrict the use of pesticides at 8:00 on a Thursday evening and for televising the program opposing such legislation at 7:00 on a Sunday morning. X's presentation is not within the exception for nonpartisan analysis, study, or research, since X disseminated its information in a manner prejudicial to one side of the legislative controversy.

Example (8). Organization Z researches, writes, prints and distributes a study on the use and effects of pesticide X. A bill is pending in the U.S. Senate to ban the use of pesticide X. Z's study leads to the conclusion that pesticide X is extremely harmful and that the bill pending in the U.S. Senate is an appropriate and much needed remedy to solve the problems caused by pesticide X. The study contains a sufficiently full and fair exposition of the pertinent facts, including known or potential advantages of the use of pesticide X, to enable the public or an individual to form an independent opinion or conclusion as to whether pesticides should be banned as provided in the pending bills. In its analysis of the pending bill, the study names certain undecided Senators on the Senate committee considering the bill. Although the study meets the three part test for determining whether a communication is a grass roots lobbying communication, the study is within the exception for nonpartisan analysis, study or research, because it does not directly encourage recipients of the communication to urge a legislator to oppose the bill.

Example (9). Assume the same facts as in Example (8), except that, after stating support for the pending bill, the study concludes: "You should write to the undecided committee members to support this crucial bill." The study is not within the exception for nonpartisan analysis, study or research because it directly encourages the recipients to urge a legislator to support a specific piece of legislation.

Example (10). Organization X plans to conduct a lobbying campaign with respect to illegal drug use in the United States. It incurs $5,000 in expenses to conduct research and prepare an extensive report primarily for use in the lobbying campaign. Although the detailed report discusses specific pending legislation and reaches the conclusion that the legislation would reduce illegal drug use, the report contains a sufficiently full and fair exposition of the pertinent facts to enable the public or an individual to form an independent conclusion regarding the effect of the legislation. The report does not encourage readers to contact legislators regarding the legislation. Accordingly, the report does not, in and of itself, constitute a lobbying communication.

Copies of the report are available to the public at X's office, but X does not actively distribute the report or otherwise seek to make the contents of the report available to the general public. Whether or not X's distribution is sufficient to meet the requirement in §56.4911-2(c)(1)(iv) that a nonpartisan communication be made available, X's distribution is not substantial (for purposes of §56.4911-2(c)(1)(v)) in light of all of the facts and circumstances, including the normal distribution pattern of similar nonpartisan reports. X then mails copies of the report, along with a letter, to 10,000 individuals on X's mailing list. In the letter, X requests that individuals contact legislators urging passage of the legislation discussed in the report. Because X's research and report were primarily undertaken by X for lobbying purposes and X did not make a substantial distribution of the report (without an accompanying lobbying message) prior to or contemporaneously with the use of the report in lobbying, the report is a grass roots lobbying communication that is not within the exception for nonpartisan analysis, study or research.

Example (11). Assume the same facts as in Example (10), except that before using the report in the lobbying campaign, X sends the research and report (without an accompanying lobbying message) to universities and newspapers. At the same time, X also advertises the availability of the report in its newsletter. This distribution is similar in scope to the normal distribution pattern of similar nonpartisan reports. In light of all of the facts and circumstances, X's distribution of the report is substantial. Because of X's substantial distribution of the report, X's primary purpose will be considered to be other than for use in lobbying and the report will not be considered a grass roots lobbying communication. Accordingly, only the expenditures for copying and mailing the report to the 10,000 individuals on X's mailing list, as well as for preparing and mailing the letter, are expenditures for grass roots lobbying communications.

(2) *Examinations and discussions of broad social, economic, and similar problems*. Examinations and discussions of broad social, economic, and similar

problems are neither direct lobbying communications under §56.4911-2(b)(1) nor grass roots lobbying communications under §56.4911-2(b)(2) even if the problems are of the type with which government would be expected to deal ultimately. Thus, under §§56.4911-2(b)(1) and (2), lobbying communications do not include public discussion, or communications with members of legislative bodies or governmental employees, the general subject of which is also the subject of legislation before a legislative body, so long as such discussion does not address itself to the merits of a specific legislative proposal and so long as such discussion does not directly encourage recipients to take action with respect to legislation. For example, this paragraph excludes from grass roots lobbying under §56.4911-2(b)(2) an organization's discussions of problems such as environmental pollution or population growth that are being considered by Congress and various State legislatures, but only where the discussions are not directly addressed to specific legislation being considered, and only where the discussions do not directly encourage recipients of the communication to contact a legislator, an employee of a legislative body, or a government official or employee who may participate in the formulation of legislation.

(3) *Requests for technical advice.* A communication is neither a direct lobbying communication under §56.4911-2(b)(1) nor a grass roots lobbying communication under §56.4911-2(b)(2) if the communication is the providing of technical advice or assistance to a governmental body, a governmental committee, or a subdivision of either in response to a written request by the body, committee, or subdivision, as set forth in §53.4945-2(d)(2).

(4) *Communications pertaining to "self-defense" by the organization.* A communication is neither a direct lobbying communication under §56.4911-2(b)(1) nor a grass roots lobbying communication under §56.4911-2(b)(2) if:

(i) The communication is an appearance before, or communication with, any legislative body with respect to a possible action by the body that might affect the existence of the organization, its powers and duties, its tax-exempt status, or the deductibility of contributions to the organization, as set forth in §53.4945-2(d)(3);

(ii) The communication is by a member of an affiliated group of organizations (within the meaning of §56.4911-7(e)), and is an appearance before, or communication with, a legislative body with respect to a possible action by the body that might affect the existence of any other member of the group, its powers and duties, its tax-exempt status, or the deductibility of contributions to it;

(iii) The communication is by an organization that has a membership consisting solely of other organizations that are described in section 501(c)(3), and is an appearance before, or communication with, any legislative body with respect to a possible action by the body which might affect the existence of one or more of the member organizations, their powers, duties, or tax-exempt status, or the deductibility of contributions to one or more of the member organizations; or

(iv) The communication is by an organization that is a member of a limited affiliated group of organizations under §56.4911-10, and is an appearance before, or communication with, the Congress of the United States with respect to a possible action by the Congress that might affect the existence of any member of the limited affiliated group, its powers and duties, tax-exempt status, or the deductibility of contributions to it.

(d) *Certain transfers treated as lobbying expenditures*—(1) *Transfer earmarked for grass roots purposes.* A transfer is a grass roots expenditure to the extent that it is earmarked (as defined in §56.4911-4(f)(4)) for grass roots lobbying purposes and is not described in §56.4911-4(e).

(2) *Transfer earmarked for direct and grass roots lobbying.* A transfer that is earmarked for direct lobbying purposes or for direct lobbying and grass roots lobbying purposes is treated as a grass roots expenditure in full except to the extent the transferor demonstrates that the amounts transferred were expended for direct lobbying purposes. This paragraph (d)(2) shall not apply to any expenditure described in §56.4911-4(e).

(3) *Certain transfers to organizations that lobby.* A transfer that is neither a controlled grant (as defined in §56.4911-4(f)(3)) nor an expenditure described in §56.4911-4(e), and that is made to an organization not described in section 501(c)(3) that engages in attempts to influence legislation, is treated as a grass roots expenditure to the extent of the lesser of the amount of the transfer or the transferee's expenditures for grass roots lobbying. If the amount of the transfer exceeds the transferee's expenditures for grass roots lobbying, the excess will be treated as an expenditure for direct lobbying to the extent of the transferee's expenditures for direct lobbying. In applying the two preceding sentences, the expenditures of the transferee will be determined as if the regulations under section 4911 applied to the transferee.

(e) *Definitions.* For purposes of section 4911 and the regulations thereunder—

(1) *Legislation.* "Legislation" includes action by the Congress, any state legislature, any local council, or similar legislative body, or by the public in a referendum, initiative, constitutional amendment, or similar procedure. "Legislation" includes a proposed treaty required to be submitted by the President to the Senate for its advice and consent from the time the President's representative begins to negotiate its position with the prospective parties to the proposed treaty.

(2) *Action.* The term "action" is limited to the introduction, amendment, enactment, defeat or repeal of Acts, bills, resolutions, or similar items.

(3) *Legislative body.* "Legislative body" does not include executive, judicial, or administrative bodies.

(4) *Administrative bodies.* "Administrative bodies" includes school boards, housing authorities, sewer and water districts, zoning boards, and other similar Federal, State, or local special purpose bodies, whether elective or appointive. Thus, for example, for purposes of section 4911, the term "any attempt to influence any legislation" does not include attempts to persuade an executive body or department to form, support the formation of, or to acquire property to be used for the formation or expansion of, a public park or equivalent preserves (such as public recreation areas, game, or forest preserves, and soil demonstration areas) established or to be established by act of Congress, by executive action in accordance with an act of Congress, or by a State, municipality or other governmental unit described in section 170(c)(1), as compared with attempts to persuade a legislative body, a member thereof, or other governmental official or employee, to promote the appropriation of funds for such an acquisition or other legislative authorization of such an acquisition. Therefore, for example, an organization would not be influencing legislation for purposes of section 4911, if it proposed to a Park Authority that it purchase a particular tract of land for a new park, even though

such an attempt would necessarily require the Park Authority eventually to seek appropriations to support a new park. However, in such a case, the organization would be influencing legislation, for purposes of section 4911, if it provided the Park Authority with a proposed budget to be submitted to a legislative body, unless such submission is described by one of the exceptions set forth in paragraph (c) of this section.

§56.4911-3. Expenditures for direct and/or grass roots lobbying communications.

(a) *Definition of term "expenditures for"*—(1) *In general.* Expenditures for a direct or grass roots lobbying communication ("lobbying expenditures") include amounts paid or incurred as current or deferred compensation for an employee's services attributable to the direct or grass roots lobbying communication, and the allocable portion of administrative, overhead, and other general expenditures attributable to the direct or grass roots lobbying communication. Except as otherwise indicated in this paragraph (a), all costs of preparing a direct or grass roots lobbying communication are included as expenditures for direct or grass roots lobbying. For example, except as otherwise provided in this paragraph (a), all expenditures for researching, drafting, reviewing, copying, publishing and mailing a direct or grass roots lobbying communication, as well as an allocable share of overhead expenses, are included as expenditures for direct or grass roots lobbying.

(2) *Allocation of mixed purpose expenditures*—(i) *Nonmembership communications.* Except as provided in paragraph (a)(2)(ii) of this section, lobbying expenditures for a communication that also has a bona fide nonlobbying purpose must include all costs attributable to those parts of the communication that are on the same specific subject as the lobbying message. All costs attributable to those parts of the communication that are not on the same specific subject as the lobbying message are not included as lobbying expenditures for allocation purposes. Whethe- or not a portion of a communication is on the same specific subject as the lobbying message will depend on the surrounding facts and circumstances. In general, a portion of a communication will be on the same specific subject as the lobbying message if that portion discusses an activity or specific issue that would be directly affected by the proposed legislation that is the subject of the lobbying message. Moreover, discussion of the background or consequences of the proposed legislation, or discussion of the background or consequences of an activity or specific issue affected by the proposed legislation, is also considered to be on the same specific subject as the lobbying communication.

(ii) *Membership communications.* In the case of lobbying expenditures for a communication that also has a bona fide nonlobbying purpose and that is sent only or primarily to members, an organization must make a reasonable allocation between the amount expended for the lobbying purpose and the amount expended for the nonlobbying purpose. An organization that includes as a lobbying expenditure only the amount expended for the specific sentence or sentences that encourage the recipient to take action with respect to legislation has not made a reasonable allocation. For purposes of this paragraph, a communication is sent only or primarily to members if more than half of the recipients of the communication are members of the organization making the communication within the meaning of §56.4911-5. See §56.4911-5 for separate rules on communications sent only or primarily to members. Nothing in this paragraph shall change any allocation required by §56.4911-5.

(3) *Allocation of mixed lobbying.* If a communication (to which §56.4911-5 does not apply) is both a direct lobbying communication and a grass roots lobbying communication, the communication will be treated as a grass roots lobbying communication except to the extent that the organization demonstrates that the communication was made primarily for direct lobbying purposes, in which case a reasonable allocation shall be made between the direct and the grass roots lobbying purposes served by the communication.

(b) *Examples.* The provisions of paragraph (a) of this section are illustrated by the following examples. Except where otherwise explicitly stated, the expenditure test election under section 501(h) is assumed to be in effect for all organizations discussed in the examples in this paragraph (b). See §56.4911-5 for special rules applying to the member communications described in some of the following examples.

Example (1). Organization R makes the services of E, one of its paid executives, available to S, an organization described in section 501(c)(4) of the Code. E works for several weeks to assist S in developing materials that urge voters to contact their congressional representatives to indicate their support for specific legislation. In performing this work, E uses office space and clerical assistance provided by R. R pays full salary and benefits to E during this period and receives no reimbursement from S for these payments or for the other facilities and assistance provided. All expenditures of R, including allocable office and overhead expenses, that are attributable to this assignment are grass roots expenditures because E was engaged in an attempt to influence legislation.

Example (2). An organization distributes primarily to nonmembers a pamphlet with two articles on unrelated subjects. The total cost of preparing, printing and mailing the pamphlet is $11,000, $1,000 for preparation and $10,000 for printing and mailing. The cost of preparing one article, a nonlobbying communication, is $600. The article is printed on three of the four pages in the pamphlet. The cost of preparing the second article, a grass-roots lobbying communication that addresses only one specific subject, is $400. This article is printed on one page of the four page pamphlet. In this situation, $400 of preparation costs and $2,500 (25% of $10,000) of printing and mailing costs are expenditures for a grass roots lobbying communication.

Example (3). Assume the same facts as in Example (2), except that the pamphlet is distributed only to members. In addition, assume the second article states that the recipient members should contact their congressional representatives. The organization allocates $400 of preparation costs and $2,500 of printing and mailing costs as expenditures for direct lobbying (see §56.4911-5(c)). The allocation is reasonable for purposes of §56.4911-3(a)(2)(ii).

Example (4). Organization J places a full-page advertisement in a newspaper. The advertisement urges passage of pending legislation to build three additional nuclear powered submarines, and states that readers should write their Congressional representatives in favor of the legislation. The advertisement also provides a general description of J's purposes and activities, invites readers to become members of J and asks readers to contribute money to J. Except for the cost of the portion of the advertisement describing J's purposes and activities and the portion specifically seeking members and contributions, the entire cost of the advertisement is an expenditure for a grass roots lobbying communication, because the entire advertisement, except for the lines specifically describing J and specifically seeking members and contributions, is on the same specific subject as the grass roots lobbying message.

Example (5). Assume the same facts as in Example (4), except that J places in the newspaper two separate half-page advertisements instead of one full-page advertisement. One of the two advertisements discusses the need for three additional nuclear powered submarines and urges readers to write their Congressional representatives in favor of the pending legislation to build the three submarines. The other advertisement contains only the membership and fundraising appeals, along with a general description of J's purposes and activities. The half-page advertisement urging readers to write to Congress is a grass roots lobbying communication and all of J's expenditures for producing and placing that advertisement are expenditures for a grass roots lobbying communication. J's expenditures for the other half-page advertisement are not expenditures for a grass roots or direct lobbying communication.

Example (6). Assume the same facts as in Example (4), except that the communication by J is in a letter mailed only to members of J, rather than in a newspaper advertisement, and the invitation to become a member of J is an invitation to join a new membership category. In addition, assume that the communication states that the member recipients should ask nonmembers to write their Congressional representatives. J allocates one-half of the cost of the mailing as an expenditure for a grass roots lobbying communication (see §56.4911-5(d)). Because the communication had both bona fide nonlobbying (e.g., membership solicitation and fundraising) purposes as well as lobbying purposes, J's allocation of one-half of the cost of the communication to grass roots lobbying and one-half to nonlobbying is reasonable for purposes of §56.4911-3(a)(2)(ii).

Example (7). A particular monthly issue of organization X's newsletter, which is distributed mainly to nonmembers of X, has three articles of equal length. The first article is a grass roots lobbying communication, the sole specific subject of which is pending legislation to help protect seals from being slaughtered in certain foreign countries. The second article discusses the rapid decline in the world's whale population, particularly because of the illegal hunting of whales by foreign countries. The third article deals with air pollution and the acid rain problem in North America. Because the first article is a grass roots lobbying communication, all of the costs allocable to that article (e.g., one-third of the newsletter's printing and mailing costs) are lobbying expenditures. The second article is not a lobbying communication and the pending legislation relating to seals addressed in the first article does not affect the illegal whale hunting activities. Because the second and third articles are not lobbying communications and are also not on the same specific subject as the first article, no portion of the costs attributable to those articles is a grass roots lobbying expenditure.

Example (8). Organization T, a nonmembership organization, prepares a three page document that is mailed to 3,000 persons on T's mailing list. The first two pages of the three page document, titled "The Need for Child Care," support the need for additional child care programs, and include statistics on the number of children living in homes where both parents work or in homes with a single parent. The two pages also make note of the inadequacy of the number of day care providers to meet the needs of these parents. The third page of the document, titled "H.R. 1," indicates T's support of H.R. 1, a bill pending in the U.S. House of Representatives. The document states that H.R. 1 will provide for $10,000,000 in additional subsidies to child care providers, primarily for those providers caring for lower income children. The third page of the document also notes that H.R. 1 includes new federal standards regulating the quality of child care providers. The document ends with T's request that recipients contact their congressional representative in support of H.R. 1. The entire three page document is on the same specific subject, and, therefore, all expenditures of preparing and distributing the three page document are grass roots lobbying expenditures.

Example (9). Assume the same facts as in Example (8), except that T is a membership organization, 75 percent of the recipients of the three page document are members of T, and 25 percent of the recipients are nonmembers and are not subscribers within the meaning of §56.4911-5(f)(5). Assume also that the document states that readers should write to Congress, but does not state that the readers should urge nonmembers to write to Congress. T treats the document as having a bona fide nonlobbying purpose, the purpose of educating its members about the need for child care. Accordingly, T allocates one-half of the cost of preparing and distributing the document as a lobbying expenditure (see §56.4911-5(e)(2)(i)), of which 75 percent is a direct lobbying expenditure (see §56.4911-5(e)(2)(iii)) and 25 percent is a grass roots lobbying expenditure (see §56.4911-5(e)(2)(ii)). The remaining one-half is allocated as a nonlobbying expenditure. T's allocation is reasonable for purposes of §56.4911-3(a)(2)(ii) and is correct for purposes of §56.4911-5(e).

Example (10). Assume the same facts as in Example (9), except that T allocates one percent of the cost of preparing and distributing the document as a lobbying expenditure (for purposes of §56.4911-5(e)(2)) and 99 percent as a nonlobbying expenditure. T's allocation is based upon the fact that out of 200 lines in the document, only two lines state that the recipient should contact legislators about the pending legislation. T's allocation is unreasonable for purposes of §56.4911-3(a)(2)(ii).

Example (11). Organization F, a nonmembership organization, sends a one page letter to all persons on its mailing list. The only subject of the letter is the organization's opposition to a pending bill allowing private uses of certain national parks. The letter requests recipients to send letters opposing the bill to their congressional representatives. A second one page letter is sent in the same envelope. The second letter discusses the broad educational activities and publications of the organization in all areas of environmental protection and ends by requesting the recipient to make a financial contribution to organization F. Since the separate second letter is on a different subject from the lobbying letter, and the letters are of equal length, 50 percent of the mailing costs must be allocated as an expenditure for a grass roots lobbying communication.

Example (12). Assume the same facts as in Example (11), except that F is a membership organization and the letters in question are sent primarily (90 percent) to members. The other 10 percent of the recipients are nonmembers and are not subscribers within the meaning of §56.4911-5(f)(5). Assume also that the first letter does not state that readers should urge nonmembers to write to legislators. F allocates one-half of the mailing costs as a lobbying expenditure, of which 90 percent is a direct lobbying expenditure and 10 percent is a grass roots lobbying expenditure (see §56.4911-5(e)(2)). F's allocation is reasonable for purposes of §56.4911-3(a)(2)(ii) and is correct for purposes of §56.4911-5.

Par. 7. Proposed §56.4911-4 is amended by revising paragraphs (b)(2), (b)(5), (b)(6), (c)(7), and (f)(2) to read as follows:

§56.4911-4 Exempt purpose expenditures.

* * * * * *

(b) *Included expenditures.* * * *

(2) Amounts paid or incurred as current or deferred compensation for an employee's services for a purpose enumerated in section 170(c)(2)(B).

* * * * * *

(b) *Included expenditures.* * * *

(5) Amounts paid or incurred for activities described in §56.4911-3,

(6) Amounts paid or incurred for activities described in §56.4911-5 that are not lobbying expenditures, and

* * * * * *

(c) *Excluded expenditures.* * * *

(7) Amounts paid or incurred for the production of income, whether or not described in section 512(a)(1).

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(f) *Definitions.*

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(2) For purposes of paragraph (c) of this section, a separate fund raising unit of any organization must consist of either two or more individuals a majority of whose time is spent on fund raising for the organization, or any separate accounting unit of the organization that is devoted to fund raising.

* * * * * *

Par. 8. Proposed §56.4911-5 is amended as follows, to read as set forth below:

1. Paragraphs (a) through (d) and paragraph (e)(1) are revised to read as set forth below.

2. Paragraph (f)(6) is revised to read as set forth below.

3. A new paragraph (f)(8) is added, to read as set forth below.

§56.4911-5 Communications with members.

(a) *In general.* For purposes of section 4911 and §56.4911-2, expenditures for certain communications between an organization and its members are treated as expenditures for direct lobbying, as expenditures for grass roots lobbying, or as other than lobbying expenditures in accordance with this section.

(b) *Communication directed only to members; excepted communication.* Expenditures for a communication that refers to, and reflects a view on, specific legislation are not lobbying expenditures if the communication satisfies the following requirements:

(1) The communication is directed only to members of the organization,

(2) The specific legislation the communication refers to, and reflects a view on, is of direct interest to the organization and its members;

(3) The communication does not directly encourage the member to engage in direct lobbying (whether individually or through the organization); and

(ii) The communication does not directly encourage the member to engage in grass roots lobbying (whether individually or through the organization).

(c) *Communication directed only to members: expenditures for direct lobbying.* Expenditures for a communication that refers to, and reflects a view on, specific legislation and that satisfies the requirements of paragraphs (b)(1), (b)(2), and (b)(4) of this section, but does not satisfy the requirements of paragraph (b)(3) of this section, are treated as expenditures for direct lobbying.

(d) *Communication directed only to members; grass roots expenditures.* Expenditures for a communication that refers to, and reflects a view on, specific legislation and that satisfies the requirements of paragraphs (b)(1) and (b)(2) of this section, but does not satisfy the requirements of paragraph (b)(4) of this section, are treated as grass roots expenditures (whether or not the communication satisfies the requirements of paragraph (b)(3) of this section.

(e) *Written communications directed to members and nonmembers*—(1) *In general.* Expenditures for any written communication that is designed primarily for members of an organization (but not directed only to members) and that refers to, and reflects a view on, specific legislation of direct interest to the organization and its members, are treated as expenditures for direct or grass roots lobbying in accordance with paragraph (e)(2) or (e)(3) of this section. For purposes of this section, a communication is designed primarily for members of an organization if more than half of the recipients of the communication are members of the organization.

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(f) *Definitions and special rules.* * * *

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(6) *Directly encourages*—(i) *Direct lobbying*—(A) *In general.* For purposes of this section, a communication directly encourages a recipient to engage in direct lobbying, whether individually or through the organization, if the communication:

(*1*) States that the recipient should contact a legislator or an employee of a legislative body, or should contact any other government official or employee who may participate in the formulation of legislation (but only if the principal purpose of urging contact with the government official or employee is to influence legislation);

(*2*) States the address, telephone number, or similar information of a legislator or an employee of a legislative body; or

(*3*) Provides a petition, tear-off postcard or similar material for the recipient to communicate his or her views to a legislator or an employee of a legislative body, or to any other government official or employee who may participate in the formulation of legislation (but only if the principal purpose of so facilitating contact with the government official or employee is to influence legislation).

(B) *"Self-defense" exception for communications with members.* Notwithstanding the provisions of paragraph (f)(6)(i)(A) of this section, for purposes of paragraphs (b)(3), (e)(2)(i), and (e)(3)(ii) of this section, a communication that directly encourages a member to engage in direct lobbying activities that are described in section 4911(d)(2)(C) and that would not be attempts to influence legislation if engaged in directly by the organization is treated as a communication that does not directly encourage a member to engage in direct lobbying.

(ii) *Grass roots lobbying.* For purposes of paragraphs (b)(4) and (e)(3)(i) of this section, a communication directly encourages recipients to engage individually or collectively (whether through the organization or otherwise) in grass roots lobbying if the communication:

(A) States that the recipient should encourage any nonmember to contact a legislator or an employee of a legislative body, or to contact any other government official or employee who may participate in the formulation of legislation (but only if the principal purpose of urging contact with the government official or employee is to influence legislation);

(B) States that the recipient should provide to any nonmember the address, telephone number, or similar information of a legislator or an employee of a legislative body; or

(C) Provides (or requests that the recipient provide to nonmembers) a petition, tear-off postcard or similar material for the recipient (or nonmember) to use to ask any nonmember to communicate views to a legislator or an employee of a legislative body, or to any other government official or employee who may participate in the formulation of legislation, but only if the principal purpose of so facilitating contact with the government official or employee is to influence legislation. For purposes of this paragraph, a petition is provided for the recipient to use to ask any nonmember to communicate views if, for example, the petition has an entire page of preprinted signature blocks. Similarly, for purposes of this paragraph, where a communication is distributed to a single member and provides several tear-off postcards addressed to a legislator, the postcards are presumed to be provided for the member to use to ask a nonmember to communicate with the legislator.

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(8) *Reasonable allocation rule.* In the case of lobbying expenditures for a communication that also has a bona fide nonlobbying purpose and that is sent only or primarily to members, an organization must make a reasonable allocation between the amount expended for the lobbying purpose and the amount expended for the nonlobbying purpose. See §56.4911-3(a)(2)(ii).

Par. 9. Proposed §56.4911-6, paragraphs (a)(3), (a)(4), (b)(2), and (b)(3), are revised to read as follows:

§56.4911-6 Records of lobbying and grass roots expenditures.

(a) *Records of lobbying expenditures.* * * *

(3) The portion of amounts paid or incurred as current or deferred compensation for an employee's services for direct lobbying;

(4) Amounts paid for out-of-pocket expenditures incurred on behalf of the organization and for direct lobbying, whether or not incurred by an employee;

* * * * * *

(b) *Records of grass roots expenditures.* * * *

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(2) The portion of amounts paid or incurred as current or deferred compensation for an employee's services for grass roots lobbying;

(3) Amounts paid for out-of pocket expenditures incurred on behalf of the organization and for grass roots lobbying, whether or not incurred by an employee;

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Par. 10. Proposed §56.4911-7 is amended by revising paragraph (c) to read:

§56.4911-7 Affiliated group of organizations.

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(c) *Governing instrument*. One organization (the "controlling" organization) is affiliated with a second organization (the "controlled" organization) by reason of the governing instruments of the controlled organization if the governing instruments of the controlled organization expressly or by implication limit the independent action of the controlled organization on legislative issues by requiring it to be bound by decisions of the other organization on legislative issues.

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Lawrence B. Gibbs,
Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on December 22, 1988, 8:45 a.m. and published in the issue of the Federal Register for December 23, 1988, 53 F.R. 51826)

Notice of Proposed Rulemaking

Benefits Provided Under Certain Employee Benefit Plans

EE-130-86

AGENCY: Internal Revenue Service, Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations relating to benefits provided under certain employee benefit plans under sections 89 and 125 of the Internal Revenue Code of 1986. The regulations reflect changes made by the Revenue Act of 1978 [1978-3 C.B. (Vol. 1) 1], the Tax Reform Act of 1984 [1984-3 C.B. (Vol.1) 1], the Tax Reform Act of 1986 [1986-3 C.B. (Vol.1) 1], and the Technical and Miscellaneous Revenue Act of 1988. The regulations provide the public with guidance on the nondiscrimination and qualification requirements for certain employee benefit plans and affect sponsors of, and participants in, a variety of types of plans, including accident and health plans, group-term life insurance, and dependent care assistance programs.

DATES: Written comments and requests for a public hearing must be delivered or mailed on or before May 8, 1989. The amendments are generally proposed to apply to plan years beginning after December 31, 1988.

ADDRESS: Send comments and requests for a public hearing to: Commissioner of Internal Revenue, Attention: CC:CORP:T:R (EE-130-86), Washington, DC 20224.

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 1980 (44 U.S.C. 3504(h)). Comments on the collections of information should be sent to the Office of Management and Budget, Paperwork Reduction Project, Washington, DC 20503, with copies to the Internal Revenue Service, Attention: IRS Reports Clearance Officer TR:FP, Washington, DC 20224.

The collections of information in these regulations are in §1.89(a)-1 and §1.89(k)-1. Certain of this information is required by the Internal Revenue Service to memorialize the method of testing used by the employer in determining whether it meets the requirements of section 89(a) and correctly reports an employee's wages on the Form W-2. Additional requirements include the preparation of a written plan document, a notice relating to benefits (both required under section 89(k)). The likely respondents/recordkeepers are employers who provide welfare benefit programs to their employees.

These estimates are an approximation of the average time expected to be necessary for a collection of information. They are based on such information as is available to the Internal Revenue Service. Individual recordkeepers may require more or less time, depending on their particular circumstances.

The burden estimates represent an estimation of the actual time for recordkeeping, learning about the law, computations and testings.

The estimated total annual reporting and/or recordkeeping burden: 9,000,000 hours. With respect to learning about the law, testing and making any written elections, the estimated annual burden per respondent/recordkeeper varies from 1 hour to 40 hours, depending on individual circumstances, with an estimated average of 10 hours. The estimated number of respondents and/or recordkeepers: 750,000. With respect to physically preparing the written plan, notice and statement relating to employees, the estimated annual burden per respondent/recordkeeper varies from 30 minutes to 4 hours, depending on individual circumstances, with an estimated average of 2 hours. The estimated number of respondents and/or recordkeepers: 750,000. Estimated annual frequency of response (for reporting requirements only): as necessary.

BACKGROUND

This document contains proposed additions to the Income Tax Regulations (26 CFR Part 1) under sections 89 and 125 of the Internal Revenue Code of 1986 (Code). The additions with respect to section 89 are proposed to conform the regulations to section 1151 of the Tax Reform Act of 1986 (TRA '86) (100 Stat. 2494), and section 3021 of the Technical and Miscellaneous Revenue Act of 1988 (TAMRA '88) (102 Stat. 3625). The additions with respect to section 125 are proposed pursuant to section 134 of the Revenue Act of 1978 (92 Stat. 2763), section 101 of the Technical Corrections Act of 1979 (92 Stat. 2227), section 226 of the Miscellaneous Revenue Act of 1980 (94 Stat. 3525), section 531(b)(4) of the Tax Reform Act of 1984 (96 Stat. 494), section 1151 of the Tax Reform Act of 1986 (TRA '86) (100 Stat. 2494), and section 1011B of the Technical and Miscellaneous Revenue Act of 1988 (TAMRA '88) (102 Stat. 3485).

Section 89 was intended, in part, to discourage employers from offering health plans and other welfare benefits that disproportionately favor highly compensated employees either as to coverage or extent of benefits. A principal objective of this legislation was to extend health coverage for employees not now covered. The sanction for failing to meet nondiscrimination criteria outlined in the statute and this implementing rule is the taxation of the excess value of highly compensated employees' benefits.

To help provide an improved basis for evaluation of the specific content and effect of the statute and these regulations, comments are invited on changes in plan provisions, the numbers and types of employees eligible for plans affected by these regulations, and employee participation rates that may be associated with one or more changes proposed in these regulations. Information indicating the effect on particular groups of employees identified by wage levels, occupations, industries or other characteristics would be especially useful. Comments also are invited on the expected effect on costs to employers and health providers which result from particular requirements.

EXPLANATION OF RULES

The proposed regulations include guidance in three general areas. First, they provide information with respect to miscellaneous matters relating to the nondiscrimination rules of section 89(a). Second, the proposed regulations contain detailed guidance with respect to the qualification requirements of section 89(k). Finally, the proposed regulations include questions and answers relating to section 125 (cafeteria plans) and supplementing the existing proposed regulations contained at §1.125-1 (49 FR 19321) [1984-1 C.B. 563]. The proposed regulations include a variety of special rules to facilitate the application of and compliance with sections 89 and 125, particularly for plan years beginning in 1989.

1. *In general.*

These proposed regulations constitute the issuance of comprehensive section 89 rules on which taxpayers may rely. Nevertheless, until the later of January 1, 1990, or the beginning of the second testing year beginning after December 31, 1988, if an employer reasonably and in good faith complies with the requirements of section 89 (including the legislative history thereto), the employer will be treated as having satisfied section 89. After this transition period, this standard of compliance will not apply to the extent that these proposed regulations address issues under section 89. Whether compliance is reasonable and in good faith is to be determined on the basis of all the facts and circumstances, including whether the employer makes a reasonable and good faith effort to collect and analyze the necessary data and information, and whether the employer consistently resolves unclear issues in its favor.

These questions and answers do not provide comprehensive guidance on certain issues. For example, no guidance is provided on the special multiemployer plan rules adopted in TAMRA '88. In addition, this guidance does not address the separate line of business rules of section 414(r) or the extent to which additional employer disaggregation is available under section 89. In addition, the proposed regulations generally do not address the application of section 89 to group-term life insurance. These matters will be addressed in future guidance.

The proposed regulations also do not address certain issues with regard to the application of section 89 to former employees and with regard to who is an excludable employee under section 89(h). Nevertheless, under the excludable employee rules, if any employee included in a collective bargaining unit receives any employer-provided benefit, no employee in that collective bargaining unit may be treated as an excludable employee merely because the employee is a member of the collective bargaining unit. This is the case without regard to the fact that the employer-provided benefit is in the form of an employer contribution under a collective bargaining agreement to a multiemployer plan. See section 1151(k) of TRA '86 and paragraph (a)(2) of Question and Answer (Q&A) 10 of the proposed regulation for the effective date of section 89 for certain collectively bargained plans.

The proposed regulations provide that, in general, section 414(n) applies to employee benefit plans covered by section 89 in the same manner as it applies to qualified plans covered by section 401(a). They also include a delegation to the Commissioner to provide guidance in the form of revenue rulings, notices or other publications of general applicability on the extent to which the differing nature of these types of plans require different rules. The Service invites comments on the manner in which the leased employee rules apply to plans covered by section 89 and, in particular, on the extent to which different rules are appropriate.

The proposed regulations also clarify that plans are not exempt from section 89 merely because they are maintained by the federal government, state or local governments, or employee organizations. In addition, plans maintained by tax-exempt entities are subject to the requirements of section 89, with the exception that a plan maintained exclusively for church employees by an entity described in section 3121(w) is not required to satisfy the requirements of section 89.

If the public wishes to comment on the content and timing of additional guidance that may be required to implement the law, the Service will consider these comments in developing further guidance. In particular, the Service invites comments regarding the exclusion of certain classes of employees for purposes of applying the nondiscrimination rules of section 89 (e.g., prisoners incarcerated in federal or state institutions or clients in sheltered workshops maintained by charitable entities) similar to the exclusion provided in the safe harbors in Notice 89-23, page 654, this Bulletin.

2. *Nondiscrimination Requirements*

Section 89(a) is generally applicable to accident and health plans within the meaning of sections 105 and 106 (health plans) and group-term life insurance plans within the meaning of section 79. In addition, an employer may elect to treat certain other plans as subject to section 89(a). The term "benefit" appears throughout the proposed regulations. Unless indicated otherwise, the term "benefit" in connection with the nondiscrimination requirements of section 89(a) means the value of the coverage provided under the plan in the case of insurance type plans and, in the case of noninsurance type plans, the value of the payments, reimbursements, services and products provided under the plan. The proposed regulation contained at §1.89(a)-1 includes questions and answers relating to nondiscrimination rules for purposes of section 89.

Q&A-1 of §1.89(a)-1 sets forth in general terms the nondiscrimination tests applicable under section 89(a). In general, an employer has two approaches to nondiscrimination testing under section 89. Under the first approach, an employer's employee benefit plan satisfies section 89(a) only if (i) at least 50 percent of the employees eligible to participate in a plan are nonhighly compensated employees (the 50 percent eligibility test); (ii) at least 90 percent of the nonhighly compensated employees are eligible to participate in the plan or plans of the same type that, on an aggregate basis, are at least 50 percent as valuable as the combined value of the plans of the same type that are available to any highly compensated employee (the 90 percent/50 percent eligibility test); and (iii) the average benefit received by nonhighly compensated employees under all plans of the same type is at least 75 percent of the average benefit received by highly compensated employees under such plans (the 75 percent benefits test).

Under the second approach, an employer's employee benefit plan satisfies section 89(a) only if it benefits at least 80 percent of the employer's nonhighly compensated employees (the 80 percent coverage test). An employer may elect to test its health and group-term life insurance plans (and determine excess benefits, if any) under the 80 percent coverage test notwithstanding the fact that the first approach would produce different amounts of excess benefits.

Under either of the two approaches, a plan fails to satisfy section 89(a) if the plan contains any provision that by its terms, operation or otherwise discriminates in favor of highly compensated employees (the nondiscriminatory provisions test).

For 1989 and 1990, an employer may decide to adopt an alternative to the 75 percent benefits test for its health plans. Under this alternative, set forth in Q&A-2 an employer must treat as includible in gross income (i.e., as discriminatory excess benefits) all employer-provided coverage under its health plans with respect to certain highly compensated employees. Also, if an employer adopts this alternative for 1989, the employer may use a modified version of the 90 percent/50 percent eligibility test under which at least 80 percent of the nonhighly compensated employees must be eligible to participate in plans of the same type that, on an aggregate basis, are at least 66 percent as valuable as the aggregate value of the plans of the same type available to any highly compensated employee. For testing years ending in 1990, this modified version of the 90 percent/50 percent eligibility test is not available and the class of highly compensated employees who are considered to receive taxable employer-provided health coverage under the alternative to the 75 percent benefits test is broadened.

Q&A-2 also provides a permanent alternative to the general nondiscrimination tests for certain large employers whose employees are substantially all nonhighly compensated employees. Under this alternative, an employer's health plans satisfy section 89(a) if the employer employs at least 5,000 individuals; at least 90 percent of the full-time active employees are nonhighly compensated employees; less than 0.75 percent of all active employees have compensation in excess of twice the section 414(q)(1)(C) amount ($50,000 indexed); at least 80 percent of those employees eligible to participate in each plan are nonhighly compensated employees and 80 percent of the nonhighly compensated employees have available to them under all health plans a health benefit that is at least 80 percent as valuable as the largest such benefits available to any highly compensated employee; and at least 66 percent of all nonhighly compensated employees receive core health benefits that are at least 66 percent as valuable as the largest such benefit available to any highly compensated employee. In addition, the nondiscriminatory provisions test must be satisfied. This alternative is only available to determine if any employer's health plan or plans are discriminatory: it is not available to determine the amount of excess benefits.

Core health coverage generally means comprehensive major medical and hospitalization coverage. Dental, vision and health coverages provided under flexible spending arrangements (see paragraph (c) of Q&A-7 of proposed §1.125-2) are not core health benefits. Note that the definition of "core health coverage" under section 89 is not necessarily the same as the definition of "core coverage" under section 4980B (COBRA continuation coverage) and, therefore, no inference should be drawn from these proposed regulations with respect to the meaning of such term under section 4980B.

Q&A-3 details the treatment of family and other coverage under section 89 and the extent to which such coverages may be tested separately from employee-only coverage. Included in Q&A-3 is guidance relating to the use of sworn statements when employee-only coverage is to be tested separately. The proposed regulations state that a sworn statement need not be notarized but, for testing years commencing on or after January 1, 1990, a sworn statement must be made under penalty of perjury. An example of a sworn statement is provided.

Q&A-4 sets forth rules relating to health plan comparability and health plan aggregation for the purposes of the 50 percent eligibility test and the 80 percent coverage tests. These rules were changed extensively by TAMRA '88. The comparability rules in the proposed regulations generally enable health plans that fail the 50 percent eligibility test or the 80 percent coverage test on an individual basis to satisfy such tests on a group basis.

Q&A-5 and Q&A-6 of the proposed regulation set forth the method for nondiscrimination testing. Q&A-5 states that testing for compliance with the nondiscrimination requirements of section 89(a) is done by reference to the employees employed on, and benefits provided for, a single day (the testing day), and such results are then annualized for the entire testing year with adjustments to reflect certain benefit changes during the testing year (both before and after the testing day). In general, the facts on the testing day must be adjusted to reflect benefit changes due to changes in plan terms and, in the case of highly compensated employees, changes in elections by such employees. If the terms of available plans change during an open season, benefit changes that occur due to elections during that open season are considered changes due to changes in plan terms. The proposed regulation contains a transition rule for 1989 that generally allows benefit changes prior to July 1, 1989 to be disregarded.

The employer must designate a uniform 12-month testing period for all its plans of the same type. In certain circumstances, an employer may elect a short testing year. To the extent that the employer elects to test plans of different types together for purposes of certain nondiscrimination tests, all these plans must be tested on a uniform testing year. Thus, if an employer tests its group-term life insurance plans with its dependent care assistance programs for purposes of the 75 percent benefits test, all such plans and programs must be tested on the same 12-month period. The same rule applies where the employer aggregates its health plans with its group-term life insurance plans to enable its group-term life insurance plans to satisfy the requirements of the 75 percent benefits test.

As set forth in Q&A-6, the first testing year of an employer with respect to plans of the same type generally must begin on the first day of the first plan year that any plan of that type is subject to section 89. Also, the employer may use an earlier testing year, including the calendar year, for 1989. Thus, for testing years beginning in 1989, the employer is required to test all its plans of the same type together even though not all of such plans are subject to the requirements of section 89 for the entire testing year. In these circumstances, the proposed regulation requires an employer to test all benefits under the plans as if they were subject to section 89 for the entire testing year. However, in determining any excess benefits under the plans, Q&A-6 contains rules under which an employer may prorate the amount of any excess to reflect the extent to which coverage is subject to section 89.

Q&A-7 sets forth rules relating to valuing coverage under a health plan. These rules apply until the Service publishes valuation procedures under section 89(g)(3)(B). Q&A-7 provides that an employer may use any reasonable method for valuing a health plan and specifies that the cost of the health plan is a reasonable method of valuation. Specifically, in valuing coverage an employer is permitted to use the cost of the applicable premium under section 4980B(f)(4) for continuation coverage under a group health plan and is permitted to adjust the premium for differences related to geographic locale, the demographics of the participant population, and utilization. No inference should be drawn from Q&A-7 concerning the method that may be used to determine the applicable premium under section 4980B(f)(4).

The proposed regulation clarifies that cost containment features may be disregarded under a reasonable method of valuation. Similarly, the fact that a delivery system used by a plan is different from a delivery system used by another plan should not affect the values of such plans. Thus, the fact that one plan is provided through a health maintenance organization and another through a traditional indemnity program should not cause the value of the plans to differ as long as the coverage under both plans is substantially similar.

The method of valuing health plans used by an employer for purposes of section 89 must be applied consistently for all the employer's health plans, except that the employer may use the cost method described in section 89(g)(3)(E) for multiemployer plans.

When determining the amount of excess benefits under section 89(b), an employer is required to use the cost method used for determining the applicable premium under section 4980B(f)(4), even if that was not the valuation method the employer used for testing purposes. This method must be used for calculating both the highly and nonhighly compensated employees' employer-provided benefits when excess benefits for highly compensated employees are determined. The only permissible adjustment to this method is for differences in the premium due to utilization.

Q&A-7 also sets forth the method of valuing coverage under flexible spending arrangements that provide health benefits. See Q&A-7 of §1.125-2 of the proposed regulation for the definition of a flexible spending arrangement. Such coverage is to be valued on the basis of its cost (in general, the premium required for the health coverage under the arrangement). As is the case with any valuation method, the fact that a premium is not paid does not affect the value of the coverage so long as the coverage is provided.

Q&A-8 of the proposed regulation contains an explanation of the treatment of salary reduction contributions under the nondiscrimination tests of section 89. Salary reduction contributions generally are defined as elective, pre-tax contributions under a cafeteria plan. TAMRA '88 contains a provision allowing, in certain cases, salary reduction contributions to be taken into account as employer contributions in performing the 90 percent/50 percent eligibility test. In addition to this provision, the proposed regulation describes circumstances in which certain salary reduction contributions by highly compensated employees must be taken into account as employer contributions and circumstances in which certain salary reduction contributions by nonhighly compensated employees must be treated as after-tax employee contributions. This mandatory treatment of salary reduction contributions applies to testing years beginning after 1989.

Q&A-9 sets forth the method by which excess benefits provided under a discriminatory employee benefit plan are to be calculated.

Q&A-10 contains guidance relating to the effective dates of the nondiscrimination and qualification requirements. Generally, the requirements apply to plans for plan years that commence on or after January 1, 1989. With respect to health plans, a special rule applies if the designated plan year of such a plan begins later in calendar year 1989 than the plan year for such health plan began in 1988.

Section 89 provides a later effective date that may apply with respect to collectively bargained plans. In the case of a plan maintained pursuant to a collective bargaining agreement ratified before March 1, 1986, the rules under section 89 do not apply to employees covered by such agreement in years beginning before the earlier of January 1, 1991, or the date on which the last collective bargaining agreement relating to the plan expires (determined without regard to any extension thereof after February 28, 1986). Thus, such a collectively bargained plan is not subject to section 89 before the date determined under the preceding sentence, and collectively bargained employees under such a plan may be treated as excludable employees until such date for purposes of applying section 89 to those other plans of the same type of the employer that are subject to section 89. The proposed regulation provides that the employer may elect to take all such otherwise excludable collectively bargained employees under a plan into account and, in so doing, to accelerate the effective date with respect to the collectively bargained plan for purposes of the nondiscrimination tests.

3. *Qualification Requirements Under Section 89(k)*

Unless statutory employee benefit plans and certain other plans meet the requirements of section 89(k) employer-provided benefits received under such plans are includible in an employee's gross income, notwithstanding the fact that the employer-provided benefits are otherwise excludable under the Code. The term "benefit" for purposes of the section 89(k) qualification requirements, in contrast to the definition of the term "benefit" for purposes of the nondiscrimination tests, means the value of the payments, reimbursements, services and products provided under the plan.

In order to meet the requirements of section 89(k), a plan must be in writing, legally enforceable, maintained for the exclusive benefit of employees, and established with the intent that it will be maintained for an indefinite period of time. In addition, an employer must provide those who are eligible to participate in the plan with reasonable notice of benefits available under the plan.

Section 89(k) applies to statutory employee benefit plans and certain other types of plans maintained by an employer. Section 89(k) generally applies to the following types of plans, regardless of whether such plans are subject to nondiscrimination testing under section 89(a): accident and health plans; group-term life insurance plans; dependent care assistance programs; qualified tuition reduction programs; cafeteria plans; fringe benefit programs providing no-additional-cost services, qualified employee discounts, or employer-operated eating facilities, the benefits from which are otherwise excludable from the gross income of the beneficiary; and plans to which section 505 applies. The list of specific kinds of plans contained in the proposed regulation that are of a type to which section 89(k) applies is not intended to be exhaustive.

The proposed regulation contains several special rules with respect to accident or health plans. In general, an accident or health plan is not subject to section 89(k) unless the employer-provided benefits under the plan are (or are intended to be) excludable from gross income under section 105(b) or (c). Thus, for example, sick pay and disability plans are generally not subject to the rules of section 89(k).

Because coverages under accidental death and dismemberment (AD&D plans) plans and business travel accidental death plans are eligible for the exclusion under section 106, benefits provided pursuant to such coverages are excludable under sections 101 and 105(c). Thus, such plans are subject to the provisions of section 89(k). The coverages and benefits under these plans, like other accident or health plans the coverage of which is excludable (or of a kind that is excludable) under section 106, may not be excluded under section 132. If a death benefit under an AD&D plan is not conditioned on the accidental death of the employee, that benefit is not part of an AD&D plan.

The proposed regulation states that a plan that is a part of an organization described in section 501(c)(9) or 501(c)(17) must meet the requirements of section 89(k) and that, to the extent that the plan provides benefits of the type provided by statutory employee benefit plans, such benefits must be considered in nondiscrimination testing under section 89. If a plan does not meet the requirements of section 89(k), the related organization is not exempt from tax under section 501(a). Section 89 applies to the plan that is part of a voluntary employees' beneficiary association (VEBA) even if the VEBA is a collectively bargained VEBA as described in section 505(a)(2).

Section 89(k)(1)(A) provides that a plan must be in writing. The proposed regulation provides that all of the material terms of a plan must be contained in a single written document. However, the document may incorporate material terms by reference to other documents rather than setting forth such terms in full. The proposed regulation also clarifies that a single written document may satisfy the writing requirement for several plans. Similarly, material terms contained in one document related to several plans may be incorporated in each of the single written documents for such plans. These rules have been included to give employers the flexibility to group their plans in written documents in various ways so long as all of the coverage is in fact in writing.

Both the proposed regulation and section 89 require that an employer's elections with respect to nondiscrimination testing be in writing. If any such election is not in writing it is waived. For example, if no testing year is designated in writing with regard to any health plan, all health plans must be tested on the calendar year. The nondiscrimination testing elections are not required to be in the single written document. Consequently, the failure to make an election in writing does not cause a plan to fail to meet the writing requirement.

The proposed regulation provides that a plan must be in writing prior to the first day on which coverage or benefits are available under the plan. There is a transition rule under which a plan is not required to meet the writing requirement of section 89(k) before the later of the beginning of the first day of the second plan year beginning after December 31, 1988, and the end of the 12-month period beginning on the first day of the first plan year that the plan is subject to section 89.

Section 89(k)(1)(B) provides that a plan must be legally enforceable. The intent of this provision is to ensure that the employer cannot exercise excessive discretion. Therefore, the proposed regulation provides that, in general, the conditions required for an employee to participate in or obtain a benefit under a plan must be definitely determinable and the employee must be able to compel the coverage or payment of benefits described in the plan. Except in certain circumstances, a plan fails the enforceability requirement if coverage or a benefit available under the plan is subject to the discretion of the employer, either in operation or under the terms of the plan. Nevertheless, the proposed regulation permits employer discretion relating to certain administrative acts. In addition, an employer generally may expand coverage on a retroactive basis if the employer memorializes such expansion in writing, provides notice of such expansion, and meets the permanence requirements of section 89(k) with regard to the expanded coverage. The fact that such limited employer discretion does not violate the enforceability requirement of section 89(k) does not mean that, under certain circumstances, such employer discretion would not cause the plan to fail the nondiscrimination tests of section 89, in particular the nondiscriminatory provisions test of section 89(d)(1)(C).

The proposed regulation contemplates that many cost containment features existing in the health care industry today do not violate the enforceability requirements of section 89(k). For example, a managed care program that allows an insurer to grant a benefit not otherwise available under the plan in lieu of a benefit described in the plan does not violate the enforceability requirement if the patient, the employer and the insurance company consent to such alternative, a physician recommends or concurs with such alternative, and the plan describes the possibility of such alternative as well as the general criteria under which such alternative is available and may be selected. Similarly, health benefits may be conditioned on a medical opinion of a physician.

The proposed regulation contains a transition rule with regard to the enforceability rules of section 89(k). A plan is not required to satisfy the enforceability rules outlined in the proposed regulation before the first day of the second plan year that the plan is subject to section 89.

Section 89(k)(1)(C) provides that employees must be provided reasonable notification of benefits available in a plan. The purpose of this requirement is to inform an individual who is eligible to participate in the plan of its essential features. Therefore, the proposed regulation requires that individuals eligible for coverage or benefits under a plan be provided with a summary explanation of these features, including directions concerning the method by which individuals may receive more information. Such notice must be given to an individual prior to the initial availability of coverage or benefits to such individual.

The proposed regulation states that the employer must provide the notice. In the case of a multiemployer plan, the plan administrator must provide the notice. Nevertheless, the notice requirements are satisfied if an insurance company or other health care insurer or provider (e.g., a health maintenance organization) provides the notice.

The proposed regulation provides a transition rule for the notice requirement for plan years commencing in 1989. Under this rule, an employer is not required to provide notice to employees for any such plan year until July 1, 1989. Thus, for example, an employer is first required to provide notice under section 89(k) with respect to a calendar year plan by July 1, 1989. Similarly, with respect to a plan that uses a September 1 through August 30 plan year, notice under section 89(k) is first required by September 1, 1989. The delay in the notice to employees under this rule does not preclude the transitional relief providing for a delay in the requirement that a plan be in writing.

The reporting, notification and written plan requirements under this regulation are in addition to, and not in lieu of, reporting, disclosure, notification and written plan requirements which may otherwise apply under Title I of the Employee Retirement Income Security Act of 1974 [1974-3 C.B. 1] or any other law.

Section 89(k)(1)(D) provides that a plan must be maintained for the exclusive benefit of employees. The purpose of the exclusive benefit requirement is to preclude an employer from extending its plan to individuals who have no current or prior employment-type relationship with the employer. The proposed regulation provides, in general, that a plan must be maintained for the exclusive benefit of those employees who are described in the plan as eligible to participate. A plan may fail this requirement by its terms or through its operation.

The proposed regulation provides rules concerning who may participate under a plan. In general, only individuals who are or who are treated as employees (or former employees) of the employer or who otherwise perform services for the employer may participate under a plan of the employer. The proposed regulation does not have any effect on any other existing or future eligibility rule concerning who may participate in a plan. Thus, for example, a self-employed individual described in section 401(c)(1) cannot be a participant in a cafeteria plan even though such individual is treated as an employee for purposes of section 89(k).

There is a transition rule relating to the applicability of the exclusive benefit requirement. The proposed regulation provides that an employer is not required to meet the exclusive benefit requirement until the first day of the second plan year that the plan is subject to section 89.

Section 89(k)(1)(E) requires that a plan must be established with the intention that it will be maintained for an indefinite period of time. The proposed regulation focuses on the operation of the plan, as opposed to the plan terms, in determining whether the plan was intended to be maintained for an indefinite period of time. Accordingly, if a plan is materially amended or terminated and the coverage has been in effect for at least a consecutive 12-month period, the requirement of section 89(k)(1)(E) is satisfied, regardless of any terms of the plan which may provide that the employer has the right to change or terminate the plan. However, if a plan is materially amended or terminated before the coverage has been in effect for a consecutive 12-month period, the plan is considered to have been established with the intent of being temporary, unless the employer can demonstrate that there is a substantial business purpose for such termination or amendment.

The proposed regulation contains several rules relating to the sanction under section 89(k). In general, the proposed regulation provides that if a plan fails to satisfy the qualification requirements of section 89(k), the value of the employer-provided benefits received (rather than the value of the coverage provided), is not excludable from gross income. Thus, for example, the exclusions provided in sections 101 and 105 are generally not available with respect to benefits provided under an accident or health plan. All employees who receive benefits are subject to this sanction without regard to whether they are highly compensated employees within the meaning of section 414(q).

The proposed regulation contains a rule that allows correction of failures to comply with section 89(k) in certain circumstances. If there is a de minimis failure to comply with certain requirements, the employer may correct the failure within 90 days of its occurrence. If the employer timely corrects the failure, the plan does not fail section 89(k) merely because of such failure. A failure is not de minimis under this rule if correction requires the amendment of the plan document to reduce coverage on a retroactive basis to conform the document to the operation of the plan.

The proposed regulation clarifies the definition of a plan with respect to the sanction under section 89(k). In the case of a health plan, to the extent that the coverage providing the benefit taxable by reason of section 89(k) may reasonably be separated from other plan coverage, the proposed regulation permits the failed portion of the plan to be treated as a separate plan.

The proposed regulation provides for a limitation on the amount that must be included in the income of an employee as a result of section 89(k). The limitation is the sum of the following (dollar amounts are indexed in accordance with section 414(q)(1)(C)): 10 percent of the first $50,000 of the employee's compensation; 25 percent for amounts of such compensation in excess of $50,000 and up to $100,000; 75 percent for amounts of such compensation in excess of $100,000 and up to $150,000; and 100 percent of compensation in excess of $150,000. In addition, the Commissioner, through revenue rulings, notices or other publication of general applicability, is authorized to adjust the amounts of the sanction where such adjustment is appropriate and is not inconsistent with the purposes of section 89(k). Section 213 governs whether the amount includible in income as a result of section 89(k) is deductible.

If the sanction under section 89(k) is imposed with regard to a benefit under coverage that is determined under section 89(a) to discriminate in favor of a highly compensated employee, the proposed regulation provides for the coordination of the two sanctions. In general, the higher of the two taxable amounts must be included in the gross income of the highly compensated employee.

4. *Miscellaneous matters relating to section 125.*

Proposed §1.125-2 contains seven questions and answers that supplement and, in part, update the questions and answers contained in proposed regulations under §1.125-1 that were published on May 7, 1984 (49 FR 19321), and amended on December 31, 1984 (49 FR 50733). Q&A-1 of proposed §1.125-2 provides that Q&A-2 through Q&A-6 of that section are generally effective in accordance with the effective date provisions of section 89 (generally plan years commencing after December 31, 1988). In addition, Q&A-1 provides that Q&A-7 of proposed §1.125-2 (relating to flexible spending arrangements subject to sections 106 and 105) applies to plan years beginning after December 31, 1989.

Many of the questions and answers under §1.125-2 clarify previously proposed §1.125-1 as well as §1.125-2T of the Temporary Regulations published on February 4, 1986 (51 FR 4318). To the extent the provisions of proposed §1.125-2 clarify the provisions of proposed §1.125-1 or §1.125-2T and are less restrictive, the Service will apply them as if contained in those regulations. However, consistent with the statement in the preamble to the May 7, 1984 Notice of Proposed Rulemaking, to the extent that the provisions of proposed §1.125-2 clarify the provisions of proposed §1.125-1 and §1.125-2T and are more restrictive, the Service will apply them only as set forth in Q&A-1 of proposed §1.125-2.

Q&A-2 and Q&A-3 of the proposed regulation under §1.125-2 restate the general requirements of section 125. Q&A-4 sets forth what benefits are treated as qualified benefits and what benefits constitute cash under a cafeteria plan. For example, Q&A-4 provides that a benefit that is taxable because it is determined to be an excess benefit under section 89(b) or because the plan fails to satisfy section 89(k) remains a qualified benefit under section 125. As a result of this provision a cafeteria plan may provide such taxable benefits.

The proposed regulation provides further guidance with regard to the rule that a cafeteria plan may not operate to defer compensation. Thus, under Q&A-5, to the extent that a benefit carries over to the following plan year, such benefit may not be offered under a cafeteria plan. For example, life or health insurance with a savings or investment feature (e.g., so-called whole-life or whole-health insurance) may not be offered in a cafeteria plan. Q&A-5 also contains a rule to determine the extent to which the inclusion of elective vacation days under a cafeteria plan operates to permit the deferral of compensation.

A cafeteria plan may permit employees to make elective contributions under a qualified cash or deferred arrangement described in section 401(k). Similarly, a cafeteria plan does not impermissibly allow the deferral of compensation merely because, as an option under the plan, employees may make after-tax employee contributions under a qualified plan that is subject to section 401(m). Finally, the deferred compensation prohibition does not prevent an employer from providing employer matching contributions subject to section 401(m) with respect to elective contributions under section 401(k) or after-tax employee contributions subject to section 401(m).

Q&A-6 clarifies and expands the rule contained in proposed §1.125-1 concerning when an employee may revoke a benefit election and make a new election under a cafeteria plan. In general, Q&A-6 provides that a plan may allow such a revocation and subsequent election in the following circumstances: when a third-party health care insurer or provider significantly increases the cost to the employee of coverage or significantly curtails or ceases coverage; when the participant has a change in family status; or when the participant has separated from service. In addition, a cafeteria plan may provide that a benefit ceases if the participant has ceased making required premium payments. Finally, a cafeteria plan may allow a revocation or modification with respect to elective contributions subject to section 401(k) and after-tax employee contributions subject to section 401(m), to the extent such modification or revocation is permitted under section 401(k) or 401(m).

Q&A-7 contains special rules applicable to health plans that are flexible spending arrangements (FSAs). These rules are intended to protect the integrity of the distinction between the taxable treatment of personal medical expenses (subject to the rules of section 213) and the more favorable tax treatment of employer-provided health plan coverage and benefits under section 106 or 105, including benefits received under employee-purchased accident or health coverage under section 104.

In general, if a health plan has a low maximum limitation on benefits and the amount of the premium for coverage is the same or similar to this limitation on benefits, there is a significant concern that the plan operates primarily to exclude from income amounts paid for personal medical expenses that would otherwise only be deductible under section 213 to the extent that they exceed 7.5 percent of adjusted gross income. This concern is greater if, with respect to such plan, there is no person, such as an employer or insurance company, who bears a risk of experience loss with respect to the health plan and thus has an interest in regulating the arrangement to minimize adverse selection and substantiate claimed expenses. In order to limit the extent to which health FSAs effectively operate to exclude amounts paid for personal medical expenses, Q&A-7 applies requirements to health FSAs that are similar to the requirements that an independent health insurer with a meaningful risk of loss would apply to protect against adverse selection and the inappropriate reimbursement of expenses. Thus, the requirements in the proposed regulation are consistent with those features that are commonly associated with arrangements that exhibit the basic risk-shifting and risk-spreading characteristics of insurance.

Q&A-7 clarifies that an employee's salary reduction contributions under a health FSA are payments of a premium by the employee for health coverage with respect to which the maximum reimbursement amount is the same or similar to the amount of the required premium. Therefore, health FSAs are bona fide plans and are not separate, employee-by-employee, health expense reimbursement accounts that operate in a manner similar to employee-funded, defined contribution plans. The maximum amount of reimbursement available under a health FSA at any particular time with respect to an individual cannot be based on the amount of premium that the individual has paid as of such time. Rather, the maximum reimbursement amount must be uniform throughout the coverage period. In addition, health FSAs cannot reimburse employees for premiums for other health coverage. Finally, because there is no party directly involved in an FSA with an interest in assuring that claims are bona fide, the proposed regulation imposes certain claims substantiation requirements for FSAs.

Under the proposed regulation, experience gains under health FSAs (i.e., premiums in excess of claims paid plus expenses) may be treated as gains under bona fide health plans. Thus, such gains may be available to pay reasonable and bona fide dividends or premium refunds to the premium payers. Similarly, experience gains may be used to reduce required premiums for coverage in future years. For example, experience gains for one year may be used in a second year to permit the health FSA to charge all eligible employees only a $490 premium for coverage with a $500 reimbursement maximum. In no case, however, may the treatment of experience gains under a health FSA have the effect, directly or indirectly, of reimbursing employees based on their individual claims.

RELIANCE ON THESE PROPOSED REGULATIONS

Taxpayers may rely on these proposed regulations for guidance pending the issuance of final regulations. Because these proposed regulations are generally effective for years beginning after December 31, 1988, the Service will apply these proposed regulations in issuing rulings and in examining returns with respect to taxpayers and plans after that date. If future regulations are more restrictive than these proposed regulations, such regulations will be applied without retroactive effect.

SPECIAL ANALYSES

The Commissioner of Internal Revenue has determined that this proposed rule is not a major rule as defined in Executive Order 12291 and that a regulatory impact analysis is therefore not required. Although this document is a notice of proposed rulemaking which solicits public comments, the Internal Revenue Service has concluded that the regulations proposed herein are interpretative and that the notice and public procedure requirements of 5 U.S.C. 553 do not apply. Accordingly, the proposed regulations do not constitute regulations subject to the Regulatory Flexibility Act (5 U.S.C. Chapter 6).

COMMENTS AND REQUESTS FOR PUBLIC HEARING

Before adopting these proposed regulations, consideration will be given to any written comments that are submitted (preferably eight copies) to the Commissioner of Internal Revenue. All comments will be available for public inspection and copying. A public hearing will be held upon written request to the Commissioner by any person who has submitted written comments. If a public hearing is held, notice of the time and place will be published in the FEDERAL REGISTER.

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LIST OF SUBJECTS IN 26 CFR 1.61-1 through 1.281-1

Deductions, Exemptions, Income taxes, Taxable income.

Proposed amendments to the regulations

The proposed amendments to 26 CFR Part 1 are as follows:

INCOME TAX REGULATIONS (26 CFR Part 1)

Paragraph 1. The authority citation for Part 1 is amended by adding the following citation:

Authority: 26 U.S.C. 7805 §§1.89(a)-1 and 1.89(k)-1 also issued under 26 U.S.C. 89(m).

Par. 2. New §§1.89(a)-1 and 1.89(k)-1 are added immediately after §1.88-1 to read as follows:

§1.89(a)-1 Miscellaneous questions and answers relating to nondiscrimination rules for certain employee benefit plans.

The following is a list of the questions addressed in this section:

Q-1: What are the section 89 nondiscrimination rules?

Q-2: What transitional and special rules are available to health plans under section 89?

Q-3: Under what circumstances may employees be disregarded for purposes of section 89 when the employees receive health coverage from other employers or when employees do not have a family or have a family whose members receive health coverage from another employer?

Q-4: What is a health plan under the section 89 nondiscrimination rules and to what extent are health plans comparable or aggregated for purposes of such rules?

Q-5: What is the testing methodology for applying the nondiscrimination rules under section 89?

Q-6: What is the period for testing whether the

nondiscrimination rules of section 89 are satisfied?

Q-7: For purposes of applying section 89 to an employer's health plan, what rules apply for determining the employer-provided benefits and calculating the excess benefits?

Q-8: How are salary reduction contributions treated for purposes of the section 89 nondiscrimination tests?

Q-9: How is an excess benefit under the section 89 nondiscrimination rules to be determined with respect to health plans?

Q-10: What are the effective dates of the section 89 nondiscrimination and qualification rules?

Q-1: What are the section 89 nondiscrimination rules?

A-1: (a) *Nondiscrimination rules*—(1) *In general.* Section 89(a) provides that, notwithstanding any other provision of the tax law specifically excluding items from gross income (e.g., sections 79 and 106), the gross income of a highly compensated employee (as defined in section 414(q)) includes an amount equal to the employee's employer-provided benefit that is found to be discriminatory under the rules provided in this section. See paragraph (f)(3) of this Q&A-1 for the definition of "employer-provided benefit" for these nondiscrimination rules. The nondiscrimination requirements of section 89(a), however, do not affect the exclusion from gross income of death benefits under section 101(a) and accident and health benefits under sections 104 and 105.

(2) *Timing of inclusion and deduction.* The excess benefit for a testing year generally is treated as received on the last day of the testing year. Thus, the excess benefit for a testing year generally is included in a highly compensated employee's gross income for the employee's taxable year with or within which the testing year ends. Similarly, the excess benefit for a testing year generally is treated as paid by the employer on the last day of the testing year. Thus, the excess benefit for a testing year is deductible by the employer only for the taxable year of the employer with or within which the testing year ends. Also, for purposes of determining the deductibility of both employer-provided benefits that are not excess benefits and employer-provided benefits that are excess benefits, excess benefits are deemed to be attributable to the employer-provided benefits provided latest during the testing year. For purposes of determining the treatment of excess benefits under section 404, excess benefits are treated as paid under a plan or arrangement that defers the receipt of compensation or benefits to the extent that, under the rule of this paragraph (a)(2), the excess benefits are received after the end of the employer's taxable year in which the services creating the right to such compensation or benefits are performed. For these purposes excess benefits are deemed to be attributable to employees' services performed latest in such testing year. Excess benefits are treated as paid under such a plan or arrangement even if they are received not more than a brief period (e.g., 2½ months) after the end of the employer's taxable year (see §1.404(b)-1T) and even if the employer elects the rule of section 89(a)(2)(B) with respect to excess benefits. An employer's election of the rule of section 89(a)(2)(B) for a testing year must be made in writing by January 31 of the first calendar year following the calendar year in which the testing year ends. Such election, when made, must apply for all plans of the same type.

(b) *Discriminatory employee benefit plan*—(1) *In general.* A statutory employee benefit plan is a discriminatory employee benefit plan for a testing year unless, for such year, the plan satisfies the requirements of paragraphs (c) and (d) of this Q&A-1. Alternatively, in lieu of the requirements of paragraph (d) of this Q&A-1, an employer may elect to apply the requirements of paragraph (e) of this Q&A-1 to a statutory employee benefit plan. However, for testing years beginning in 1989, a statutory employee benefit plan is not treated as a discriminatory employee benefit plan for purposes of section 4976 if the excess benefits with respect to such plan are properly reported in accordance with section 89(l).

(2) *Disability coverage.* Generally, a plan (or portion thereof) that provides disability coverage is not subject to the requirements of paragraphs (c), (d) or (e) of this Q&A-1 for a testing year and, thus, may not be taken into account in determining whether any other accident or health plan satisfies the requirements of such paragraphs. For example, short-term sick pay, short-term and long-term disability plans, worker's compensation plans (as defined in paragraph (f)(1)((v) of this Q&A-1), plans described in section 104(a)(4) and (5) and similar wage continuation plans are not subject to the requirements of paragraphs (c), (d) or (e) of this Q&A-1, even if there are significant employer-provided benefits with respect to such plans. This paragraph (b)(2) does not apply with respect to disability coverage the benefits of which are excludable from gross income under section 105(b) or (c).

(3) *No employer-provided benefit.* If there is no employer-provided benefit (other than by reason of coverage under such plan being considered excess benefit) for a testing year, with respect to a plan that is otherwise subject to the nondiscrimination rules of section 89, such plan is not subject to the requirements of paragraphs (c), (d) or (e) of this Q&A-1 for such testing year. See Q&A-7 of this section to determine a plan's employer-provided benefit. An employer cannot take into account a plan (or portion thereof) providing no employer-provided benefit in determining whether other plans meet the requirements of paragraphs (c), (d) or (e) of this Q&A-1.

(4) *Employers with only highly compensated employees.* A statutory employee benefit plan is not subject to the requirements of paragraphs (c), (d) or (e) of this Q&A-1 for a testing year if such plan is maintained by an employer that, for such year, only has employees who are highly compensated employees.

(c) *Nondiscriminatory provisions requirement*—(1) *In general.* A plan satisfies the requirement of this paragraph (c) and section 89(d)(1)(C) only if the plan does not contain any provision that (by its terms, operation, or otherwise) discriminates in favor of highly compensated employees. In making this determination, an employer must take into account all plans of the same type. For purposes of this requirement, an employer's election with respect to testing (e.g., designation of a testing day) is subject to the nondiscriminatory provisions requirement even though it is not required to be in the single written document required under section 89(k)(1)(A).

(2) *Waiting periods under core health plans.* If an employer has two or more core health plans with different waiting periods, the core health plans do not satisfy the nondiscriminatory provisions test of this paragraph (c) unless each plan satisfies the 50 percent eligibility test of paragraph (d)(3) of this Q&A-1 either on an individual basis or by inclusion in a group of comparable plans, under paragraph (b) of Q&A-4 of this section, that includes only one or more additional core health plans that have the same or shorter waiting periods. If a plan fails to satisfy this paragraph (c) by reason of this paragraph (c)(2), the excess benefit attributable to this failure is the employer-provided benefit under the plan that relates to the period of coverage that prevents the plan from being included in a group of comparable plans under the preceding sentence.

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

Example 1. Assume that an employer has 25 employees, 5 of whom are highly compensated employees. Two of the 20 nonhighly compensated employees have families. The employer provides employee-only health coverage with an employer-provided benefit of $2,000 to all employees, and provides the highly compensated employees with an additional plan providing employee-only coverage with an employer-provided benefit of $2,200. In addition, the employer provides family-only health coverage (with an employer-provided benefit of $2,000) to all of the nonhighly compensated employees, but makes such family-only coverage available to the highly compensated employees only if they pay the total cost of such coverage on an after-tax employee contribution basis. Thus, the highly compensated employees receive no employer-provided benefit with respect to such family-only coverage. The employer decides to treat all of its employees as having a family (see Q&A-3 of this section). The family-only coverage that is treated as received by employees without families may be used under the comparability rule of paragraph (c)(2) of Q&A-4 of this section to support the additional $2,200 employee-only coverage provided to highly compensated employees. Although after the application of the comparability rule, the $2,200 employee-only coverage for the highly compensated passes the 80 percent coverage test set forth in paragraph (e) of this Q&A-1, the nondiscriminatory provisions test is violated. This is because the coverage of 18 of the 20 nonhighly compensated employees is not meaningful because they are not in fact receiving benefits under the family-only coverage.

Example 2. A school district selects July 1 as its testing day. On that day, the school district has no part-time employees and only administrative personnel, regular faculty and maintenance personnel on its payroll. The designation of July 1 as the testing day does not constitute the designation of a testing day that is fairly representative of the employee pool and business operation of the school district and, therefore, such designation violates the nondiscriminatory provisions test.

Example 3. An employer that operates a department store selects July 1 as its testing day. Traditionally, the number of the employees employed by the employer on July 1 does not reasonably reflect the number of the employer's employees employed during most of its fiscal year. This designation violates the nondiscriminatory provisions test.

Example 4. Assume that an employer maintains numerous health plans (both core and noncore plans) for its 5,000 employees. All but one core health plan, Plan X, provides for a 3-month waiting period for new employees. Plan X provides coverage after 1 month of employment for certain executive personnel. This 1-month waiting period provision violates the nondiscriminatory provisions test of this paragraph (c) unless Plan X satisfies the 50 percent eligibility test of paragraph (d)(3) of this Q&A-1 either on an individual basis or by inclusion with another core health plan or plans with the same or shorter waiting periods in a group of comparable plans under paragraph (b) of Q&A-4 of this section. If the 1-month waiting period provision fails the nondiscriminatory provisions test of this paragraph (c), then the employer-provided benefit under Plan X that relates to coverage for the period between the first and third months of employment is treated as an excess benefit of each highly compensated employee eligible for coverage under Plan X after 1 month of employment.

(d) *Eligibility and benefit requirements*—(1) *In general.* A plan satisfies the requirements of this paragraph (d) only if the tests of paragraphs (d)(2), (d)-(3), and (d)(4) of this Q&A-1 are satisfied.

(2) *90 percent/50 percent eligibility test*—(i) *In general.* A plan satisfies this test only if at least 90 percent of all nonhighly compensated employees have available under all plans of the same type an employer-provided benefit that is at least 50 percent of the largest employer-provided benefit available under all such plans to any highly compensated employee. To the extent that an employee is eligible to be covered under two or more plans of different types (see paragraph (f)(2)(i) of this Q&A-1), but not fully under all such plans, the employee cannot be treated as eligible for the full employer-provided benefit of each plan for purposes of the 90 percent/50 percent test. Instead, the employer must use a reasonable, uniform, and nondiscriminatory allocation method to allocate to such employee only a reasonable portion of each plan's full employer-provided benefit. Whether a plan is available to an employee is determined under all of the facts and circumstances. For example, an HMO at a location distant from the location of the employer might not, under the facts and circumstances, be reasonably available to employees at the location of the employer. See Q&A-8 of this section for the treatment of salary reduction contributions under this test. Also, see Q&A-2 of this section for a transition rule for the 1989 testing year.

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

Example. An employer has 12 employees, 10 of whom are nonhighly compensated employees. The employer maintains two health plans. Plan A has an employer-provided benefit of $1,000 It is available to 9 of the 10 nonhighly compensated employees and both of the highly compensated employees. Plan B, a dental plan,has an employer-provided benefit of $500. It is available only to the two highly compensated employees. The health plans meet the requirements of this paragraph (d)(2). This is the result since 90 percent of the nonhighly compensated employees (9 of 10) have available to them an employer-provided benefit of $1,000, which is more than 50 percent of $1,500, the largest employer-provided benefit available to any highly compensated employee. Note that the dental plan in this example fails the 50 percent eligibility test set forth in paragraph (d)(3) of this Q&A-1.

(3) *50 percent eligibility test*—(i) *In general.* A plan satisfies this test only if the plan satisfies the requirement of either paragraph (d)(3)(ii) or paragraph (d)(3)(iii) of this Q&A-1. An employee is eligible to participate in a plan only if, under all of the facts and circumstances, the employee is reasonably eligible to participate in such plan. See Q&A-4 of this section with respect to rules relating to the comparability and aggregation of health plans.

(ii) *50 percent eligibility.* A plan satisfies the requirement of this paragraph (d)(3)(ii) only if at least 50 percent of the employees eligible to participate in the plan are nonhighly compensated employees.

(iii) *Nondiscriminatory ratio.* A plan satisfies the requirements of this paragraph (d)(3)(iii) only if the highly compensated eligibility percentage does not exceed the nonhighly compensated eligibility percentage. The highly compensated eligibility percentage is the percentage determined by dividing the number of highly compensated employees eligible to participate in the plan by the total number of highly compensated employees. The nonhighly compensated eligibility percentage is the percentage determined by the same method substituting nonhighly compensated employees for highly compensated employees.

(iv) *Example.* The provisions of this paragraph (d)(3) are illustrated in the following example:

Example. An employer maintains a plan providing for medical diagnostic examinations to a group of management personnel. Of this group, 10 percent are nonhighly compensated employees. Unless the plan can be treated as part of a group of comparable plans that passes the 50 percent eligibility test (see paragraph (b) of Q&A-4 of this section), the plan fails the tests described in this paragraph (d)(3).

(4) *75 percent benefits test*—(i) *In general.* A plan satisfies the test of this paragraph (d)(4) only if the average employer-provided benefit actually received under all plans of the same type by nonhighly compensated employees is at least 75 percent of the average employer-provided benefit actually received under all plans of the same type by highly compensated employees. See paragraph (f)-(2)(ii) of this Q&A-1 for a rule under which, in certain circumstances, plans that are not of the same type may be treated as plans of the same type for purposes of this paragraph (d)(4). Also, see Q&A-2 of this section for transition rules for the 1989 and 1990 testing years.

(ii) *Example.* The provisions of this paragraph (d)(4) are illustrated in the following example:

Example. An employer has 5 highly compensated employees and 15 nonhighly compensated employees. The employer maintains only one health plan with an employer-provided benefit of $1,500. All of the highly compensated employees and 10 of the nonhighly compensated employees participate in the plan. The employer's health plan does not meet the requirements of this paragraph (d)(4) since the average employer-provided benefit of the nonhighly compensated employees is only $1,000 ((10 × $1,500)/15), and this amount is less than 75 percent of the average employer-provided benefit of the highly compensated employees, which is $1,500 ((5 × $1,500)/5). In order to meet the requirements of this paragraph (d)(4), the average employer-provided benefit of the nonhighly compensated employees must be at least $1,125

(75 percent of $1,500) or the average employerprovided benefit of the highly compensated employees must be no more than $1,333.33 ($1000 is 75 percent of $1333.33).

(e) *80 percent coverage test.* A plan that is a health plan or a group-term life insurance plan satisfies the requirements of this paragraph (e) only if at least 80 percent of the nonhighly compensated employees are covered under such plan and the plan meets the requirements of paragraph (c) of this Q&A-1 (the nondiscriminatory provisions test). Plans of the same type may pass the 80 percent test separately or together (e.g., by reason of health plans being comparable). See Q&A-4 of this section with respect to rules relating to comparability and aggregation. If any of an employer's plans of the same type are tested under this paragraph (e), all plans of the same type must be tested under the requirements of this paragraph (e). The employer must elect in writing to use this 80 percent test.

(f) *Definitions*—(1) *Statutory employee benefit plan*—(i) *In general.* The term "statutory employee benefit plan" means an accident or health plan (within the meaning of sections 106 and 105) or a group-term life insurance plan (within the meaning of section 79). Also, under section 89(i)(2), an employer may treat certain other plans as statutory employee benefit plans.

(ii) *Health plan.* In general, the term "health plan" means an accident or health plan under section 105 or 106, except to the extent the plan is a disability plan (see paragraph (b)(2) of this Q&A-1). In addition, a plan that provides payments for accidental death and dismemberment, or business travel accident insurance, is an accident or health plan because coverage under such plan is eligible for the exclusion under section 106. Furthermore, plan that provides for medical diagnostic procedures or physical examination is an accident or health plan because the plan is eligible for the exclusion under section 106.

(iii) *Church plans.* The term "statutory employee benefit plan" does not include a plan maintained by a church (as defined in section 3121(w)(3)(A)), including a qualified church-controlled organization within the meaning of section 3121(w)(3)(B)), if the plan is maintained exclusively for clergy and church employees, and their spouses and dependents.

(iv) *Plans maintained by governments.* A plan does not fail to be a statutory employee benefit plan merely because it is maintained by a state or local government or political subdivision or instrumentality thereof, by the District of Columbia, or by the federal government or a political subdivision or instrumentality thereof.

(v) *Worker's compensation.* The term "statutory employee benefit plan" does not include a worker's compensation plan that pays amounts from a sickness and disability fund maintained for employees under the laws of the United States, a state or the District of Columbia (i.e., a fund maintained pursuant to a worker's compensation act or statute in the nature of a worker's compensation act, the benefits from which are excludable under section 104(a)(1)). Thus such a plan is not subject to the nondiscrimination requirements of section 89. An employer may not take into account a worker's compensation plan (or portion thereof) in determining whether other plans meet the requirements of paragraphs (c), (d) or (e) of this Q&A-1. However, accident or health plans maintained by a government (as defined in paragraph (f)(1)(iv) of this Q&A-1) that provide benefits that are excludable from the income of the employee solely by reason of section 105(b) or (c) are not worker's compensation plans within the meaning of the first sentence of this paragraph (f)(1)(v) and thus are subject to the nondiscrimination requirements of section 89.

(2) *Plans of the same type*—(i) *In general.* Two or more plans are treated as plans of the same type if all of such plans are included in only one of the following categories: accident or health plans (sections 106 and 105); group-term life insurance (section 79); qualified group legal services plans (section 120); educational assistance programs (section 127); or dependent care assistance programs (section 129).

(ii) *Election.* For purposes of applying the requirements of paragraph (d)(4) of this Q&A-1 (the 75 percent benefits test) to plans of the same type other than health plans for a testing year, an employer may elect in writing to treat all plans of the types specified in the election as plans of the same type. Although this election is not available for purposes of determining whether the health plans of the employer satisfy the 75 percent benefits test, if such plans satisfy the 75 percent benefits test they may be taken into account in determining whether plans of the same type (e.g. group-term life insurance plans), other than health plans, satisfy such test. For any testing year, if an employer elects to take health plans into account in determining whether two or more plans of another type or types satisfy the 75 percent benefits test, all of the employer's health plans must be taken into account with all other plans of the type or types subject to the election. Thus, for example, if an employer elects to take its health plans into account in testing its group-term life insurance plans and dependent care assistance programs for purposes of the 75 percent benefits test, all such plans must be tested on an aggregated basis under the 75 percent benefits test.

(3) *Employer-provided benefit.* In the case of any health or group-term life insurance plan, the employer-provided benefit for purposes of this section is the value of the coverage under the plan that is attributable to employer contributions. For example, in the case of a health plan, the employer-provided benefit is the employer-provided portion of the value of the entitlement to receive payment on account of personal injury or sickness including medical care or reimbursements of specified medical expenses or other medical benefits, subject to various conditions and limits, rather than the value of the reimbursements, products, services and other benemployreceived pursuant to the health coverage. See Q&A-7 of this section for guidance relating to the value of health coverage. See section 89(g)(3)(C) for rules with respect to the value of coverage under a group-term life insurance plan. In the case of any other statutory employee benefit plan, an employee's employer-provided benefit under section 89 is the employer-provided portion of the value of the reimbursements, products, services and other benefits provided under the plan (rather than the value of the coverage or the entitlement to such benefits).

(4) *Highly compensated employee.* The term "highly compensated employee" is defined as that term is defined in section 414(q). For purposes of determining who is a highly compensated employee under section 89, the testing year is the determination year.

(5) *Nonhighly compensated employee.* The term "nonhighly compensated employee" is defined as each employee other than a highly compensated employee.

(6) *Employee*—(i) *In general.* The term "employee" generally means an individual who performs service for the employer maintaining the plan and who is either a common law employee of the

employer, a self-employed individual treated as an employee under section 401(c)(1), or an individual who is treated as an employee with respect to the employer for purposes of the provision (e.g., section 106) that provides for the exclusion of the benefit being tested under section 89.

(ii) *Leased employees*—(A) *In general.* The term "employee" includes a leased employee who is treated as an employee of the employer-recipient pursuant to the provisions of section 414(n)(1)(A) or section 414(o)(2) and the regulations thereunder. In general, section 414(n) applies with respect to employee benefit plans covered by section 89 in the same manner as it applies with respect to qualified plans covered by section 401(a). Thus, the rule of section 414(n)(1)(B) permitting a recipient to take into account certain benefits provided by a leasing organization is available with respect to benefits subject to section 89. The safe harbor exception of section 414(n)(5), however, is not available with respect to section 89. In addition, the rule of §1.414(n)-1(b)(10) regarding services performed on a "substantially full-time basis" is to be applied by appropriately adjusting the hour of service requirements to reflect the 6-month period of service requirement. Nevertheless, a leaseemployoyee may be disregarded by an employer-recipient when testing its health plans if the employer-recipient treats the health coverage received by the leased employee from the leasing organization as health coverage received from another employer and, on such basis, applies the rules of Q&A-3 of this section with respect to such leased employee. Notwithstanding the immediately preceding sentence, no leased employee described in this paragraph (f)(6)(ii) may be disregarded as having coverage from another employer unless the value of employer-provided core health benefits actually received by the leased employee from the leasing organization under its plan is at least 50 percent as valuable as the highest employer-provided core health benefit available to any highly compensated employee of the employer-recipient.

(B) *Additional rules.* The differing natures of employee benefit plans covered by section 89 and qualified plans covered by section 401(a) may require different rules in certain circumstances. The Commissioner may provide such rules, to the extent appropriate, through revenue rulings, notices, and other guidance of general applicability.

(iii) *Excluded employees.* In general, the term "employee" does not include employees who are excluded employees under section 89(h) and thus who are excluded from consideration in applying the nondiscrimination rules of section 89 with respect to other employees. For example, employees who are included in a unit of employees covered by a collective bargaining agreement are excluded employees only if there is evidence that the type of benefits provided under the plan being tested under section 89 was the subject of good faith bargaining and no employee in such collective bargaining unit of employees is eligible to receive or does receive any benefit under the plan or any plan of the same type.

(7) *Core health benefits.* Except as provided otherwise in this section, the terms "core health benefits," "core health coverage," and "core health plan" generally refer to coverage providing comprehensive major medical and hospitalization benefits and similar types of health benefits. Dental care, vision care, accidental death and dismemberment, and disability coverage are examples of health benefits that generally are not core health plans. Also, any health coverage provided through a flexible spending arrangement (as defined in Q&A-7 of §1.125-2) is not a core health benefit.

(g) *Written election.* In general, unless specifically provided otherwise, an election required to be in writing under this section must be in writing by January 31 of the first calendar year following the calendar year in which excess benefits for the testing year (without regard to whether there are such excess benefits for such year) would be treated as received under paragraph (a)(2) of this Q&A-1. However, if an employer makes an election under section 89(a)(2)(B) to delay the inclusion of excess benefits in income for one year, then any other written elections must be in writing by January 31 of the first calendar year following the calendar year in which excess benefits for the testing year (without regard to whether there are such excess benefits for such year) are treated as received under paragraph (a)(2) of this Q&A-1. See Q&A-1(a)(2) for the time for making the section 89(a)(2)(B) election. The elections must be written in a manner that will allow a reconstruction of the employer's method of testing.

Q-2: What transitional and special rules are available to health plans under section 89?

A-2: (a) *Transition rule for 75 percent benefits test*—(1) *In general.* With respect to the 1989 and 1990 testing years, an employer's health plans are deemed to satisfy paragraph (d)(4) of Q&A-1 of this section (the 75 percent benefits test) with respect to active employees for a testing year if the requirements of paragraphs (a)(2), (a)(3), and (a)(4) of this Q&A-2 are satisfied with respect to such testing year.

(2) *Testing years ending in 1989 and 1990.* The requirement of this paragraph (a)(2) is satisfied only if the testing year ends in either the 1989 calendar year or the 1990 calendar year. For purposes of this paragraph (a), a testing year that ends in 1989 is a 1989 testing year and a testing year that ends in 1990 is a 1990 testing year.

(3) *Employer election.* The requirement of this paragraph (a)(3) is satisfied only if the employer elects in writing the application of the transition rule in this paragraph (a) with respect to a testing year.

(4) *Includible coverage for applicable group of employees*—(i) *In general.* The requirement of this paragraph (a)(4) is satisfied for a testing year only if the employer-provided benefits (including the portion attributable to salary reduction contributions) under all health plans of the employer received by the applicable group of employees for the testing year are treated as excess benefits for such testing year. If an employer makes an election under paragraph (a) of this Q&A-2, then in determining whether the requirements of paragraphs (d)(2) and (d)(3) of Q&A-1 of this section (the 90 percent/50 percent eligibility test and the 50 percent eligibility test, respectively) are met, the employer may treat benefits that are includible in gross income by reason of this paragraph (a)(4) as attributable to after-tax employee contributions.

(ii) *Applicable group of employees*—(A) *1989 testing year.* For a 1989 testing year, the applicable group of employees includes all active employees of the employer for such year who had more than a 5 percent ownership interest in the employer (determined in accordance with section 416(i)) at any time between January 1, 1988, and the end of the testing year, and the applicable number of the highly compensated active employees of the employer who receive the most compensation for the 1989 testing year. The applicable number for the preceding sentence is the number of employees representing 20 percent of the highly compensated active employees of the employer for the testing year, but in no event greater than 1,000 highly compensated employees and in no event less than 10 employees (or the total number of highly compensated employees of the employer if less than 10).

(B) *1990 testing year*. For a 1990 testing year, the applicable group of employees includes all highly compensated active employees of the employer for such year who had more than a 5 percent ownership interest in the employer (determined in accordance with section 416(i)) at any time between January 1, 1989, and the end of the testing year, and the applicable number of highly compensated active employees of the employer (or all highly compensated active employees if the employer has fewer than the applicable number of such employees) who receive the most compensation for the 1990 testing year. The applicable number for the preceding sentence is the number of employees representing 40 percent of the highly compensated active employees of the employer for the testing year, but in no event greater than 2,000 highly compensated employees and in no event less than 50 employees (or the total number of highly compensated employees of the employer if less than 50).

(C) *Compensation*. For purposes of identifying those highly compensated employees who receive the greatest amount of compensation, "compensation" means "compensation" as defined in section 414(q)(7). In the case of two or more employees with the same amount of compensation, the employer may decide which of such employees is to be treated as receiving more compensation.

(b) *Transition rule for 90 percent/50 percent eligibility test*. If an employer's health plans are deemed to satisfy paragraph (d)(4) of Q&A-1 of this section (the 75 percent benefits test) by reason of paragraph (a) of this Q&A-2 for a testing year ending in 1989, then, for such testing year, such employer may elect in writing to apply the 90 percent/50 percent eligibility test of paragraph (d)(2) of Q&A-1 of this section with respect to active employees for such testing year by substituting "80 percent" for "90 percent" and by substituting "66 percent" for "50 percent" (i.e., the test may be treated as an 80 percent/66 percent eligibility test). The rule of this paragraph (b) is not applicable for purposes of determining excess benefits under section 89(b).

(c) *Special rule for certain large employers*—(1) *In general*. An employer's health plans are deemed to satisfy the requirements of paragraph (d) of Q&A-1 of this section (the eligibility and benefit requirements) with respect to active employees for a testing year if all of the requirements of paragraphs (c)(2) through (c)(7) of this Q&A-2 are satisfied for such testing year. In applying the requirements of paragraphs (c)(2) through (c)(7) of this Q&A-2, only nonexcludable employees are taken into account and, for such purpose, the excluded employee rules of section 89(h)(1)(A), (B), (C), and (D) are to be applied without regard to the last sentence of section 89(h)(1) and without regard to sections 89(h)(2) and 89(h)(3). Thus, for example, differences in eligibility waiting periods do not result in the loss of an employee's status as an excludable employee to the extent that the period with respect to such employee does not exceed the maximum period allowed under section 89(h) (e.g., 6 months for core health coverage). The nondiscriminatory provisions test of paragraph (c) of Q&A-1 of this section does not apply to waiting periods under core health plans as discussed in paragraph (c)(2) of Q&A-1 of this section with respect to plans tested under this paragraph (c). The rules of this paragraph (c) are not applicable for purposes of determining excess benefits under section 89(b).

(2) *Employer election*. The requirement of this paragraph (c)(2) is satisfied with respect to a testing year only if the employer elects in writing the application of the rule of this paragraph (c) with respect to such testing year. If any of an employer's health plans are tested under this paragraph (c), all of such employer's health plans must be tested under this paragraph (c).

(3) *Minimum number of employees*. The requirement of this paragraph (c)(3) is satisfied for a testing year only if the employer employs at least 5,000 active employees on at least 1 day in each quarter of such testing year.

(4) *Minimum percentage of nonhighly compensated employees*. The requirement of this paragraph (c)(4) is satisfied only if at least 90 percent of the employer's active employees are nonhighly compensated employees.

(5) *Maximum percentage of highly compensated employees*. The requirement of this paragraph (c)(5) is satisfied only if fewer than 3/4 percent (0.75 percent) of the employer's active employees have annual compensation (within the meaning of section 414(q)(7)) in excess of 200 percent of the dollar amount in effect under section 414(q)(1)(C) for the testing year.

(6) *Health plan eligibility*—(i) *In general*. The requirement of this paragraph (c)(6) is satisfied only if both of the tests in paragraphs (c)(6)(ii) and (c)(6)(iii) are satisfied. For purposes of this paragraph (c)(6) the comparability rules of paragraph (c) of Q&A-1 of this section are available.

(ii) *80 percent eligibility test*. This test is satisfied only if at least 80 percent of the employees eligible to participate in each health plan of the employer are nonhighly compensated employees. For purposes of this paragraph (c)(6)(ii) the comparability rules of Q&A-4(b) of this section and the family eligibility test rules of Q&A-3(b) of this section are available.

(iii) *80 percent/80 percent eligibility test*. This test is satisfied only if at least 80 percent of the nonhighly compensated employees of the employer have available to them under all health plans an employer-provided benefit that is at least 80 percent as valuable as the largest employer-provided benefit available under all such health plans to any highly compensated employee. The rules relating to the application of the 90 percent/50 percent eligibility test apply in making this determination.

(7) *Benefits test*. The requirement of this paragraph (c)(7) is satisfied only if at least 66 percent of the nonhighly compensated employees of the employer actually receive core health coverage with an employer-provided benefit that is at least 66 percent as valuable as the largest employer-provided benefit available under all health plans (including both core and noncore health coverage) to any highly compensated employee. In determining the largest employer-provided benefit available to a highly compensated employee, the rules applicable to the 75 percent benefits test apply, except that for this purpose salary reduction contributions are treated as employer contributions. For purposes of this paragraph (c)(7), the coverage rules of Q&A-3(c) of this section are available.

Q-3: Under what circumstances may employees be disregarded for purposes of section 89 when the employees receive health coverage from other employers or when employees do not have a family or have a family whose members receive health coverage from another employer?

A-3: (a) *In general*. For purposes of determining whether health plans providing coverage to the spouse and dependents (if any) of an employee (i.e., family-only coverage) satisfy the requirements of paragraph (d)(2) (the 90 percent/50 percent eligibility test) and paragraph (d)(3) (the 50 percent eligibility test) of Q&A-1 of this section, an employer may elect in writing to apply the rules of paragraph (b) of this Q&A-3. Also, for purposes of determining whether health plans satisfy the requirements of paragraph (d)(4) (the 75 percent benefits test) or paragraph (e) (the 80 percent coverage test) of Q&A-1 of this section, the employer may elect in writing to apply the rules of paragraph (c) of this Q&A-3.

(b) *Eligibility tests.* An employee who is eligible to receive family-only coverage under a health plan or would be eligible under the same terms and conditions as other eligible employees if the employee had a spouse and dependents may be treated as eligible to receive such family-only coverage without regard to whether the employee has a spouse and dependents. This is the case without regard to whether there is a requirement of an employee contribution or other employee election under the plan so long as any such election is uniformly available. If the employer applies the rule of this paragraph (b) with regard to any employee or any health plan, the employer must apply the rule uniformly with regard to all employees and health plans except to the extent such application would cause a plan to fail the nondiscriminatory provisions test of paragraph (c) of Q&A-1 of this section.

(c) *75 percent benefits test and 80 percent coverage test*—(1) *Separate testing.* Except as otherwise provided in this paragraph (c), an employer may elect in writing to apply the requirements of paragraph (d)(4) or (e) of Q&A-1 of this section for a testing year by testing its health plan or plans that provide employee-only coverage separately from the health plan or plans that provide family-only coverage. If the employer tests family only coverage separately from employee only coverage all family only coverage must be tested together under this paragraph (c). Therefore, an employer may not separately test coverage provided to a spouse from coverage provided to a dependent. Separate testing may be elected under this paragraph (c)(1) without regard to the fact that family-only coverage is not available as a separate option to employees (i.e., the employee-only and family-only coverages are available or provided only as a package to the employee). No amendment to a written plan document is required to test separately under this paragraph (c)(1).

(2) *Presumption of family status.* In applying the requirements of paragraph (d)(4) or (e) of Q&A-1 of this section for a testing year to a health plan that provides family-only coverage, an employee does not fail to be treated as receiving family-only coverage merely because the employee does not have a spouse or dependents. This is the case without regard to whether the employer has elected separate testing in accordance with paragraph (c)(1) of this Q&A-3. Thus, for example, if an employer automatically provides an employee with family-only coverage (i.e., such coverage is provided on a nonelective, noncontributory basis) or automatically provides an employee with family-only coverage if the employee purchases employee-only coverage and the employee does purchase such employee-only coverage, the employee may be treated as having received the family-only coverage even though the employee does not have a spouse or dependents. However, see paragraph (c) of Q&A-1 of this section with respect to the application of the nondiscriminatory provisions test to certain plans that provide family-only coverage.

(3) *Other core health coverage*—(i) *Employer does not elect separate testing.* If an employer does not elect to test plans providing employee-only coverage separately from plans that provide family-only coverage (as permitted under paragraph (c)(1) of this Q&A-3), an employee who has a family (as determined under this paragraph (c)) may be disregarded for purposes of applying the requirements of paragraphs (d)(4) and (e) of Q&A-1 of this section the following two requirements are met. First, such employee and family members (if any) all receive core health coverage from another employer or from the spouse's or a dependent's employer or if the employer does not provide a health plan that includes employer-provided, family-only coverage. Second, the employee receives core health coverage from another employer or from the spouse's or a dependent's employer.

(ii) *Employer elects separate testing.* If an employer elects to test employee-only coverage separately from family-only coverage (as permitted under paragraph (c)(1) of this Q&A-3), an employee may be disregarded for purposes of applying the requirements of paragraphs (d)(4) and (e) of Q&A-1 of this section with respect to the family-only coverage if such employee does not have a family (as determined under this paragraph (c)) or if such employee has a family and the family members all receive core health coverage from another employer or from the spouse's or a dependent's employer. Similarly, for purposes of applying the requirements of paragraphs (d)(4) and (e) of Q&A-1 of this section with respect to the employee-only coverage, an employee may be disregarded if the employee receives core health coverage from another employer or from the spouse's or a dependent's employer. In testing only the health plan or plans that provide employee-only coverage, employees are taken into account without regard to whether they have families.

(4) *Sworn statements*—(i) *In general.* An employer may not elect the rules of paragraph (c)(3) of this Q&A-3 unless the employer obtains and maintains adequate sworn statements that satisfy the requirements of paragraph (c)(4)(ii) of this Q&A-3. In the absence of an adequate sworn statement with respect to an employee or the application of paragraph (c)(4)(iii) of this Q&A-3, certain presumptions, set forth in section 89(g)(2)-(C), are to be applied with respect to those facts that would otherwise have been provided on the sworn statement.

(ii) *Adequate sworn statement.* An adequate sworn statement must contain sufficient information to indicate whether the employee has a spouse or any dependents and, if so, the number of dependents and the current receipt by the employee and any spouse and dependents of core health coverage under a plan of another employer or the employer of the spouse or dependent. An employer cannot rely on sworn statements for testing years beginning after 1989 unless such statements are made under penalty of perjury and contain a designation of the employer-provided health coverage currently received by the employee under the employer's health plan or plans. In lieu of including information about the employer-provided health coverage being received by an employee under the employer's health plans, an employer may use any other reasonable method to enable it to determine, for each testing year, the extent to which an employee who is receiving core health coverage under a plan of another employer is also receiving employer-provided health coverage from the employer. A sworn statement is not required to be notarized or on a form approved in advance by the

Commissioner. The rule of this paragraph (c)(4)(ii) is illustrated by the following example:

Example. As part of its open season on the selection of health plan coverage, an employer requests that an employee complete a form providing information about the employee's family status, number of dependents and whether the employee or the employee's spouse or dependents receive core health coverage through another employer or the employer of the spouse or a dependent. If the employee does receive other core health coverage, the form also requests the name of the other employer and, if applicable, the insurance company administering the program or providing the other coverage. At the bottom of the form, just above the signature block and date, is the following phrase: "Under penalties of perjury, I declare that the information I have furnished above, to the best of my knowledge and belief, is true, correct, and complete." This form satisfies the sworn statement requirement of section 89(g)(2)(B) and this Q&A-3 provided that the employer also is able to determine for each testing year, by other reasonable means, the extent to which employees who receive other core health coverage also receive health coverage from the employer.

(iii) *Exception*. If an employee is eligible to receive employee-only coverage under a core health plan of the employer with a substantial employer-provided benefit at no cost to the employee and such employee does not elect to receive any employee-only coverage under a core health plan of the employer, the employer may treat such employee as having completed an adequate sworn statement that the employee has core health coverage from another employer. Similarly, if an employee is eligible to receive family-only coverage under a core health plan of the employer with a substantial employer-provided benefit and at no cost, and such employee does not elect to receive any family-only coverage under a core health plan of the employer, the employer may treat such employee as having completed an adequate sworn statement that the employee has no family or has a family all the members of which receive other core health coverage. Even if a sworn statement is deemed to have been completed under this paragraph (c)(4)(iii), the employer must establish by other reasonable methods the extent to which employees described in this paragraph (c)(4)(iii) receive health coverage from such employer. For purposes of this paragraph (c)(4)(iii), the plan has a cost to the employee if the employee is required to make any after-tax or salary reduction contributions or to waive any other benefit (taxable or otherwise) in order to obtain the health coverage.

(iv) *Frequency of sworn statements*. An employer that elects to use sworn statements as permitted under this paragraph (c)(4) must obtain such statements on no less frequent a basis than once each 3-consecutive years. If the employer does not obtain sworn statements from substantially all of its employees or from a statistically valid random sample of all of its employees determined under statistical standards consistent with those in paragraph (d) of Q&A-5 of this section, the employer must obtain such sworn statements on an annual basis.

(5) *Certain highly compensated employees*. A highly compensated employee cannot be disregarded under paragraph (c)(3) of this Q&A-3 if such employee receives an employer-provided benefit under all health plans of the employer that is greater than 133⅓ percent of the average employer-provided benefit under all such health plans received by nonhighly compensated employees (after applying the rule of paragraph (c)(6) of this Q&A-3). The rule of this paragraph (c)(5) is applied separately with respect to employee-only coverage and family-only coverage if the employer elects under paragraph (c)(1) of this Q&A-3 to test such coverages separately.

(6) *Certain nonhighly compensated employees*. A nonhighly compensated employee may not be disregarded under paragraph (c)(3) of this Q&A-3 because of other core health coverage unless, at the time such other coverage ceases, such employee is eligible to elect coverage under any core health plan of the employer for which the employee was eligible (through election or otherwise) during the immediately preceding period in which the employee could have elected such coverage (e.g. an open season). The election period for purposes of the rule in this paragraph (c)(6) must be no shorter than 30 days). This paragraph (c)(6) applies without regard to the reason for the cessation of the employee's other core health coverage and without regard to whether the employer's health plans otherwise permit employees to commence coverage at other than an open season. Similarly, a nonhighly compensated employee may not be disregarded as having no family or having a family with other coverage under paragraph (c)(3) of this Q&A-3 unless such employee is eligible to elect (on the same conditions set forth in the preceding two sentences) family-only coverage, upon a change in family status in which the employee acquires a family or upon a loss of such other coverage for a member of the family. This paragraph (c)(6) does not require that an employee be eligible to participate under a plan for which the employee would not previously have been eligible. In addition, any otherwise applicable eligibility conditions that would have barred participation during the immediately preceding open season, such as insurability, may continue to be applied with respect to eligibility resulting under this paragraph (c)(6) but only if such conditions exist at the time the other core health coverage ceases and such conditions are applied on a uniform, consistent and nondiscriminatory basis. However, in no event may an employer impose conditions on eligibility that were not previously applicable to such employee during the immediately preceding open season. Conditions that were previously applicable, may be applied with regard to the facts in existence either at the time of previously eligibility or at the time the other core coverage ceases, as long as such application is on a uniform, consistent and nondiscriminatory basis. This paragraph (c)-(6) is applicable only for plan years beginning after December 31, 1990.

(7) *Eligibility requirement*. An employer may not disregard employees under paragraph (c)(3) of this Q&A-3 for purposes of applying paragraph (e) of Q&A-1 of this section (the 80 percent coverage test) unless paragraph (e) of Q&A-1 of this section would be satisfied without use of the rules contained in such paragraph (c)(3) of this Q&A-3 on the basis of eligibility to participate instead of coverage received.

Q-4: What is a health plan under the section 89 nondiscrimination rules and to what extent are health plans comparable or aggregated for purposes of such rules?

A-4: (a) *In general*. Except as otherwise provided in this section, a health plan is a uniform entitlement provided to employees with respect to payments on account of personal injury or sickness, including specified medical claims, expenses, products or services. Any difference in entitlement creates separate health plans. In addition, any difference in cost to different groups of employees, including the fact that salary reduction contributions are required for coverage that is identical to coverage that is otherwise employer-provided, creates separate plans. Each option as to coverage is treated as a separate health plan for purposes of section 89. However, paragraphs (b) through (f) of this Q&A-4 provide testing rules under which comparable health plans may be treated as a single health plan, rules when two or more health plans must be aggregated and treated as a single plan, and rules when separate health plans may be restructured. These rules apply solely for purposes of testing an employer's health plans under the section 89 nondiscrimination rules, and do not require that the single written document required by Q&A-3 of proposed §1.89(k)-1 relating to any of such plans be modified to conform to the testing status of such plans under these rules.

(b) *Comparable health plans for 50 percent eligibility test.* For purposes of applying paragraph (d)(3) of Q&A-1 of this section (the 50 percent eligibility test), two or more health plans included in a group of comparable plans may be treated as a single health plan. A group of plans is comparable if the smallest employer-provided benefit available to any employee in any plan in the group is at least 95 percent of the largest employer-provided benefit available to any employee in any plan in the group. See paragraph (d) of this Q&A-4 for mandatory aggregation rules that may be applicable before the application of this paragraph (b).

(c) *Comparable health plans for 80 percent coverage test*—(1) *In general.* Except as otherwise provided in this paragraph (c), for purposes of applying paragraph (e) of Q&A-1 (the 80 percent coverage test) of this section, two or more health plans included in a group of comparable plans, may be treated as a single health plan. A group of plans is comparable if the smallest employer-provided benefit available to any employee in any plan in the group is at least 90 percent of the largest employer-provided benefit available to any employee in any plan in the group. See paragraph (e) of this Q&A-4 for mandatory aggregation rules that may be applicable before the application of this paragraph (c).

(2) *Alternative general comparability rule.* At the employer's written election, a group of plans is comparable for purposes of applying paragraph (e) of Q&A-1 (the 80 percent coverage test) if the smallest employer-provided benefit available to any employee in any plan in the group is at least 80 percent of the largest employer-provided benefit available to any employee in any plan in the group. This alternative general comparability rule is available only if the employer applies the requirements of paragraph (e) of Q&A-1 by substituting "90 percent" for "80 percent." Thus, this alternative general comparability rule applies only if at least 90 percent of the nonhighly compensated employees are covered under the health plan or group of comparable plans being tested.

(3) *Restriction on general comparability.* If a plan fails to satisfy paragraph (d)(3) of Q&A-1 of this section (the 50 percent eligibility test), the failed plan may not be included with any other plan in a group of comparable plans under paragraphs (c)(1) or (c)(2) of this Q&A-4 unless the following two requirements are met. First, themployoyer-provided benefit of the group of comparable plans is within at least 95 percent of the employer-provided benefit of the failed plan. Second, the failed plan and the group of comparable plans, considered together, are comparable under paragraph (c)(1) or (c)(2) of this Q&A-4. The following example illustrates the rules of this paragraph (c)(3)(iii):

Example. Assume that an employer with 25 employees, 5 of whom are highly compensated employees, provides all nonhighly compensated employees with a health plan with an employer-provided benefit of $3,000. In addition, the employer provides a health plan with an employer-provided benefit of $3,750 only to its highly compensated employees. The employer tests its health plans under the 80 percent coverage test of paragraph (e) of Q&A-1 of this section. Because the additional $3,750 health plan is available only to highly compensated employees and thus fails the 50 percent eligibility test, such plan may not be aggregated with the $3,000 plan unless the employer-provided benefit under the $3,750 plan is reduced to $3,158 ($3,000 is 95 percent of $3,158) or the employer-provided benefit under the other plan is increased to $3,562 (95 percent of $3,750).

(4) *Deemed comparability rule*—(i) *Health plan outside comparability range.* A health plan (or a group of health plans treated as a single health plan) that is not otherwise included with another health plan in a group of comparable plans (determined under paragraph (c)(1) through (3) of this Q&A-4) may be included in such group if the employer-provided benefit under the former health plan (or group of health plans) is greater than the employer-provided benefit under the latter health plan (or group of plans); the former health plan's nonhighly compensated coverage percentage is at least 80 percent of its highly compensated coverage percentage; and, after the inclusion of the former plan in a group with the latter plan, the nonhighly compensated coverage percentage remains at least 80 percent the of highly compensated coverage percentage for such group. No plan can be included under this rule if a plan with a smaller employer-provided benefit has previously been included in the group of comparable plans under this rule. If the employer elects the alternative general comparability rule of paragraph (c)(2) of this Q&A-4, "90 percent" must be substituted for "80 percent" in the preceding sentence. The deemed comparability rule of this paragraph (c)(4) is applied by treating the resulting group of comparable plans as a single health plan. The employer-provided benefit for such single health plan, except as provided in paragraph (c)(5)(i) of this section, is the largest employer-provided benefit of any plan included in the group.

(ii) *Coverage percentages.* For purposes of this paragraph (c)(4), a health plan's (or group's) nonhighly compensated coverage percentage is the percentage determined by dividing the number of nonhighly compensated employees covered by the plan (or the group) by the total number of nonhighly compensated employees of the employer. A health plan's (or group's) highly compensated coverage percentage is the percentage determined in the same manner by reference only to highly compensated employees.

(iii) *Examples.* The following examples illustrate the application of the rules of this paragraph (c)(4):

Example 1. Assume that an employer maintains four health plans that constitute a group of comparable plans under the general comparability rule of paragraph (c)(1) of this Q&A-4. The employer also maintains another health plan that has too large an employer-provided benefit to permit it to be included in the group of comparable plans under the general comparability rule. Under this paragraph (c)(4), if the nonhighly compensated coverage percentage with respect to such plan is at least 80 percent of the highly compensated coverage percentage for such plan and if after inclusion of the plan with the group of four comparable plans, the resulting group of plans has a nonhighly compensated coverage percentage that is at least 80 percent of the highly compensated coverage percentage, then the plan may be included in the group of comparable health plans to form a new group of comparable plans.

Example 2. Assume the same facts as in Example 1, except that the *other* health plan has too small an employer-provided benefit to permit it to be included in a group of comparable plans under the general comparability rule of paragraph (c)(1) of this Q&A-4. If the nonhighly compensated coverage percentage for the group of comparable plans is at least 80 percent of the highly compensated coverage percentage for such group, and if, after inclusion of the other plan with the group of comparable plans, the resulting group of plans has a nonhighly compensated coverage percentage that is at least 80 percent of the highly compensated coverage percentage, then the group of comparable plans may be included with the other plan to form a new group of comparable plans.

(5) *Employee cost comparability*—(i) *In general.* Health plans may be treated as a group of comparable plans if such plans are available to all of the employees who are covered under any of such plans on the same terms and conditions

and the difference in the annual employee costs between the plan in the group with the largest employee cost and the plan in the group with the smallest employee cost is not greater than $100 (adjusted for testing years beginning after 1989 in accordance with section 89(g)(1)(E)(v)). Two or more plans generally are not available on the same terms if the employee cost for one plan is in the form of after-tax employee contributions and the employee cost for another plan is in the form of salary reduction contributions. A health plan is available to an employee only if, under all of the facts and circumstances, the plan is reasonably available to such employee. The employer-provided benefit for a group of comparable plans determined under this paragraph (c)(5)(i) is deemed to be the largest employer-provided *core health* benefit of any plan included in the group under this paragraph (c)(5)(i). If both salary reduction contributions and after-tax employee contributions are required under each of the plans, the plans may be treated as comparable if the maximum total amount of such contributions under each plan does not differ from the maximum total amount of such contributions under any of the other plans by more than $100. The rules of this paragraph (c)(5)(i) are illustrated by the following examples:

Example 1. Assume that an employer maintains two health plans, Plan X and Plan Y. Plan X is provided to employees at no employee cost. Plan Y is available to employees under a cafeteria plan for $100 a year, to be paid through salary reduction contributions. These plans may not be treated as part of a group of comparable plans under an analysis that compares the after-tax employee contributions required for Plan X ($0) with the after-tax employee contributions required for Plan Y ($0) because Plan Y is not actually available for only $0 in after-tax employee contributions, but rather is available for $100 in salary reduction contributions. However, these plans may be treated as part of a group of comparable plans under an analysis that compares the salary reduction contributions of Plan X ($0) with the salary reduction contributions of Plan Y ($100) because the salary reduction contributions under each plan do not differ by more than $100 and neither plan has any required after-tax contributions.

Example 2. Assume that an employer maintains two health plans, Plan V and Plan W. Plan V is provided to employees for an after-tax employee contribution of $20 a year and a salary reduction contribution of $20 a year. Plan W is provided to employees for an after-tax employee contribution of $100 and a salary reduction contribution of $100. These two plans may not be treated as part of a group of comparable plans under this paragraph (c)(5)(i) because the maximum total amount of after-tax and salary reduction contributions under Plan V ($40) differs from the maximum total amount of after-tax and salary reduction contributions for Plan W ($200) by more than $100.

(ii) *Coordination rule.* A health plan that is not included in a group of comparable plans under paragraph (c)(5)(i) of this Q&A-4 may be included with such group of comparable plans under the comparability rules of paragraphs (c)(1) through (c)(4) of this Q&A-4 if such plan and the group are otherwise comparable under such rules. The employer-provided benefit under the group of plans is to be determined under the rule of paragraph (c)(5)(i) of this Q&A-4.

(iii) *Special employee cost rule.* A health plan that is not otherwise included in a group of comparable plans may be included in a group with respect to an employee if the employer-provided benefit under the plan to be included is less than the employer-provided benefit of the plan within the group of comparable plans with the largest employer-provided benefit and, in the case of a nonhighly compensated employee, the employee is eligible on the same terms and conditions as other employees to participate in the plan in such group with the largest employer-provided benefit and the annual employee cost for the employee under the plan to be included is equal to or greater than the greatest employee cost for the employee under any plan in the group of comparable plans minus $100. Thus, the rule of this paragraph (c)(5)(iii) applies if a nonhighly compensated employee may choose a more expensive plan with a lesser employer-provided benefit than any plan in the group so long as the conditions of this paragraph (c)(5)(iii) are satisfied. A health plan is available to an employee only if, under all of the facts and circumstances, the plan is reasonably available to such employee. This paragraph (c)(5)(iii) may be applied with respect to a health plan and a group of comparable plans or with respect to two groups of comparable plans otherwise determined under paragraph (c)(1) or (c)(5) of this Q&A-4. In such case, the employer-provided benefit of the group of comparable plans is the largest employer-provided benefit of any plan (whether or not that plan is a core health plan) in such group and the lowest employee cost permitted within the group of comparable plans is equal to the employee cost for the plan in such group with the largest employee cost minus $100. The rules of this paragraph (c)(5)(iii) are illustrated by the following examples:

Example 1. Assume that an employer permits all of its employees to elect coverage under one of two health plans: Plan A (with an employer-provided benefit of $3,000 and an employee contribution of $300) and Plan B (with an employer-provided benefit of $2,200 and an employee contribution of $500). These two plans may form a group of comparable plans under this paragraph (c)(5)(iii) because Plan B's employer-provided benefit is less than Plan A's employer-provided benefit and Plan B's required employee contribution of $500 is greater than $200 (i.e., Plan A's required employee contribution minus $100).

Example 2. Assume that an employer permits all of its employees to elect coverage under any one of four health plans: Plan A (with an employer-provided benefit of $2,000 and an employee contribution of $125); Plan B (with an employer-provided benefit of $2,500 and an employee contribution of $225); Plan C (with an employer-provided benefit of $3,000 and an employee contribution of $200); and Plan D (with an employer-provided benefit of $2,500 and an employee contribution of $300). Plans A, B, and C may be included in a group of comparable plans under the rules of paragraph (c)(5)(i). Plan D may be included in such group under the rules of paragraph (c)(5)(iii) with respect to all employees because Plan D's employer-provided benefit of $2,500 is less than Plan C's employer-provided benefit of $3,000 and Plan D's required employee contribution of $300 is greater than $125 (i.e., Plan B's required employee contribution of $225 minus $100).

Example 3. Assume that an employer permits all of its employees to elect coverage under one of three health plans: Plan A (with an employer-provided benefit of $3,000 and an employee contribution of $500); Plan B (with an employer-provided benefit of $2,700 and an employee contribution of $350); and Plan C (with an employer-provided benefit of $2,500 and an employee contribution of $450). Plans A and B are included in a group of comparable plans determined under paragraph (c)(1) of this Q&A-4 (i.e., 90 percent of $3,000 is $2,700). Plan C may be included in such group under the rules of this paragraph (c)(5)(iii) because Plan C's employer-provided benefit of $2,500 is less than Plan A's employer-provided benefit of $3,000 and Plan C's required employee contribution of $450 is greater than $400 (i.e., Plan A's required employee contribution of $500 minus $100).

(iv) *Employee cost.* For purposes of this paragraph (c)(4), the term "employee cost" refers to both the employee's after-tax employee contributions and salary reduction contributions that are required in order for the employee to receive coverage under the health plan. The de minimis employee cost comparability rule of this paragraph (c)(5) may be applied on the basis of either after-tax employee contributions or salary reduction contributions under a cafeteria plan, but not both. Thus, for example, health Plan X that is available for $50 in after-tax employee contributions and health Plan Y that is available for $100 in salary reduction contributions under a cafeteria plan may not be treated as comparable plans under this paragraph (c)(5).

(d) *Mandatory aggregation of plans for the 50 percent eligibility test*—(1) *In general.* For purposes of applying paragraph (d)(3) of Q&A-1 of this section (the 50 percent eligibility test), if an employee may receive coverage under two or more health plans the rules of this paragraph (d) must be applied with respect to such plans. In addition, such plans may not be included in a group of comparable plans under paragraph (b) of this Q&A-4 with regard to such employee until the rules of this paragraph (d) have been applied with respect to such plans. Such health plans must be aggregated into an additional, single health plan that provides all of the coverage provided under any of the separate plans. The additional plan is treated as having an employer-provided benefit equal to the sum of the employer-provided benefits of each of the included plans (with an appropriate adjustment to eliminate the multiple inclusion of overlapping coverage). A nonhighly compensated employee is treated as eligible for both the additional plan and the separate plans. A highly compensated employee is treated as eligible only for the additional plan and is no longer treated as eligible for the separate plans.

(2) *Special rule for salary reduction contributions*. Any employer-provided benefit that is a non-core health benefit and is attributable to salary reduction contributions available to any nonhighly compensated employee under a non-core health plan of the employer that, after application of paragraph (d)(1) of this Q&A-4, exceeds the greater of $2,000 (adjusted for testing years beginning after 1989 in accordance with 89(g)(1)-(E)(v)) or the employees' actual salary reduction contribution is not considered available to such employee. This paragraph (d)(2) is effective for plan years beginning after December 31, 1989.

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

Example 1. Assume that, under an employer's health program, an employee is permitted to elect coverage under one plan from among two health indemnity plans provided through insurance companies and two HMO plans. The indemnity and HMO plans are four alternative health coverages and thus an employer is not required to apply this paragraph (d).

Example 2. Assume the same facts as *Example 1*. In addition to electing one of the indemnity or HMO plans, an employee may also elect coverage under any one or more of the following plans: a dental plan, a vision plan and various levels of health coverage (up to and including $1000) under a health flexible spending arrangement (FSA). Under this paragraph (d), each of the indemnity and HMO plans must be aggregated with the 3 elective plans, before testing any of the plans under the 50 percent eligibility test.

Example 3. Employee X is a nonhighly compensated employee and may receive coverage under either Plan A or Plan B, each of which has an employer-provided benefit of $500, or under both Plans A and B. Under this paragraph (d), for Employee X, Plan A and Plan B must be aggregated to form an additional Plan AB for purposes of the 50 percent eligibility test. In addition, Plan AB is treated as having an employer-provided benefit equal to $1,000 (assuming no overlapping coverage). Thus, there are three health plans that each must pass the 50 percent eligibility test: Plan A ($500), Plan B ($500), and Plan AB ($1,000). Employee X is treated as eligible for all three plans.

Example 4. An employer maintains two health plans: Plan A ($500) and Plan B ($500). The following table illustrates all of the eligible employees for these two plans. In addition, HCE denotes a highly compensated employee and NCE denotes a nonhighly compensated employee.

Employee	*Plan A*	*Plan B*
HCE 1 500	500	
HCE 2	500	Not Elig.
HCE 3	Not Elig.	500
HCE 4	500	500
NCE 1	500	500
NCE 2	Not Elig.	500
NCE 3	500	Not Elig.
NCE 4	500	Not Elig.
NCE 5	Not Elig.	500

The following table reflects the plans after the application of this paragraph (d):

Employee	*Plan A*	*Plan B*	*Plan AB*
HCE 1	Not Elig.	Not Elig.	1000
HCE 2	500	Not Elig.	Not Elig.
HCE 3	Not Elig.	500	Not Elig.
HCE 4	Not Elig.	Not Elig.	1000
NCE 1	500	500	1000
NCE 2	Not Elig.	500	Not Elig.
NCE 3	500	Not Elig.	Not Elig.
NCE 4	500	Not Elig.	Not Elig.
NCE 5	Not Elig.	500	Not Elig.

After application of this paragraph (d), there are three plans that must satisfy the 50 percent eligibility test. Plan A and Plan B satisfy the 50 percent eligibility test, both as separate plans and as plans included in a group of comparable plans under paragraph (b) of this Q&A-4. However, Plan AB fails the 50 percent eligibility test. See Q&A-9 for rules relating to the determination of the excess benefit with respect to a plan that fails to satisfy the 50 percent eligibility test.

Example 5. An employer maintains two health plans: Plan A ($7,000) and Plan B($500). The following table illustrates all of the eligible employees for these two plans.

Employee	*Plan A*	*Plan B*
HCE 1	$1,000	$500
HCE 2	$1,000	$500
NCE 1-100	$1,000	Not Elig.

The following table reflects the plans after the application of this paragraph (d):

Employee	*Plan A*	*Plan B*	*Plan AB*
HCE 1	Not Elig.	Not Elig.	$1,500
HCE 2	Not Elig.	Not Elig.	$1,500
NCE 1-100	$1,000	Not Elig.	Not Elig.

After application of this paragraph (d), there are three plans that must pass the 50 percent eligibility test. Plan A passes the 50 percent eligibility test. Plan B is no longer available to any employee and is not required to be tested under the 50 percent eligibility test. However, Plan AB fails the 50 percent eligibility test. Under Q&A-9, an excess benefit must be imputed to HCEs 1 & 2 so that Plan AB may be included in a group of comparable plans under paragraph (b) of this Q&A-4.

(e) *Mandatory aggregation of plans for the 80 percent coverage test*—(1) *In general*. For purposes of applying paragraph (e) of Q&A-1 of this section (the 80 percent coverage test), if an employee receives coverage under two or more health plans the rules of this paragraph (e) must be applied with respect to such plans. In addition, such plans may not be included in a group of comparable plans under paragraph (c) of this Q&A-4 with regard to such employee until the rules of this paragraph (e) have been applied with respect to such plans. Such health plans must be aggregated into an additional, single health plan that provides all of the coverage that is provided under any of the separate plans. The additional plan is treated as having an employer-provided benefit equal to the sum of the employer-provided benefits of each of the included plans (with an appropriate adjustment to eliminate the multiple inclusion of overlapping coverage). A nonhighly compensated employee is treated as covered under both the additional plan and the separate plans. A highly compensated employee is treated as covered under the additional plan and not covered under the separate plans.

(2) *Exception*. This paragraph (e) does not apply with respect to two or more health plans if at least 90 percent of the nonhighly compensated employees eligible for coverage under each plan are eligible for coverage under all of such plans on the same terms and conditions as other employees, and each plan (prior to application of the comparability rules of paragraph (c) of this Q&A-4) satisfies the 80 percent coverage test.

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

Example 1. Assume that an employer maintains two health plans, Plan A and Plan B. Each has an employer-provided benefit of $500. Also, each plan covers 45 percent of the employer's nonhighly compensated employees who are not covered by the other plan. Employee X, a highly compensated employee, and Employee Y, a nonhighly compensated employee, are covered by both Plan A and Plan B. Plan A and Plan B must be aggregated to form an additional single health plan because the exception of paragraph (e)(2) of this Q&A-4 does not apply. Thus, there are three health plans: Plan A ($500), Plan B ($500), and Plan AB ($1,000). The plans fail the 80 percent coverage test because Plan AB may not be included with Plan A and Plan B under any of the comparability rules of paragraph (c) of this Q&A-4. Thus, the employer provided benefit under Plan AB must be reduced to $526 with respect to Employee X for all plans to pass the 80 percent coverage test.

Example 2. Assume that an employer maintains two health plans, Plan A and Plan B. Each has an employer-provided benefit of $500. Each plan is available on the same terms to all employees of the employer and covers over 80 percent of the employer's nonhighly compensated employees. Because these plans qualify for the exception of paragraph (e)(2) of this Q&A-4, the employer is not required to aggregate the plans under this paragraph (e). Plan A and Plan B, each satisfy the 80 percent coverage test.

Example 3. An employer maintains two health plans. Plan A has an employer-provided benefit of $1,000 and Plan B has an employer-provided benefit of $500. The following table illustrates all of the eligible employees for these two plans. HCE denotes a highly compensated employee and NCE denotes a nonhighly compensated employee.

Employee	*Plan A*	*Plan B*
HCE 1	$1,000	$500
HCE 2	$1,000	Not Elig.
NCE 1	$1,000	$500
NCE 2-100	$1,000	Not Elig.

The following table reflects the plans after the application of this paragraph (e):

Employee	*Plan A*	*Plan B*	*Plan AB*
HCE 1	Not Elig.	Not Elig.	$1,500
HCE 2	$1,000	Not Elig.	Not Elig.
NCE 1	$1,000	$500	$1,500
NCE 2-100	$1,000	Not Elig.	Not Elig.

After application of this paragraph (e), there are three plans that must be comparable in order for the plans to pass the 80 percent coverage test. The plans fail the 80 percent coverage test even though Plans A and B may be included in a group of comparable plans under paragraph (c)(3) because Plan AB may not be included in a group of comparable plans with Plan A and Plan B under any of the rules of paragraph (c) of this Q&A-4 for inclusion in a group of comparable plans with Plans A and B. It does, however, pass the 50 percent eligibility test, and therefore Plan AB's employer-provided benefit may be reduced to $1,111 (1000 is 90 percent of $1,111) and the health plans are considered comparable.

(f) *Permissive plan restructuring*. For purposes of applying paragraphs (d)(3) and (e) of Q&A-1 of this section (the 50 percent eligibility test and the 80 percent coverage test, respectively) an employer may, in certain circumstances, restructure two or more health plans into two or more restructured health plans on the basis of the value of coverages under such plans. To the extent mandatory aggregation is applicable and if the employer decides to apply the comparability rules of this Q&A-4, such mandatory aggregation and comparability rules must be applied prior to the application of the permissive restructuring rule of this paragraph (f). Pursuant to this rule, two or more health plans may be restructured into one health plan of common value and two or more plans of distinct values. In all cases, to the extent the values of any plans being restructured are equivalent, the values may be restructured into only one plan. Thus, for example, if an employer has 3 plans (after the application of the mandatory aggregation and the comparability rules of this Q&A-4), Plan A with an employer-provided benefit of $7000, Plan B with an employer-provided benefit of $6000 and Plan C with an employer-provided benefit of $4000, and if the employer decides to restructure the three plans under this paragraph (f), then the plans are restructured into three plans with employer-provided benefits of $4000, $2000 and $1000 respectively.

(g) *Authority to issue additional requirements*. The Commissioner, in revenue rulings, notices and other publications of general applicability, may make any modification to, or issue such additional requirements for the application of, the rules contained in this Q&A-4 as may be necesary to ensure proper compliance with the intent of such rules and section 89(g)(1).

Q-5: What is the testing methodology for applying the nondiscrimination rules under section 89?

A-5: (a) *In general*. Except as otherwise provided in this Q&A-5, the determination of whether a statutory employee benefit plan is a discriminatory employee benefit plan for a testing year is made on the basis of all of the applicable facts with respect to the employees of the employer as of the testing day included within such testing year. Such facts generally are to be treated as in existence for the entire testing year.

(b) *Adjustments to facts on the testing day*—(1) *Changes in plan terms*. If the employer-provided benefit (actually provided or made available) of an employee who is taken into account on the testing day changes during the testing year (either before or after the testing day) in connection with any change in plan terms, the amount taken into account as such employee's employer-provided benefit for such testing year must be adjusted to reflect the employer-provided benefit for the portions of the testing year both before and after such change.

(2) *Election changes by highly compensated employees*—(i) *In general*. If the employer-provided benefit (actually provided or made available) of a highly compensated employee for a testing year who is taken into account on the testing day changes during the testing year (either before or after the testing day) solely on account of an election of the employee the amount taken into account as such employee's employer-provided benefit for such testing year must be adjusted to reflect the employer-provided benefit for the portions of the testing year both before and after such change.

(ii) *Special rule for the first quarter of each testing year*. An employer must make the adjustments otherwise required under this paragraph (b)(2) for election changes during the first quarter of a testing year only for those election changes by employees who were highly compensated employees for the immediately preceding testing year and employees who, for the current testing year, either are among the 100 highly compensated employees who receive the most compensation for the current testing year or are 5 percent owners of the employer (as determined under section 416(i)).

(3) *Distinction between changes in plan terms and election changes*. A change in an employee's employer-provided benefit is treated as an election change only if such change is exclusively attributable to an election change by the employee that is not in connection with or otherwise related to any change in the terms of the plan or other plans of the same type available to the employee. Changes in an employee's employer-provided benefit are treated as attributable to changes in plan terms even if the changes are pursuant to an election of the employee that occurs in conjunction with any change in the terms of the plan (or of another plan of the same type available to such employee). Thus, for example, if during an open season or election period an employee elects to change health plan coverage and there is any change to any one or more of the health plans available to such employee during the open season, such employee's change in employer-provided benefit is treated as in connection with a change in plan terms even if the employee is not covered, either before or after the open season, by a health plan that changed. An increase or decrease in the after-tax employee contributions or employer contributions, including salary reduction contributions, is treated as a change in plan terms.

(4) *Taking required adjustments into account*—(i) *In general*. Adjustments taken into account under this paragraph (b) are to be taken into account as of the effective date of the change in the employer-provided benefit.

(ii) *Adjustment period rule*—(A) *In general*. If the requirements of paragraph (b)(4)(ii)(B) and (C) of this Q&A-5 are satisfied, an employer may on a uniform and consistent basis treat employer-provided benefit changes as having become effective as of the first day of the applicable adjustment period or periods.

(B) *Adjustment period*. The requirement of this paragraph (b)(4)(ii)(B) is satisfied only if the employer uses at least 24 adjustment periods for its testing year. Adjustment periods must be regular, uniform periods throughout the testing year. For example, an employer may use each 2-week pay period as an adjustment period.

(C) *Applicable adjustment periods*. The requirement of this paragraph (b)(4)-(ii)(C) is satisfied only if, in the case of a nonhighly compensated employee, the lowest employer-provided benefit of such employee on any day during an adjustment period is taken into account for at least either the current adjustment period (i.e., the period during which the change in employer-provided benefit occurred) or the adjustment period immediately following the effective date of the benefit change. In the case of a highly compensated employee, the highest employer-provided benefit of such employee on any day during an adjustment period must be taken into account for at least either the current adjustment period or the adjustment period immediately following the effective date of the benefit change.

(5) *Transition rule for 1989*—(i) *In general*. For any testing year that begins prior to July 1, 1989, the employer may apply the nondiscrimination rules of section 89 (including the rules of Q&A-2 of this section) with respect to its health plans for such testing year in accordance with the rules in paragraph (b)(5)(ii) through (iv) of this Q&A-5.

(ii) *Partial testing year*. The facts with respect to all employees of the employer as of the testing day for the testing year are to be treated as in existence for the entire partial testing year. The partial testing year begins on the earliest of July 1, 1989; the testing day for such testing year; or the first day of the calendar month beginning three months before the end of the testing year. The last day of the partial testing year is the last day of such testing year.

(iii) *Adjustments*. The employer-provided benefit (received or made available) of an employee determined as of the testing day is to be adjusted for the partial testing year as required under this paragraph (b) for elections and plan design changes occurring during the partial testing year as if the partial testing year were the entire testing year.

(iv) *Annualization of employer-provided benefit*. The employer-provided benefit (received or made available) of an employee for the partial testing year (determined after the application of the other rules in this paragraph (b)(5)) is multiplied by the applicable fraction for the testing year and such product is deemed to be the employer-provided benefit (received or made available) of the employee for the testing year for purposes of applying the section 89 nondiscrimination tests to such testing year. The numerator of the applicable fraction for a testing year is the total number of calendar months in the testing year and the denominator of such fraction is the number of calendar months in the partial testing year.

(v) *Transition rule inapplicable with respect to certain plans*—(A) *Changes in plan terms*. The rule of this paragraph (b)(5) is not available with respect to a health plan that provides an employer-provided benefit for the partial testing year that is less, by more than a de minimis amount, than such plan's employer-provided benefit for the portion of the testing year that precedes the partial testing year. Thus, for example, the rule of this paragraph (b)(5) is not available if an employer amends its health plan to provide that employee contributions for coverage during the partial testing year are to be in the form of after-tax employee contributions rather than salary reduction contributions. See paragraph (c) of Q&A-1 of this section (the nondiscriminatory provisions test).

(B) *New plans*. The rule of this paragraph (b)(5) is not available with respect to a health plan that is first established, or coverage under a health plan that is first provided, on or after January 1, 1989, and that terminates or ceases to be provided before the end of the partial testing year. Also, such plan or coverage may fail to satisfy the requirement of section 89(k)(1)(E) (that a plan be established with the intention of being maintained for an indefinite period of time).

(C) *Certain discriminatory plans*. The rule of this paragraph (b)(5) is not applicable with regard to a plan unless, for the testing year, at least 25 percent of those employees eligible to participate in the plan are nonhighly compensated employees or such plan satisfies the alternative 50 percent eligibility test of paragraph (d)(3)(iii) of Q&A-1 of this section. The rules of Q&A-4 of this section are not available in determining whether a plan meets this 25 percent requirement.

(vi) *Example*. The rules of this paragraph (b)(5) are illustrated in the following example:

Example. Assume that an employer maintains several health plans, one of which has a plan year beginning on January 1, 1989. The employer elects to use a calendar year testing year for purposes of testing its health plans under section 89. Under this paragraph (b)(5), if the employer elects a testing day of July 1, 1989 (or any day after such date and before January 1, 1990), the employer may apply the testing day and benefit adjustment rules of section 89 to the period between July 1, 1989 and January 1, 1990 as if such period were the entire testing year. Thus, for example, only those benefit changes that occur during the partial testing year need to be taken into account under the rules of this paragraph (b). Then, employees' employer-provided benefits (received or made available) for the partial testing year are converted into employer-provided benefits for the full testing year by multiplying each of such benefits by two (i.e., 12/6, which is the applicable fraction, the numerator of which is the total number of calendar months in the testing year and the denominator of which is the number of calendar months in the partial testing year). The section 89 nondiscrimination tests are then applied with respect to such annualized employer-provided benefits.

(c) *Testing day*. The testing day is the single day within the testing year that is elected in writing as the testing day for purposes of applying the nondiscrimination tests of section 89 with respect to the testing year. The testing day is not required to be designated in the single written document required under section 89(k)(1)(A) (See Q&A-3 of §1.89(k)-1). If a testing day is not elected in writing, the testing day is the last day of the testing year. All plans of the same type, and plans that are not of the same type but are treated as of the same type for nondiscrimination testing under section 89, must have the same testing day. The testing day for any testing year beginning after December 31, 1990, is the same testing day used for the immediately preceding testing year unless a change in such testing day is made with the consent of the Commissioner or is in accordance with such rules as the Commissioner may provide with respect to changes in testing days. The election of a testing day is subject to the requirements of the nondiscriminatory provisions test of paragraph (c) of Q&A-1 of this section. Thus, an employer's testing day must reasonably reflect the employee pool of the employer and the business of the employer throughout the year.

(d) *Sampling*. For purposes of determining whether a statutory employee benefit plan is a discriminatory employee benefit plan, an employer may elect in writing to apply the rules of paragraphs (d) and (e) of Q&A-1 of this section (the general eligibility and benefits tests and the alternative 80 percent coverage test, respectively), paragraph (c) of Q&A-2 of this section (the special rule for certain large employers), and paragraph (c)(4) of Q&A-3 of this section (relating to sworn statements) on the basis of a statistically valid random sample of the employer's employees. A sample is statistically valid for purposes of this paragraph (d) only if the statistical method and sample size result in at least a 95 percent probability that the results of the sample with respect to the applicable requirements have a margin of error not greater than 3 percent. Also, the statistical validity of the sample and statistical method and analysis must be confirmed in a written opinion of a qualified and independent third party.

Q-6: What is the period for testing whether the nondiscrimination rule of section 89 are satisfied?

A-6: (a) *Testing year*—(1) *In general.* An employer must apply the nondiscrimination tests of section 89 to its health plans and other statutory employee benefit plans on the basis of a testing year that begins on the first day of a calendar month and ends on the last day of a calendar month, regardless of the beginning of the plan year or years of such plans. Unless the employer elects otherwise in accordance with paragraph (a)(2) of this Q&A-6, the testing year for all statutory employee benefit plans is the calendar year.

(2) *Election of different testing year.* An employer may elect a uniform 12-month testing year other than the calendar year for purposes of applying the section 89 nondiscrimination tests to all plans of the same type. Thus, for example, an employer may elect to apply the section 89 nondiscrimination tests to all of its health plans on the basis of an April 1 to March 30 testing year. In addition, if the 75 percent benefits test is applied on an aggregate basis to plans of different types (e.g., health plans, group-term life insurance plans, and dependent care assistance programs) as though such plans were plans of the same type, the same testing year must be used with respect to all such plans.

(3) *Election.* An employer must make the election of a testing year described in paragraph (a)(2) of this Q&A-6 in writing prior to the commencement of the testing year to which the election relates. See paragraph (b)(3) of this Q&A-6 for a transition rule for 1989.

(b) *First testing year in 1989*—(1) *In general.* Notwithstanding paragraph (a) of this Q&A-6, for the first testing year applicable with respect to plans of the same type, the employer may elect to apply the section 89 nondiscrimination tests with respect to all plans of the same type on the basis of any 12-month period beginning on the first day of any calendar month beginning on or after January 1, 1989, but no later than the first day that any plan of such type first becomes subject to the section 89 nondiscrimination tests. The rule of this paragraph (b) is applicable even though not all of the plans of the same type are subject to the section 89 nondiscrimination tests for the entire first testing year. See paragraph (c) of this Q&A-6 for special rules applicable to the section 89 nondiscrimination tests in such cases. The rule of this paragraph (b)(1) is illustrated in the following example:

Example. Assume that an employer maintains three health plans, Plan A, Plan B and Plan C. Plan A's plan year begins on March 1, Plan B's plan year begins on July 1, and Plan C's plan year begins on September 1. The section 89 nondiscrimination rules apply to plan years that begin after December 31, 1988. For these plans, the employer may elect as its first testing year under section 89 any 12-month period beginning on or after January 1, 1989, and on or before March 1, 1989. This is the case even though not all of the health coverage provided during any of these possible first testing years is subject to the section 89 nondiscrimination tests.

(2) *Short testing year.* An employer may elect to apply the section 89 nondiscrimination tests to its first testing year commencing in 1989 with respect to all plans of the same type on the basis of a first testing year that is shorter than 12 months in duration. However, if an employer applies the section 89 nondiscrimination tests on the basis of such a short first testing year, the second testing year for such employer for such plans must be 12 months in duration. In addition, in no case may any employer-provided benefit subject to the section 89 nondiscrimination tests either be excluded from consideration in a testing year or considered in more than one testing year. The rule of this paragraph (b)-(2) is illustrated in the following example:

Example. Assume that an employer's first testing year in 1989 for its health plans commences on March 1, 1989. The employer may elect to use a first testing year of March 1, 1989, to December 31, 1989, for all of its health plans. In such case, the employer's second testing year must commence on January 1, 1990, and must be 12 months in duration.

(3) *Election*—(i) *First day.* An employer must elect the first day of the first testing year beginning in 1989 with respect to plans of the same type in writing prior to the earlier of the first day of the second testing year for such plans or January 1, 1990. If an employer fails to make an election by such required date with respect to plans of the same type, the first day of the first testing year beginning in 1989 for all plans of such type is January 1, 1989.

(ii) *Last day.* If an employer uses a short testing year for the first testing year beginning in 1989 with respect to plans of the same type, the employer must elect the last day of such year in writing prior to such last day. Thus, for example, if an employer decides to begin the first testing year for its health plans on March 1, 1989, and, after such date, decides to use a calendar year testing year beginning in 1990, the employer must, before December 31, 1989, elect December 31, 1989, as the last day of the first testing year.

(c) *Testing where not all plans are subject to section 89*—(1) *In general.* If, during a testing year with respect to plans of the same type, there is any employer-provided benefit that is not subject to the section 89 nondiscrimination rules for the entire testing year, the rules of this paragraph (c) apply for purposes of testing and excess benefit calculations.

(2) *Testing.* All employer-provided benefits available or provided during the first testing year applicable with respect to plans of the same type are taken into account in applying the nondiscrimination tests of section 89. This is the case even if such employer-provided benefits are provided under a plan that is not yet subject to section 89. The rule of this paragraph (c)(2) is illustrated in the following example:

Example. Assume that an employer maintains three health plans. Plan A's plan year begins on March 1, Plan B's plan year begins on July 1, and Plan C's plan year begins on September 1. The section 89 nondiscrimination rules apply to plan years that begin after December 31, 1988. Assume further that the employer elects as its first testing year under section 89 the 12-month period beginning on March 1, 1989. For purposes of applying the nondiscrimination tests of section 89, all health coverage provided during this 12-month period, including coverage under Plans B and C from March 1, 1989, until July 1, 1989, and September 1, 1989, respectively, is taken into account.

(3) *Excess benefit calculation*—(i) *In general.* If, during a testing year with respect to plans of the same type, an employer-provided benefit under one plan is not yet subject to the section 89 nondiscrimination rules and another plan subject to section 89 fails to satisfy the nondiscrimination rules, the rules of this

paragraph (c)(3) apply for purposes of calculating the amount of excess benefit (if any) that is attributable to employer-provided benefits subject to section 89 for such testing year. Plans that are not of the same type but are being tested under the 75 percent benefits test as if they were of the same type are to be treated as plans of the same type for purposes of this paragraph (c)(3).

(ii) *Total excess benefit.* The excess benefit for the testing year with respect to plans of the same type is calculated with regard to an employee under the generally applicable rules of section 89 as if all employer-provided benefits provided under such plans during such year were subject to section 89. See Q&A-9 of this section for rules governing the determination of excess benefits.

(iii) *Excess benefit subject to section 89*—(A) *Determination with respect to the 90 percent/50 percent eligibility and 75 percent benefits tests.* For purposes of determining excess benefit resulting from the failure of the employer to meet the requirements of paragraph (d)(2) or (d)-(4) of Q&A-1 of this section, the portion of an excess benefit that is attributable to employer-provided benefits subject to section 89 for the testing year with respect to the plan or plans being tested is determined by multiplying the excess benefit determined under paragraph (c)-(3)(ii) of this Q&A-6 by a fraction. The numerator of the fraction is the total employer-provided benefit for the highly compensated employee under the plan or plans being tested that are subject to section 89, and the denominator is the total employer-provided benefit for the highly compensated employee under the plan or plans being tested for the first testing year, whether or not they are subject to section 89. The rule of this paragraph (c)(3)(iii)(A) is illustrated by the following example:

Example. Assume that an employer maintains two health plans, Plan A and Plan B. The plan years for these plans and the effective dates for these plans for purposes of section 89 are January 1, 1989, and July 1, 1989, respectively. Plan A provides health coverage with an annual, employer-provided benefit of $1,000, and Plan B provides health coverage with an annual employer-provided benefit of $2,000. In each case, the employer-provided benefit for the 1989 year is the same as the benefit for the prior year. With regard to its health plans, the employer uses a 12-month testing year beginning on January 1, 1989. Thus, in applying the section 89 nondiscrimination tests, all health coverage under Plan B for this testing year must be taken into account. Assume that, for the 1989 testing year, the employer determines that a highly compensated employee who was in Plan A and Plan B for the entire testing year has an excess benefit of $500 for the testing period. The applicable fraction for this employee is $2,000/$3,000. The $2,000 numerator represents the annual employer-provided benefit of Plan A ($1,000) because it was subject to section 89 for the entire testing year plus ½ of the annual employer-provided benefit of Plan B ($2,000) because it was only subject to section 89 for ½ of the testing year. The denominator is the annual employer-provided benefit of Plans A and B. Thus, the employee is treated as having received an excess benefit in the amount of $333.33 (i.e., 66⅔ percent of $500).

(B) *Determination with respect to 50 percent eligibility and 80 percent coverage tests.* If an excess benefit with regard to a highly compensated individual is attributable to a plan failing to meet the requirements of the 50 percent eligibility test or the 80 percent coverage test, then this paragraph (c)(3)(iii)(B) applies. The portion of an employee's excess benefit that is attributable to employer-provided benefits for the testing year with respect to the plan or plans being tested is determined by multiplying the excess benefit determined under paragraph (c)(3)(ii) of this Q&A-6 by a fraction. The numerator of the fraction is the number of months in the testing year that the plan or plans failing the applicable requirement is subject to section 89, and the denominator is the number of months that constitute such testing year. In the case of plans that have become subject to section 89 at different times during the testing year, which plans are aggregated under the mandatory aggregation requirements of paragraphs (d) and (e) of Q&A-4 of this section, the excess benefit is determined by calculating a weighted average for each of the originally separate plans in the aggregated plan and adding together such weighted averages. The weighted average for each plan is determined by multiplying the excess benefit by a fraction. The numerator of the fraction is the product of the total amount of the employer-provided benefit for the plan year (without regard to whether such coverage was subject to section 89 for the entire testing year) multiplied by the number of months that such plan has been subject to section 89. The denominator is the product of the total amount of the employer-provided benefit for all the separate plans in the aggregated plan (without regard to whether such coverage was subject to section 89 for the entire testing year) multiplied by the number of months in the testing year.

(d) *Changes in testing year*—(1) *In general.* Subject to paragraph (d)(2) of this Q&A-6, an employer may elect to change its testing year with respect to plans of the same type if such election is made in writing prior to the beginning of such new testing year. In no case may any such change result in any employer-provided benefit subject to the section 89 nondiscrimination tests not being included in any testing year or being included in more than one testing year. See also paragraph (b)(2) of this Q&A-6 (precluding changes in an employer's second testing year with respect to plans of the same type if the employer has elected a short first testing year for 1989).

(2) *Commissioner approval.* An employer's election to change its testing year with respect to plans of the same type subject to section 89 may be made without the prior approval of the Commissioner, provided that the first day of the new testing year is on or before January 1, 1991, such change otherwise meets the requirements of paragraph (d)-(1) of this Q&A-6, and such change has no discriminatory effect. For all subsequent changes in testing years, the employer must obtain the prior approval of the Commissioner or must meet such requirements as the Commissioner may otherwise prescribe.

(3) *Example.* The provisions of this paragraph (d) are illustrated as follows:

Example. An employer is using the calendar year as its testing year for its health plans. On October 3, 1990, the employer designates the 12-month period beginning each December 1 as its new testing year, effective December 1, 1990. This is a permissible change in testing year. The result of this designation is that the employer's testing year beginning on January 1, 1990, is a short year ending on November 30, 1990.

Q-7: For purposes of applying section 89(a) to an employer's health plan, what rules apply for determining the employer-provided benefit and calculating the excess benefits?

A-7: (a) *In general.* For purposes of nondiscrimination testing under section 89, the employer-provided benefit under a health plan is the value of the health coverage under the plan that is attributable to employer contributions, determined in accordance with the rules in this Q&A-7. See paragraph (h) of this Q&A-7 for rules governing the determination of the excess benefit (if any) under section 89.

(b) *Reasonable valuation methods.* (1) *In general.* Prior to the effective date of procedures prescribed by the Secretary in accordance with section 89(g)(3)(B), employers may use any reasonable valuation method for valuing health coverage under each plan for purposes of applying the nondiscrimination tests of section 89. The employer must be able to demonstrate that its method for valuing such health coverage is actuarially reasonable. All features of a health plan must be taken into account under a reasonable method. However, unless the employer is using a reasonable cost method to value health coverage (in accordance with paragraph (c) of this Q&A-7), a reasonable valuation method may disregard those features that have a de minimis effect on the total value of the coverage under the plan and are not disproportionately available to highly compensated employees. The features that are disregarded cannot, in the aggregate, result in a more than de minimis effect on the total value of the plan. If a feature is disregarded as de minimis with respect to one health plan, it must be disregarded with respect to all health plans. An entitlement to a periodic medical diagnostic or physical examination, whether or not required as a condition of employment, is not considered to have a de minimis effect on the total value of the health coverage under the plan and thus the entitlement must be taken into account in valuing coverage even if the plan is available to nonhighly compensated employees on the same or a more favorable basis than it is to highly compensated employees and even for employees who do not actually undergo the covered examinations.

(2) *Presumption where value is substantially unrelated to cost.* If the employer is not using a cost method permitted under section 4980B to value health coverage (in accordance with paragraph (c) of this Q&A-7), a valuation method is presumed to be unreasonable if the relative values of the plans determined under such method do not reasonably reflect the relative values that would be determined for the plans using a cost method permitted under section 4980B. However, the fact that the relative values of the plans determined by the employer reasonably reflect the relative values of such plans under a cost method permitted under section 4980B does not mean that the valuation method is necessarily reasonable. The provisions of this paragraph (b)(2) are illustrated in the following example:

Example. Assume that an employer maintains three health plans for its employees and does not use a cost method permitted under section 4980B for purposes of determining the employer-provided benefits with respect to these plans. The applicable premiums under the cost method used under section 4980B(f)(4) for these plans are as follows: Plan A, $2,500; Plan B, $2,000; and Plan C, $2,100. Thus, Plan B's value under the cost method is 80 percent of Plan A's value, and Plan C's value is 84 percent of Plan A's value. Under the employer's valuation method, the values of the plans are as follows: Plan A, $1,600; Plan B, $2,400; and Plan C, $400. Thus, under the employer's valuation method, Plan B's value is 150 percent of the value of Plan A, and Plan C's value is 25 percent of Plan A's value. These relative values do not reasonably reflect the relative values under the section 4980B cost method. Thus, the presumption of this paragraph (b)(2) applies, and unless the employer can demonstrate otherwise, its valuation method is not considered reasonable.

(3) *De minimis effect.* A feature does not have a de minimis effect on the total value of coverage unless it is demonstrably difficult to value such feature and, if it were valued, the feature would be insignificant in value.

(4) *Disproportionate ratio.* A de minimis feature of a health plan is not considered to be disproportionately available to highly compensated employees if that feature, treated as a separate plan, meets the requirements of paragraph (d)(3) of Q&A-1 of this section (the 50 percent eligibility test). For purposes of this paragraph (b)(4), the availability of the feature is determined based on all health plans of the employer.

(c) *Reasonable cost method—(1) In general.* An employer is deemed to be using a reasonable valuation method that satisfies the requirements of paragraph (b) of this Q&A-7 if the employer is using a reasonable cost method as described in this paragraph (c) to value its health coverage. The employer must be able to demonstrate that its method for determining the cost of health coverage is actuarially reasonable. The method that the employer uses to determine the applicable premium for purposes of the continuation coverage requirements for group health plans in accordance with section 4980B(f)(4) is deemed to be a reasonable cost method. If a health plan is not subject to the requirements of section 4980B, the employer may calculate cost on the basis of a method permitted to be used for determining an applicable premium under section 4980B(f)(4) as if such plan were subject to that section. A cost method does not fail to be a reasonable valuation method for purposes of section 89 merely because the calculation of cost takes into account the average annual cost under section 4980B(f)(4) of substantially similar coverage for the immediately preceding two years or the immediately preceding year if two years' data are not available or if data for the two years would not be reasonable to use under the facts and circumstances of the case.

(2) *Certain permitted adjustments*—(i) *In general.* An employer may elect in writing to make certain adjustments to the cost of health coverage in determining the value of such coverage under a reasonable cost method. These adjustments are intended to eliminate cost differences that are unrelated to the relative value of health coverage. These adjustments may be made only to the extent they have not already been taken into account (if permitted) under the method of determining the applicable premium under section 4980B. If an employer makes an adjustment of the type described in this paragraph (c)(2) with respect to one health plan, the employer must make that same type of adjustment for all health plans. Thus, if an employer maintains two plans providing identical coverage at two geographic locations and elects to make the geographic adjustment permitted in paragraph (c)(2)(ii) with respect to such plans, the employer must make a geographic adjustment to all plans at all locations since the values of these plans are compared to one another under the various tests contained in section 89.

(ii) *Geographic adjustment.* Costs may be adjusted to eliminate differences in cost solely attributable to the employer's operation in significantly separate geographic locations.

(iii) *Demographic adjustment.* Costs may be adjusted to eliminate differences in cost solely attributable to the different demographic characteristics (other than family status) of the participants in the plans.

(iv) *Utilization adjustment.* Costs may be adjusted to eliminate differences in costs solely attributable to differences in the utilization of coverage features common to two or more separate health plans. This adjustment must be made by allocating the total cost for a common feature among all the plans with such feature on the basis of the number of employees covered by such feature under each of the plans. The adjustment under this paragraph (c)(iv) is to be made only after all other adjustments that are permitted in this paragraph (c).

(d) *Certain cost containment features.* A valuation method is not unreasonable if it fails to make adjustments for bona fide cost containment features, such as second opinion requirements or requirements for physician approval prior to referral for specialized medical care. In addition, a valuation method generally is not reasonable if it makes adjustments based on the method of health benefit delivery (e.g., traditional indemnity plans, health maintenance organizations and preferred provider organizations).

(e) *Consistency rule.* With the exception of certain multiemployer plans (see section 89(g)(3)(E)), an employer must use the same valuation method (including any permitted adjustment under this Q&A-7) to value all of the health plans that are tested together under section 89.

(f) *Health coverage under flexible spending arrangements.* In the case of a health plan provided under a flexible spending arrangement (FSA) (as defined in Q&A-7 of §1.125-2), the value of the coverage for a year generally is equal to the total cost (i.e., required premium or payment) of the coverage for the year, whether or not such cost is paid through employer contributions, including salary reduction contributions, or after-tax employee contributions. If an employer is separately testing employee-only health coverage and family-only health coverage (in accordance with paragraph (c) of Q&A-3 of this section) and health coverage under an FSA is applicable to employees and their family members, the employer may elect to treat 40 percent of the value of the coverage under the health FSA as family-only coverage and 60 percent of such value as employee-only coverage. This election must apply with respect to all employees who have a spouse or dependent. The rule of this paragraph (f) is illustrated in the following example:

Example. Assume that an employer maintains a cafeteria plan under which an employee may elect to reduce his or her salary by any amount of compensation for a year, to a maximum of $2,000, for reimbursements for health expenses. Assume further that the maximum reimbursement for any particular employee under the arrangement for a year is equal to the amount the employee has elected to reduce his or her salary for the year. This arrangement is a health flexible spending arrangement (FSA). Each different amount by which an employee may elect to reduce his or her salary for a year is a separate health plan under the FSA. The salary reduction contributions are employee premium payments for the level of health coverage elected for the year. For purposes of the 90 percent/50 percent eligibility test (if salary reduction contributions are treated as employer contributions under the rules of Q&A-8 of this section), the health plan under the FSA with the largest employer-provided benefit is the plan with a $2,000 maximum reimbursement. Because all employees may elect any level of coverage under the health FSA, all of the health plans included in the health FSA satisfy the 50 percent eligibility test. For purposes of the 75 percent benefits test, if an employee elects to receive health coverage under the FSA providing for the reimbursement of up to $1,200 of health expenses for a year, the value of such coverage received for the year is $1,200. This is the case without regard to whether the employee actually pays the total required premium for the coverage, as long as the employee receives the coverage. Finally, for purposes of the 80 percent coverage test, each different level of coverage under the health FSA is a separate health plan with a value equal to the cost of such level of coverage.

(g) *Health coverage attributable to employer contributions*—(1) *In general.* The portion of the value of the health coverage of a plan that is attributable to employer contributions is determined by multiplying the value of the health coverage of the plan (determined under paragraphs (b) through (f) of this Q&A-7) by a fraction. The numerator of the fraction is the employer-paid cost of the health plan, and the denominator of the fraction is the sum of the employer-paid cost and the employee-paid cost of the health plan. For this purpose, the cost of a health plan is its actual cost determined under the same method the employer uses to determine the applicable premium (for the same coverage) for health continuation coverage purposes under section 4980B(f)(4) without regard to any of the adjustments permitted in paragraph (c) of this Q&A-7 (other than the adjustment for utilization differences). If a health plan is not subject to the requirements of section 4980B, the employer may calculate cost on the basis of a method permitted to be used for determining an applicable premium under section 4980B(f)(4) as if such plan were subject to that section. For purposes of this Q&A-7, health coverage of a self-employed individual is deemed attributable to employer contributions to the extent that a deduction under section 162(m) is allowable with respect to the coverage. Also, the determination of the extent to which health coverage is attributable to employer or employee contributions is to be made without regard to whether an employee is permitted a deduction with respect to employee contributions under section 213.

(2) *Exception.* If, for a particular health plan, the employer-paid portion of the cost (treating salary reduction contributions as employer contributions) is less than or equal to 2 percent of the sum of the employer-paid cost and the employee-paid cost of such health plan, the employer may treat such health plan as providing no employer-provide benefit.

(3) *Salary reduction contributions.* See Q&A-8 of this section for the treatment of salary reduction contributions under a cafeteria plan as either employer or employee contributions.

(h) *Calculation of excess benefit.* The amount of a highly compensated employee's excess benefit under section 89(b) with respect to a health plan is the cost of the excess benefit based on its actual cost determined under the same method the employer uses to determine the applicable premium for the same coverage for health continuation coverage purposes under section 4980B(f)(4) without regard to any of the adjustments permitted in paragraph (c) of this Q&A-7 (other than the adjustment for utilization differences). This rule applies with respect to both highly compensated and nonhighly compensated employees. Thus, an employed must use the method it uses to determine the applicable premium for all coverage provided in making the determination of excess benefits. See Q&A-9 of this section for further guidance with respect to the determination of excess benefits.

Q-8: How are salary reduction contributions treated for purposes of the section 89 nondiscrimination tests?

A-8: (a) *Treatment of salary reduction contributions*—(1) *In general.* Except as otherwise provided (see, e.g. , paragraphs (b) and (c) of this Q&A-8), salary reduction contributions are treated as employer contributions. Thus, for purposes of paragraph (d)(3) (the 50 percent eligibility test), paragraph (d)(4) (the 75 percent benefits test), and paragraph (e) (the 80 percent coverage test) of Q&A-1 of this section, the portion of the value of health coverage that is attributable to salary reduction contributions is treated as attributable to employer contributions and thus as an employer-provided benefit. See paragraph (d)(2) of Q&A-4 of this section for a special rule for the treatment of certain salary reduction contributions for purposes of the mandatory aggregation rule for the 50 percent eligibility test.

(2) *Definition of salary reduction contributions.* The term "salary reduction contributions" means all employer contributions that are excludable from the gross income of an employee by reason of section 125. Thus, all elective contributions under a cafeteria plan described in section 125 that are excludable from employees' gross incomes are salary reduction contributions, even if such amounts are available in cash or other taxable benefits only if the employee satisfies a specified condition under the plan (e.g., the completion of a statement that the employee has other health plan coverage). This is the case regardless of the manner in which such contributions are described under a plan. For example, amounts that are described as employer or company credits under a cafeteria plan are salary reduction contributions to the extent that such amounts are available to employees in cash or other taxable benefits under the plan, even if, for example, the plan defines salary reduction contri-

butions as only those contributions that are directly and explicitly deducted from employees' regular salaries.

(b) *90 percent/50 percent eligibility test*—(1) *In general.* Except as provided in paragraphs (b)(2) and (c) of this Q&A-8, for purposes of paragraph (d)(2) of Q&A-1 of this section (the 90 percent/50 percent eligibility test), salary reduction contributions are treated as employee contributions (rather than employer contributions) in computing the employer-provided benefit available to any employee.

(2) *Election to treat as employer contributions*—(i) *In general.* An employer may elect in writing to treat all salary reduction contributions as employer contributions for purposes of paragraph (d)(2) of Q&A-1 of this section (the 90 percent/50 percent eligibility test). An employer may not elect to treat some, but not all, salary reduction contributions as employer contributions. An employer election under this paragraph (b)(2) applies with respect to all salary reduction contributions with regard to plans of the same type whether or not the plans are part of the same cafeteria plan.

(ii) *Requirements to qualify for election*—(A) *In general.* In order to make an election under this paragraph (b)(2), an employer must meet the requirements of paragraphs (b)(2)(ii)(B) through (b)(2)(ii)(D) of this Q&A-8.

(B) *Plan must be available on same terms.* This requirement is satisfied only if all of the benefits available under each cafeteria plan are available on the same terms and conditions to all employees eligible to participate under such plans.

(C) *Nonhighly compensated employees may not comprise a disproportionate portion of those eligible to participate.* This requirement is satisfied only if the nonhighly compensated eligibility percentage for each cafeteria plan does not exceed the highly compensated eligibility percentage for each such plan. The nonhighly compensated eligibility percentage is the percentage determined by dividing the number of nonhighly compensated employees eligible to participate in the cafeteria plan by the total number of nonhighly compensated employees, and the highly compensated eligibility percentage is the percentage determined in the same manner by reference only to highly compensated employees.

(D) *No highly compensated employee with benefits outside cafeteria plan.* This requirement is satisfied only if no highly compensated employee eligible to participate in a cafeteria plan is eligible to participate in any other statutory employee benefit plan that is of the same type as a plan available under the cafeteria plan unless such other statutory employee benefit plan (whether inside or outside of a cafeteria plan) is available on the same terms and conditions to all nonhighly compensated employees that are eligible to participate in the cafeteria plan.

(c) *Mandatory treatment of salary reduction contributions*— (1) *In general.* Notwithstanding paragraphs (b)(1) and (b)(2) of this Q&A-8, if certain conditions set forth in paragraph (c)(2) or (c)(3) of this Q&A-8 are satisfied, an employer is required to treat some or all salary reduction contributions available to highly compensated employees as employer contributions, some or all salary reduction contributions available to nonhighly compensated employees as employee contributions, or both. Paragraphs (c)(2) and (c)(3) of this Q&A-8 are applied separately. This mandatory treatment applies only for purposes of applying the 90 percent/50 percent eligibility test of paragraph (d)(2) of Q&A-1 of this section (including the 80 percent/66 percent and 80 percent/80 percent eligibility test alternatives set forth in paragraphs (b) and (c)(6)(iii) of Q&A-2 of this section).

(2) *Highly compensated employees*—(i) *In general.* In computing the largest employer-provided benefit available to a highly compensated employee (and for purposes of the excess benefit calculation under paragraph (e) of Q&A-9 of this section), core health coverage attributable to salary reduction contributions is treated as attributable to employer contributions (rather than employee contributions) to the extent that the portion of the core health coverage attributable to salary reduction contributions exceeds 100 percent of the portion of the core health coverage attributable to employer contributions (excluding salary reduction contributions). The rule of this paragraph (c)(2) applies only if the employer has not made the election described in paragraph (b)(2) of this Q&A-8.

(ii) *Examples.* The rule of this paragraph (c)(2) is illustrated by the following examples:

Example 1. Assume that a highly compensated employee may elect coverage under one of two health plans: Plan A has an employer-provided benefit of $4,000, which is attributable to non-salary reduction, employer contributions; and Plan B (a core health plan) has a total employer-provided benefit of $5,200 (i.e., $3,200 attributable to non-salary reduction, employer contributions and $2,000 attributable to salary reduction contributions). This paragraph (c)(2) does not require that any of the salary reduction contributions for Plan B be treated as employer contributions for purposes of determining the plan with the largest employer-provided benefit available to this highly compensated employee. Thus, for purposes of the 90 percent/50 percent eligibility test and assuming that the employer has not made the election under paragraph (b)(2) of this Q&A-8, Plan A is the plan with the largest employer-provided benefit available to this employee.

Example 2. Assume the same facts as Example 1, except that Plan B's total employer-provided benefit of $5,200 is comprised of $2,500 attributable to non-salary reduction, employer contributions and $2,700 attributable to salary reduction contributions. This paragraph (c)(2) requires that $200 of the salary reduction contributions for Plan B (i.e., the excess of the salary reduction contributions over the non-salary reduction, employer contributions) be treated as employer contributions for purposes of determining the plan with the largest employer-provided benefit available to this highly compensated employee. Thus, for purposes of the 90 percent/50 percent eligibility test, Plan B is treated as having an employer-provided benefit of $2,700. However, Plan A still is the plan with the largest employer-provided benefit available to this highly compensated employee.

Example 3. Assume the same facts as in Example 1, except that Plan B has a total employer-provided benefit of $8,000 (i.e., $3,500 attributable to non-salary reduction, employer contributions and $4,500 attributable to salary reduction contributions). This paragraph (c)(2) requires that $1,000 of the salary reduction contributions for Plan B (i.e., the excess of the salary reduction contributions over the non-salary reduction, employer contributions) be treated as employer contributions for purposes of determining the plan with the largest employer-provided benefit available to this highly compensated employee. Thus, for purposes of the 90 percent/50 percent eligibility test, Plan B is treated as having an employer-provided benefit of $4,500 and, accordingly, is the plan with the largest employer-provided benefit available to this highly compensated employee.

Example 4. Assume the same facts as in Example 3, except that the highly compensated employee also may elect health coverage under a flexible spending arrangement (FSA) providing for health expense reimbursements up to and including $5,000. Because health FSAs are not core health plans, this FSA is disregarded in applying this paragraph (c)(2). Thus, the manner in which such health FSA, the employer-provided benefit of which is wholly attributable to salary reduction contributions, is taken into account for purposes of the 90 percent/50 percent eligibility test depends upon whether salary reduction contributions are generally disregarded or are generally taken into account as employer contributions for purposes of such test.

Example 5. Assume the same facts as Example 3, except that the highly compensated employee also has available Plan C, a dental plan not funded through salary reduction and with an employer-provided benefit of $500. Since the dental plan is not a core health plan, it is not considered in determining whether salary reduction contributions are treated as employer contributions under this paragraph (c)(2). However, the employer-provided benefit of the dental plan is added to the total employer-provided benefit available to the highly compensated employee in determining the largest employer-provided benefit available to any highly compensated employee.

(3) *Nonhighly compensated employees.* In computing the employer-provided benefit available to a nonhighly compensated employee, core health coverage attributable to salary reduction contributions is treated as attributable to employee contributions (rather than employer contributions) to the extent that the portion of the core health coverage attributable to salary reduction contributions exceeds 100 percent of the portion of the core health coverage attributable to employer contributions (excluding salary reduction contributions). The rule of this paragraph (c)(3) applies only if the employer has made the election described in paragraph (b)(2) of this Q&A-8.

(4) *Transition rule.* This paragraph (c) does not apply with respect to testing years beginning before January 1, 1990.

(d) *Certain part-time employees.* See section 89(g)(3)(D)(i) for the treatment of salary reduction contributions for employees described in section 89(j)(5).

Q-9: How is an excess benefit under the section 89 nondiscrimination rules to be determined with respect to health plans?

A-9: (a) *In general.* A highly compensated employee's excess benefit under a discriminatory employee benefit plan that is a health plan for a testing year generally is determined in accordance with the rules for applying the requirements of section 89 for the testing year and with the modifications set forth in this Q&A-9. Because the method for determining excess benefits thus differs from the method for applying the nondiscrimination tests of section 89, a statutory employee benefit plan that is a discriminatory employee benefit plan under the nondiscrimination tests may, in some circumstances, not have any excess benefit under this Q&A-9. Similarly, a statutory employee benefit plan is treated as not having an excess benefit under this Q&A-9 if such plan satisfies the applicable nondiscrimination tests of section 89 and thus is not a discriminatory employee benefit plan. See paragraph (b) of Q&A-1 of this section. This is the case even if such plan would be determined to have an excess benefit under the rules of this Q&A-9 if such rules were applicable to such plan. See paragraph (h) of Q&A-7 of this section for the requirement that, for purposes of determining the amount of excess benefit, the value of the benefit of all employees must be determined under the same method the employer uses for determining the applicable premium for health continuation coverage purposes under section 4980B(f)(4) and the nondiscrimination tests reapplied on such basis. In addition, see paragraph (c) of Q&A-6 for rules relating to the determination of excess benefits for testing years beginning in 1989 if some, but not all, of the employer-provided benefits for such years are subject to the section 89 nondiscrimination rules.

(b) *Determination made under failed requirements*—(1) *In general.* A highly compensated employee's excess benefit under a discriminatory employee benefit plan is determined under the failed requirements of paragraphs (c), (d) and (e) of Q&A-1 of this section. Thus, for example, if each health plan satisfies the 50 percent eligibility test, but the health plans collectively fail to satisfy the 75 percent benefits test, excess benefits are to be determined only under the 75 percent benefits test. However, an employer may elect in writing to use the 80 percent coverage test to determine excess benefits without regard to whether it used that test in determining compliance with section 89. Similarly, the employer may elect in writing to use the tests described in paragraphs (c) and (d) of Q&A-1 of this section to determine excess benefits even if it initially used the 80 percent coverage test to determine whether its plans are discriminatory.

(2) *Failure of more than one requirement.* Where an employer's health plans of the same type fail to meet more than one requirement of Q&A-1 of this section, the excess benefit calculations for the failed requirements are to be made in the following order: the 50 percent eligibility test; the 90 percent/50 percent eligibility test; and the 75 percent benefits test. If a highly compensated employee is determined to have an excess benefit under the 50 percent eligibility test, then for purposes of determining such employee's excess benefit (if any) under the 90 percent/50 percent eligibility test, such employee's employer-provided benefit for purposes of the 90 percent/50 percent eligibility test excess benefit calculation is first reduced by the amount of such employee's excess benefit determined under the 50 percent eligibility test excess benefit calculation. If a portion of the employer-provided benefit of the plan that failed the 50 percent eligibility test is attributable to salary reduction contributions, then the same portion of an employee's excess benefit with respect to such plan is treated as attributable to salary reduction contributions. For purposes of determining excess benefits under the 75 percent benefits test, a highly compensated employee's employer-provided benefit under the plan or plans that failed the 50 percent eligibility test or the 90 percent/50 percent eligibility test (or both) is first reduced by the amount of such employee's excess benefit with respect to such test or tests.

(c) *Highly compensated employees and the employer-provided benefit taken into account for purposes of determining excess benefit*—(1) *In general.* For purposes of making the excess benefit calculations under this Q&A-9, all highly compensated employees who receive employer-provided benefits for a testing year under a plan or plans that fail the applicable nondiscrimination test are eligible to be treated as receiving excess benefits. This is the case even though such highly compensated employees were not taken into account for any reason on the testing day for such testing year. In addition, only employer-provided benefits that highly compensated employees actually receive for a testing year under a plan or plans that fail the applicable nondiscrimination test may be treated as excess benefits. Thus, for example, a highly compensated employee does not have an excess benefit with respect to a plan that fails the 50 percent eligibility test merely because such employee is eligible to receive, but does not actually receive, employer-provided benefits (e.g., health plan coverage) under such plan. Similarly, employer-provided benefits that highly compensated employees do not actually receive but were treated as having received under the rules providing for the annualization and adjustment of the employer-provided benefits for the testing day are not treated as excess benefits.

(2) *Special rule.* In the case of the first testing year beginning in 1989 of an employer that is using the transition rule included in paragraph (b)(5) of Q&A-5 of this section, the excess benefits (if any) for such testing year may be determined by reference to those employer-provided benefits that highly compensated employees actually receive for the partial testing year, annualized for the entire testing year as provided in paragraph (b)(5)(iv) of Q&A-5 of this section. If an employer elects to determine excess benefits in accordance with the preceding sentence, the employer must provide those highly compensated employees having excess benefits an opportunity to demonstrate that they actually

received less employer-provided benefits during the portion of the testing year preceding the partial testing year than the deemed employer-provided benefits under paragraph (b)(5) of Q&A-5 of this section. If an employee makes such a demonstration, the employer must recalculate such employee's excess benefit based on the employer-provided benefits actually received for the entire testing year and make any amendments to required reports relating to such employee (e.g., Form W-2). This special rule is not available with respect to a plan for which paragraph (b)(5) of Q&A-5 of this section is inapplicable.

(d) *50 percent eligibility test.* A highly compensated employee's excess benefit under a health plan that fails to satisfy the 50 percent eligibility test of paragraph (d)(3) of Q&A-1 of this section is equal to that portion of the employer-provided benefit actually received by such employee under the plan that is in excess of the maximum employer-provided benefit that such plan may have and be included in a group of comparable plans under paragraph (b) of Q&A-4 of this section that satisfies the 50 percent eligibility test. The rule of this paragraph (d) is illustrated as follows:

Example. An employer maintains two health plans, Plan A and Plan B. Plan A has an employer-provided benefit of $3,000 and is automatically provided to all employees of the employer other than those eligible for Plan B. Plan B has an employer-provided benefit of $4,000 and is available to all employees who earn more than $100,000. Plan B fails to satisfy the 50 percent eligibility test. As a result, each highly compensated employee who actually receives coverage under Plan B is treated as receiving an excess benefit with respect to such plan. The employer-provided benefit under Plan B must be reduced by $842 to $3,158 ($3,000 is 95 percent of $3,158), in order for Plan B to be included in a group of comparable plans with Plan A under paragraph (b) of Q&A-4 of this section. Thus, for a highly compensated employee who received a full $4,000 employer-provided benefit under Plan B, the amount of the excess benefit with respect to Plan B is $842.

(e) *90 percent/50 percent eligibility test.* A highly compensated employee's excess benefit under plans of the same type that fail to satisfy the 90 percent/50 percent eligibility test of paragraph (d)(2) of Q&A-1 of this section is equal to that portion of the employer-provided benefit actually received by such employee under such plans that is in excess of 200 percent of the largest amount of employer-provided benefit available to at least 90 percent of the employer's nonhighly compensated employees. For this purpose, benefits attributable to salary reduction contributions by nonhighly compensated employees are not treated as employer-provided benefits, even if the employer has made the election provided under paragraph (b)(2) of Q&A-8 of this section. In addition, benefits with respect to highly compensated employees that are attributable to salary reduction contributions are not treated as employer-provided benefits except to the extent that such contributions are treated as employer contributions with regard to such employees under paragraph (c)(2) of Q&A-8 of this section. The rule of this paragraph (e) is illustrated as follows:

Example. Assume that an employer maintains numerous health plans for its employees. For a testing year, the largest employer-provided benefit available to any highly compensated employee, determined under the 90 percent/50 percent eligibility test, is $12,000. Because only 75 percent of the employer's nonhighly compensated employees have available to them an employer-provided benefit of at least $6,000, the employer's health plans fail to satisfy the 90 percent/50 percent eligibility test. As a result, the highly compensated employees who receive coverage under one or more health plans are treated as receiving an excess benefit. If, for this testing year, 90 percent of the employer's nonhighly compensated employees have available to them an employer-provided health benefit of at least $4,500, a highly compensated employee is treated as receiving an excess benefit to the extent such employee actually receives (rather than is eligible to receive) an employer-provided benefit under all health plans in excess of $9,000 (i.e., 200 percent of $4,500). If the largest amount of employer-provided benefit that is available to 90 percent of the employer's nonhighly compensated employees were $3,000 (instead of $4,500), a highly compensated employee's excess benefit would be the amount of such employee's employer-provided benefit that is in excess of $6,000. If no amount of employer-provided benefit is available to 90 percent or more of the nonhighly compensated employees, then all highly compensated employees have excess benefits equal to their total employer-provided benefits received for the testing year.

(f) *75 percent benefits test*—(1) *In general.* A highly compensated employee's excess benefit under plans of the same type that fail to satisfy the 75 percent benefits test of paragraph (d)(4) of Q&A-1 of this section is determined under the rules of this paragraph (f). If plans of different types are tested together under paragraph (f)(2)(ii) of Q&A-1 of this section, then such plans are treated as plans of the same type for purposes of this paragraph (f).

(2) *Reapply test.* The 75 percent benefits test is to be reapplied for the testing year with respect to those plans of the same type by taking into account, in accordance with paragraph (c) of this Q&A-9, all highly compensated employees of the employer and the employer-provided benefits that such employees actually received for the testing year. If upon such reapplication of the 75 percent benefits test, such test is satisfied, there are no excess benefits under section 89(b) with respect to such test.

(3) *Amount of excess benefit.* Excess benefits under the 75 percent benefits test are determined by reducing the employer-provided benefit of the highly compensated employee or employees with the highest amount of employer-provided benefit for the testing year, under the 75 percent benefits test as reapplied in accordance with this paragraph (f), until either such employee's employer-provided benefit is equal to the next highest amount of employer-provided benefit for any highly compensated employee or if no next highest such employee exists, until the employee no longer has any employer-provided benefit. This method of reduction is then applied with respect to additional highly compensated employees (beginning with highly compensated employees with the highest remaining amounts of employer-provided benefits) until the 75 percent benefits test is satisfied in accordance with this paragraph (f). A highly compensated employee's excess benefit is equal to the total amount of such employee's employer-provided benefit that is reduced under this paragraph (f).

(g) *80 percent coverage test*—(1) *In general.* A highly compensated employee's excess benefit under a plan that fails to satisfy the 80 percent coverage test of paragraph (e) of Q&A-1 of this section is equal to that portion of the employer-provided benefit received by such employee under the plan that is in excess of the maximum employer-provided benefit that such plan may have and be included in a group of comparable plans under paragraphs (c)(1) through (c)(4) of Q&A-4 of this section that satisfies the 80 percent coverage test.

(2) *Examples.* The rule of this paragraph (g) is illustrated in the following examples:

Example 1. An employer maintains numerous health plans. All but one of such employer's health plans are included in a group of comparable plans determined in accordance with paragraph (c)(5) of Q&A-4 of this section (employee cost comparability). Because over 80 percent of the employer's nonhighly compensated employees are covered by a plan included in the group of comparable plans, each of the plans in such group satisfies the 80 percent coverage test. The deemed employer-provided benefit for the group of comparable plans is $3,780. Plan F, which has an employer-provided benefit of $5,000, is not included in the group of comparable plans and thus such plan fails the 80 percent coverage test. If Plan F's employer-provided benefit were reduced by $800 to $4,200 ($3,780 is 90 percent of $4,200), it could be included in the group of comparable plans under the rules of paragraph (c)(1) of Q&A-4 of this section. Similarly, if Plan F's employer-provided benefit were reduced by $1,221 to $3,779, it could be included in the group of comparable plans under the rules of paragraph (c)(4) of Q&A-4 of this section. As a result, each highly compensated employee who receives coverage under Plan F is treated as receiving an excess benefit of $800 (the lesser of $800 and $1,221) with respect to such plan.

Example 2. Assume the same facts as Example 1 except that the plan that is not included in the group of comparable plans fails the 50 percent eligibility test of paragraph (b) of Q&A-4 of this section. Under paragraph (c)(3) of Q&A-4 of this section, the eligibility test must be satisfied before the plan may be included in a group of comparable plans in determining whether the 80 percent coverage test is satisfied. Thus, the excess benefit for Plan F must include the amount necessary to permit such plan to satisfy the 50 percent eligibility test. In this example, this would occur if Plan F's employer-provided benefit were reduced by $1,021 to $3,979 ($3,780 is 95 percent of $3,979).

Q-10: What are the effective dates of the section 89 nondiscrimination and qualification rules?

A-10: (a) *Effective date*—(1) *In general.* Except as otherwise provided in this Q&A-10, the nondiscrimination rules of sections 89(a)-(j) and 89(l)-(m) and the qualification rules of section 89(k) apply for plan years beginning after December 31, 1988.

(2) *Collectively bargained plans*—(i) *In general.* In the case of a collectively bargained plan that is adopted pursuant to one or more collective bargaining agreements ratified prior to March 1, 1986, section 89 does not apply to such plan with respect to employees included in a unit of employees covered by any of such collective bargaining agreements in years beginning before the earlier of January 1, 1991, or the date on which the last collective bargaining agreement relating to the plan expires (determined without regard to extensions after February 28; 1986).

(ii) *Definition of collectively bargained plan.* A collectively bargained plan is a plan covering only eligible individuals who are included in a unit of employees covered by an agreement that is a collective bargaining agreement entered into between employee representatives and one or more employers (as determined under section 7701(a)(46)). A plan that is maintained pursuant to two or more collective bargaining agreements is treated as two or more collectively bargained plans to the extent that the employer-provided benefits provided pursuant to the agreements are not uniform. Thus, for example, if a multiemployer plan is maintained pursuant to three collective bargaining agreements, two of which provide for an identical benefit structure and one of which provides for a different benefit structure, the plan is treated as two separate, collectively bargained plans for purposes of this paragraph (a)(2).

(iii) *Plans benefiting non-collectively bargained employees.* If a plan provides employer-provided benefits to employees who are included in a unit of employees covered by a collective bargaining agreement and to employees who are not included in any such unit of employees (i.e., non-collectively bargained employees), the non-collectively bargained employees are treated as covered by a plan that is not a collectively bargained plan for purposes of this paragraph (a)(2). Thus, the delayed effective date of paragraph (a)(2)(i) of this Q&A-10 is available only with respect to the portion of the plan that provides employer-provided benefits to the collectively bargained employees.

(iv) *Treatment of collectively bargained employees as excludable employees.* Unless the employer elects otherwise, employees who receive employer-provided benefits under a collectively bargained plan to which section 89 does not yet apply by reason of this paragraph (a)(2) are to be treated as excludable employees (i.e., as though they were described in section 89(h)) for purposes of applying the nondiscrimination tests of section 89 to plans that are subject to section 89. However, an employer may elect in writing not to treat such collectively bargained employees as excludable employees for purposes of applying section 89 to plans that are subject to section 89. Such an election must be made with respect to all collectively bargained employees, regardless of bargaining unit, and once made applies to all subsequent testing years. Such an election does not accelerate the otherwise applicable effective date with respect to the application of the qualification rules of section 89(k) to such collectively bargained plan or plans. However, if the employer makes an election under this paragraph (a)(2)-(iv), then the nondiscrimination rules of section 89 are effective with respect to such plan or plans and thus a highly compensated employee within the group of otherwise excludable employees (i.e., nonexcludable by reason of such election), may have an excess benefit under section 89(b).

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

Example 1. A collective bargaining agreement ratified in January 1986 is scheduled to expire on December 31, 1992. Such agreement provides for contributions by an employer to a multiemployer plan providing health coverage. Assuming that no employee who is included in the collective bargaining unit receives health coverage from the employer other than coverage under the multiemployer plan, the collective bargaining employees and their health coverage may be disregarded by the employer in applying the section 89 nondiscrimination tests for any period before January 1, 1991.

Example 2. Employer X maintains two health plans, Plan A (covering non-collectively bargained employees) and Plan B (covering collectively bargained employees). Plan B is a multiemployer plan that has an effective date for purposes of section 89 of January 1, 1991. Plan A is an insurance plan with a policy that expires on June 30, 1989. The collectively bargained employees receiving benefits under Plan B may be treated as excludable employees until January of 1991 and their health coverage may be disregarded by Employer X in applying the nondiscrimination tests of section 89 until that date. However, before that date, Employer X may elect to take such collectively bargained employees (and their employer-provided benefits) into account for purposes of testing Plan A for periods prior to January of 1991.

(b) *Definition of plan year*—(1) *In general.* Except as provided in paragraph (b)(2) or (b)(3) of this Q&A-10, for purposes of determining the applicable effective date of section 89 with respect to a plan, the plan year is the year that is designated as the plan year in the written plan. For plans other than health and group-term life insurance plans, if there is no such designation, the plan year is the calendar year. For purposes of this rule, the designation of a plan year solely for purposes of filing the Form 5500 is to be disregarded.

(2) *Certain health and group-term life insurance plans*—(i) *Insured plans.* If a health or group-term life insurance plan's plan year is not clearly ascertainable from a written plan document adopted and in existence on January 1, 1989, and the plan is provided under an arrangement through an insurance company, the policy year is the applicable plan year for effective date purposes. If there is no policy year, the employer may elect in writing either the limit/deductible year, the calendar year, or the employer's fiscal year as the applicable plan year for effective date purposes. If the employer does not make such an election, the applicable plan year is the calendar year. An arrangement is not provided through an insurance company for purposes of this paragraph (b) if the insurance company provides merely administrative services under the arrangement.

(ii) *Self-insured plans.* If a health or group-term life insurance plan's plan year is not clearly ascertainable from a written plan document adopted and in existence on January 1, 1989, and the coverage under such plan is not provided under an arrangement through an insurance company, the employer may elect in writing either the limit/deductible year, the calendar year, or the employer's fiscal year as the applicable plan year for effective date purposes. If the employer does not make such an election, the applicable plan year is the calendar year.

(iii) *Limit/deductible year.* The limit/deductible year is the year with respect to which the plan's benefit and deductible limits are applied, except that if different years are used for benefit limit purposes and for deductible limit purposes, it means the limit or deductible year that commences earlier in the calendar year.

(3) *Special rule to prevent delay of the section 89 effective date*—(i) *In general.* Notwithstanding paragraphs (b)(1) and (b)(2) of this Q&A-10, in the case of a health or group-term life insurance plan with respect to which the first day of the first plan year beginning after December 31, 1988 (determined under paragraphs (b)(1) and (b)(2)), is later during the calendar year than the first day of the first plan year (also determined under such paragraphs) beginning in 1988, the first plan year beginning after December 31, 1988, is deemed to begin on the day that is 12 months after the first day of the plan's first plan year beginning in 1988. Thus, section 89 becomes effective with respect to such plan on the first anniversary date of the plan's first plan year beginning in 1988. In addition, for purposes of this Q&A-10, a plan's last plan year beginning in 1988 is not treated as longer than 12 months in duration. Thus, for example, an agreement between an employer and insurance company to extend for longer than 12 months the last plan year of a health plan beginning in 1988 is not recognized for purposes of determining the applicable section 89 effective date with respect to such plan. Such plan is treated as commencing a new plan year on the day that is 12 months after the first day of the last plan year commencing in 1988.

(ii) *Exceptions*—(A) *In general.* Except as provided in paragraph (b)(3)(iii) of this Q&A-10, paragraph (b)(3)(i) of this Q&A-10 does not apply to the extent that any of the tests described in this paragraph (b)(3)(ii)(B) through (D) are satisfied.

(B) *Three-month rule.* A plan is a health plan and the first day of the plan's first plan year beginning after December 31, 1988, is not more than 3 months later during the calendar year than the first day of the plan's first plan year beginning in 1988 and the selection of the new plan year was for bona fide business reasons unrelated to section 89 (e.g., by reason of a merger or acquisition).

(C) *New carrier rule.* A plan is a health plan and the health coverage for the plan's first plan year beginning after December 31, 1988, is provided through an insurance arrangement with an insurance company unrelated to any insurance company that provided health coverage under the plan for the first day of the plan's first plan year beginning in 1988 and such change in insurance carriers and the selection of the new plan year were for bona fide business reasons unrelated to section 89.

(D) *Uniform plan year.* The first day of the plan's first plan year beginning after December 31, 1988, is the same day during the calendar year on which commenced in 1988 the plan year or years of the plan or plans of the same type that provided, in the aggregate, at least 25 percent of the total employer-provided benefits provided under all plans of the same type during 1988 and the selection of the new plan year was for bona fide business reasons unrelated to section 89. This rule may be applied in the case of a merger or acquisition by treating such transaction as having occurred on December 31, 1987.

(iii) *Retroactive plan year changes.* This paragraph (b)(3) is to be applied by disregarding any change in a plan year that is made after the commencement of such plan year.

(iv) *Additional rules.* The Commissioner may, through revenue rulings, notices, and other guidance of general applicability, provide such additional exceptions to paragraph (b)(3)(i) of this Q&A-10 as are appropriate if such exceptions do not have the effect of permitting employers to delay significantly the effective date of section 89 with respect to their plans without any significant, independent business reason.

(4) *New plans.* For purposes of this Q&A-10, a plan is not treated as a new plan commencing in calendar year 1989, unless such plan provides coverage and benefits that are substantially different from the coverage and benefits previously provided by a plan in calendar year 1988.

(5) *Certain dispositions or acquisitions.* If a person becomes or ceases to be a member of a group described in section 414(b), (c), (m) or (o) on or before December 31, 1988, the transitional rule of section 89(j)(8) is not applicable with respect to any plan of such person or of any member of such group unless the requirements of section 89 were met immediately before such change in the group. This determination is to be made as though section 89 (and this section) were effective with respect to all such plans of such person. Alternatively, for testing years beginning in 1989, the nondiscrimination rules of section 89 may be applied separately to the separate portions of the group under section 414(b), (c), (m) and (o) involved in the change of the group as if such portions did not become part of the same group until December 31, 1989.

§1.89(k)-1 Qualification requirements for certain employee welfare benefit plans.

The following is a list of the questions addressed in this section.

Q-1: What is required under section 89(k)?

Q-2: What plans must meet the requirements of section 89(k)?

Q-3: What is required under the writing requirement of section 89(k)(1)(A)?

Q-4: When is a plan legally enforceable within the meaning of section 89(k)(1)(B)?

Q-5: What constitutes reasonable notification of employees under section 89(k)(1)(C)?

Q-6: How does an employer meet the exclusive benefit requirement of section 89(k)(1)(D)?

Q-7: How is it determined whether a plan is established with the intent of being maintained for an indefinite period of time?

Q-8: What are the sanctions for failure to meet the qualification requirements of section 89(k)?

Q-1: What is required under section 89(k)?

A-1: (a) *In general.* Section 89(k) imposes the following requirements on employers maintaining certain employee benefit plans as described in Q&A-2 of this section: the plan must be in writing; employees within the class of employees designated in the plan as eligible for participation must have a legally enforceable right to participate and, if covered under such plan, to receive benefits; employees who are eligible to participate must be provided reasonable notice of the benefits available under such plan; the plan must be maintained for the exclusive benefit of employees; and the plan must be established with the intent that it will be maintained for an indefinite period of time.

(b) *Definitions*—(1) *Benefit*. For purposes of section 89(k), the term ''benefit'' or ''benefits'' means those payments, reimbursements, products and services provided under the plan to a participant on account of such participant's claim, need or event that is covered under the plan. For example, the fair market value of the use of an on-site child care facility by a participant is the benefit under a dependent care assistance program described in section 129. Similarly, reimbursement of a participant's expense incurred for a covered surgical procedure is a benefit under a health plan. Another example of a benefit under a plan is the payment of a death benefit under a group-term life insurance plan to which section 79 applies.

(2) *Employer-provided benefit*. With respect to section 89(k), the term ''employer-provided benefit'' means that portion of the benefits received by an individual that is attributable to employer contributions, including salary reduction contributions under a cafeteria plan. See paragraph (f)(3) of Q&A-1 of §1.89(a)-1 for a definition of ''employer-provided benefit'' for purposes of the nondiscrimination rules under section 89.

(3) *ERISA*. The term ''ERISA'' refers to the Employee Retirement Income Security Act of 1974, as amended.

(4) *Salary reduction contributions*. The term ''salary reduction contributions'' means elective contributions under a cafeteria plan described in section 125 that would be taxable to an employee, but for section 125, by reason of such employee's right to receive such amounts as cash or other taxable benefits. See paragraph (a)(2) of Q&A-8 of §1.89(a)-1 for further guidance regarding the term ''salary reduction contributions.''

Q-2: What plans must meet the requirements of section 89(k)?

A-2: (a) *In general*—(1) *Types of plans subject to section 89(k)*. In general, the following plans are subject to section 89(k): an accident or health plan (sections 106 and 105); a plan of an employer providing group-term life insurance (section 79); a dependent care assistance program (section 129(d)); a qualified tuition reduction program (section 117(d)); a cafeteria plan (section 125(c)); a fringe benefit program providing no-additional-cost services, qualified employee discounts, or employer-operated eating facilities, the benefits from which are excludable from the gross income of the beneficiary under section 132; and a plan of which an organization covered by section 505 is a part. Section 89(k) applies to these plans without regard to whether they are statutory employee benefit plans subject to the nondiscrimination rules of section 89 and without regard to whether they are subject to Title I of ERISA. Also, section 89(k) applies to plans described in this paragraph (a)(1) even though they are maintained by employers that are state or local governments or by the federal government. Finally, except as provided in paragraph (f) of this Q&A-2, section 89(k) also applies to plans described in this paragraph (a)(1) even though they are maintained by organizations exempt from taxation under section 501(a).

(2) *Plans maintained by an employer*. For purposes of section 89(k), a plan ''maintained by an employer'' is any plan of, or subsidized by, an employer who employs participants in the plan. A plan is maintained by an employer even if the cost of such plan is borne by the employees through after-tax employee contributions, as long as the value of the coverage under the plan for any employee is greater than such employee's after-tax contributions. See section 79 and the regulations thereunder for rules relating to when a group-term life insurance plan is subject to section 79 and, therefore, to section 89(k). For purposes of this paragraph (a)(2), the term ''employee'' includes the spouse and dependents of an employee. See also Q&A-6 of this section with regard to individuals who may participate in a plan. In addition, plans of the type described in paragraph (a)(1) of this Q&A-2 that are maintained by one or more ''employee organizations,'' as that term is defined in section 3(4) of ERISA, or that are maintained pursuant to one or more collective bargaining agreements, are maintained by one or more employers and must meet the requirements of section 89(k).

(b) *Special rules with respect to accident or health plans*—(1) *In general*. For purposes of section 89(k), an accident or health plan providing coverage that is excludable under section 106 must meet the requirements of section 89(k) if benefits under the plan are to be excludable under section 105(b) or (c) or, in the case of a death benefit under a plan described in paragraph (b)(2) of this Q&A-2, under section 101. If employer-provided benefits under an accident or health plan are not excludable under section 105(b) or (c) or section 101 (other than by reason of section 89), the plan is not required to comply with section 89(k). Thus, for example, employer-provided health plans (including plans that provide medical diagnostic examinations) must satisfy section 89(k) in order for the benefits thereunder to be excludable under section 105(b) or (c). An accident or health plan the entire cost of which is borne by the employees on an after-tax contributory basis (as determined under Q&A-7 of §1.89(a)-1) is not required to meet the requirements of section 89(k). Thus, if employees' required after-tax contributions for health coverage are equal to or exceed the applicable premium for such coverage within the meaning of section 4980B(f)-(4), then the health plan does not have an employer-provided benefit (determined under Q&A-7 of §1.89(a)-1) and thus is not subject to section 89(k).

(2) *Accidental death and dismemberment*. In order for the employer-provided benefit under an accidental death and dismemberment plan to be excludable under section 101 or 105, the plan must meet the requirements of section 89(k). For purposes of section 89, an accidental death and dismemberment plan is a plan that provides insurance type coverage attributable to employer contributions that are excludable under section 106 and that provides only benefits excludable from income under either section 105(c) or section 101 (where the benefits are payable on account of, and conditioned principally upon, the accidental death of the employee). If a plan provides for a general death benefit (described in §1.79-1(a)(1)), it is not an accidental death and dismemberment plan.

(3) *Disability and other sick pay plans*. Sick pay plans and disability plans are subject to the requirements of section 89(k) only if employer-provided benefits under such plans are excludable from gross income upon receipt by the individual under section 105(b) or (c).

(4) *Worker's compensation*. A worker's compensation plan that pays amounts from a sickness and disability fund maintained for employees under the laws of the United States, a state or the District of Columbia (i.e., a fund maintained pursuant to a worker's compensation act or a statute in the nature of a worker's compensation act, the benefits from which are excludable under section 104(a)(1)) is not subject to the requirements of section 89(k). However, accident or health plans maintained by the

United States, a state or the District of Columbia that provide benefits that are excludable from the income of an employee solely by reason of section 105(b) or (c) are not worker's compensation funds within the meaning of the preceding sentence and thus are subject to the requirements of section 89(k).

(5) *Section 401(h) accounts.* A section 401(h) account contained in a pension or annuity plan is subject to the requirements of section 89(k) with regard to benefits provided through such account.

(c) *Special rules relating to dependent care assistance programs, group legal services plans and educational assistance programs.* A dependent care assistance program (within the meaning of section 129(d)) must comply with section 89(k) without regard to whether the employer elects to treat such program as a statutory employee benefit plan as allowed under section 89(i)(2). Similarly, qualified group legal services plans (within the meaning of section 120(b)) and educational assistance programs (within the meaning of section 127(b)) must satisfy section 89(k) requirements, provided the applicable statutory provisions are in effect.

(d) *Plans to which section 505 applies.* A plan of which an organization covered by section 505 is a part must satisfy the requirements of section 89(k). Such plans include plans providing benefits through organizations described in section 501(c)(9) or 501(c)(17). If section 120 is in effect, plans providing benefits through organizations described in section 501(c)(20) must satisfy the requirements of section 89(k). The requirements of section 89(k) must be met by a plan even if the related organization qualifies as an organization that is part of a plan maintained pursuant to a collective bargaining agreement as described in section 505(a)(2).

(e) *Multiemployer plans.* If a plan is otherwise subject to section 89(k) and is a multiemployer plan within the meaning of section 3(37) of ERISA, that plan is maintained by all contributing employers and is subject to the requirements of section 89(k).

(f) *Church plans.* Employee benefit plans of a type described in paragraph (a)(1) of this Q&A-2 that are maintained by organizations described in section 3121(w) (i.e., churches or church-controlled organizations) exclusively for their employees and clergy (including the spouse or dependents of employees or clergy) are not subject to the requirements of section 89(k).

(g) *Treatment of statutory employee benefit plans providing excess benefits.* A statutory employee benefit plan that provides any amount of employer-provided benefits is subject to the requirements of section 89(k) even though the plan fails to satisfy the nondiscrimination requirements of section 89(a). Thus, for example, an employer-provided health plan that covers medical diagnostic examinations is subject to section 89(k) even if such health plan fails to satisfy the 50 percent eligibility test of section 89 and the entire value of the employer-provided coverage with respect to such plan is treated as an excess benefit under section 89(b).

(h) *Dispositions and acquisitions.* The rule of section 89(j)(8) does not apply with respect to the requirements of section 89(k). Thus, a plan that is subject to section 89(k) must continue to satisfy such requirements during the transition period (defined under section 89(j)(8)) without regard to the fact that the employer maintaining the plan has been involved in a merger, consolidation, or similar transaction.

(i) *Effective date.* Generally, see Q&A-10 of §1.89(a)-1 for the effective date of the qualification requirements of section 89(k). However, the general effective date is subject to the transition rules set forth in this section.

(j) *Coordination with ERISA provisions.* The reporting, notification and written plan document requirements contained in this section are in addition to, and not in lieu of, any requirements otherwise imposed on employer-provided benefit plans by Title I of ERISA or any other provision of law. The rules contained herein apply for purposes of section 89(k) and no inference should be drawn therefrom regarding the requirements otherwise imposed by Title I of ERISA or any other law.

Q-3: What is required under the writing requirement of section 89(k)(1)(A)?

A-3: (a) *In general.* Section 89(k)(1)-(A) requires a plan to be in writing. Generally, this means that all material terms of the plan must be contained, by direct inclusion, by incorporation by reference, or by a combination of these methods, in a single written document.

(b) *Requirement of a single written document*—(1) *In general.* The writing requirement of section 89(k) must be met with respect to a plan by a single written document. One such document may satisfy the writing requirement for more than one plan.

(2) *Incorporation by reference.* Written documents relating to the plan are treated as part of the single written document if they are specifically incorporated by reference in the single written document. Section 89(k)(1)(A) is satisfied with respect to a plan if the single written document with regard to such plan either contains all of the plan's material terms or, to the extent a material term is not employned in the single written document, incorporates by reference the document containing such term. Examples of documents which may be so incorporated in the single written document are: contracts with insurance providers; contracts with any other provider of benefits under the plan; contracts with plan administrators of, or consultants to, the plan; documents creating a trust or other funding instrument related to the plan; resolutions of the employer's governing body relating to the creation, operation, maintenance or termination of the plan; collective bargaining agreements; pronouncements made by the employer, an agent of the employer, a plan administrator or other person relating to or concerning a material term in the plan; and all plan-related documents required to be provided to any employee or filed with any regulatory agency or instrumentality of any federal, state, or local governmental body by statute, rule, or regulation, including but not limited to the documentation required to be provided to employees by the notice requirement of section 89(k)(1)(C) (see Q&A-5 of this section). There is no limitation on the number of single written documents that may incorporate a document by specific reference.

(c) *Contents of single written document*—(1) *In general.* Certain minimum information must be included in the single written document in order for the plan to satisfy the writing requirement of section 89(k)(1)(A). All material terms of the plan must be included in the single written document. If a material term of an insured plan is not defined in the single written document of the plan or in a document incorporated therein by reference, and such term is stated in the insurance contract, the term has the meaning given it by the insurance company's usual practice. See paragraph (c)-(4) of this Q&A-3 for the definition of a material term of a plan. Further, the provisions required to be included in the single written document by paragraphs (c)(2) and (c)(3) of this Q&A-3 are deemed to be material terms.

(2) *Recitation of certain qualification requirements.* The single written document must contain a recitation of the qualification requirements contained in section 89(k)(1)(B) and (D). Thus, the single written document must state that the employer intends that the plan terms, including those relating to coverage and benefits, are legally enforceable and that the plan is maintained for the exclusive benefit of employees.

(3) *Additional requirements under specific exclusion provision.* The single written document must include any information or term required by any other applicable provision of the Code or accompanying regulation.

(4) *Definition of a material term of a plan.* The phrase "material term of a plan" generally means a term relating to an employee's rights to be covered by, participate in, or benefit under a plan. The following are examples of material terms of a plan: the eligibility rules governing plan participation; terms relating to the periods during which coverage or benefits are provided; descriptions of available benefits; the procedures governing participants' elections under the plan, including the period during which an election may be made, the extent to which elections are irrevocable, and the periods with respect to which elections are effective; the manner in which employer contributions may be made under the plan, such as by salary reduction agreements between a participant and the employer and by nonelective employer contributions, as well as any maximum limitation on employer contributions on behalf of any participant; terms relating to the timing or amount of salary reduction or employee contributions to the plan; terms relating to deductibles, copayments or similar requirements, including any dollar limit on any benefit; conditions precedent or subsequent with regard to a participant's qualification or continued qualification for any coverage or benefit, including any limitations or restrictions relating to benefits, such as a pre-existing condition limitation; provisions relating to the procedure under which claims are to be made and evaluated for reimbursement; provisions relating to health continuation coverage under section 4980B; and the procedures or circumstances under which the plan may be terminated, including a statement, if applicable, that the plan may be terminated at will by the employer.

(d) *Timing*—(1) *In general.* Except as set forth in paragraph (d)(2) or (d)(3) of this Q&A-3, the material terms of the plan, as well as any amendment, extension, or modification of any of such material terms of the plan, must be in writing prior to the first day for which coverage is provided under an insured or insurance-type plan, or benefits are available under any other type of plan, or prior to the effective date of any amendment, extension or modification of such material terms, as the case may be.

(2) *Certain plan modifications*—(i) *Clarifications of material terms.* Where a plan modification constitutes merely a clarification to a material term (i.e., if the change merely clarifies an existing term in the plan and will have a de minimis impact on the individuals eligible or covered under the plan), the plan document need not reflect such modification until 120 days after the effective date of the modification or, if there is no separate effective date, until 120 days after the adoption of such amendment. A clarifying change generally includes a change in the plan language (either by addition or amendment) that reflects the previous intention of the employer with respect to a term of the plan. Whether the change is a clarifying change is to be determined not only by reference to the existing plan provisions and the notices provided to the employees, but also with regard to all of the facts and circumstances including, but not limited to, whether and the extent to which the amended language is consistent with the previous operation of the plan.

(ii) *Extension of time where notice provided.* If the employer provides reasonable notice satisfying the requirements of section 89(k)(1)(C) relating to the material terms of a plan to those entitled to notice under Q&A-5 of this section prior to the effective date of the plan or prior to the effective date of any addition or amendment to any material term of the plan (including any amendment to the terms contained in documents that are incorporated in the single written document by reference), then the time by which the single written document must meet the requirements of paragraph (d)(1) of this Q&A-3 to reflect such notice (or the related additions or amendments) is extended until 120 days after the effective date of the new plan or modification. However, this rule is available only if the notice contains a statement that the terms of the notice are legally enforceable.

(iii) *Certain retroactive modifications*—(A) *In general.* A modification to a material term of a plan does not fail to satisfy section 89(k)(1)(A) or this section merely because such modification applies retroactively to periods prior to the date of adoption of such modification if all of the conditions set forth in paragraph (d)(2)(iii)(B) through (F) are satisfied.

(B) *Expansion of coverage or benefits.* The modification must constitute an expansion of coverage or benefits under the plan (i.e., results in the plan having a larger value).

(C) *Notification.* Employees under the plan (including all employees covered under the plan for any portion of the period to which the retroactive coverage applies, regardless of whether they are currently covered) must be reasonably notified (within the meaning of Q&A-5 of this section determined without regard to the last sentence of paragraph (g)(2) of Q&A-5) of the modification within 60 days after its adoption.

(D) *Plan amendment.* The single written document must be amended to reflect the modification no later than 120 days after the adoption of the modification.

(E) *Duration.* The modification must continue in effect with respect to all eligible individuals with respect to the plan from the effective date of the modification until 12 months after the date of adoption.

(F) *Nondiscrimination.* The modification must not discriminate in favor of highly compensated employees.

(iv) *Nonmaterial terms.* Modification to any term contained in the single written document that is not a material term must be incorporated in the document no later than 120 days after the effective date of the modification or, if there is no separate effective date, no later than 120 days after the adoption of such amendment. Thus, to the extent that the single written document includes nonmaterial terms of the plan, such writing must accurately reflect such nonmaterial terms and any modifications thereto must be incorporated in the single written document within the time set forth in the preceding sentence.

(v) *Examples.* The requirements of this paragraph (d) are illustrated by the following examples:

Example 1. A plan is amended to change the level of employee contributions required to participate. This constitutes an amendment to a material term of the plan. If the employer properly notifies the employees prior to the amendment being effective, the single written document need not be amended to reflect such change until 120 days after the effective date of such change as long as the notice contains a statement that its terms are legally enforceable.

Example 2. An administration agreement incorporated by reference in the plan document is amended to change the timing of fees paid to the plan administrator. Unless the circumstances indicate that this is a material term, no amendment to the plan document is required until 120 days after the effective date of the new fee agreement. In such case, the single written document must be amended to reflect by specific reference (by an addendum or otherwise) the date of execution of the new fee agreement.

(3) *Exception for certain on-site medical and eating facilities.* Certain on-site medical and eating facilities are exempt from the requirements of section 89(k)(1)(A). An on-site medical facility is described in this paragraph (d)(3) if it is located and operates exclusively on a work-site of the employer and there is no physician care provided at the site at any time. A wellness program sponsored by the employer may be considered an on-site medical facility. A medical facility is not described in this paragraph (d)(3) unless access to the facility is available on the same terms to each member of a group of employees that is defined under a reasonable classification set up by the employer that does not discriminate in favor of highly compensated employees. An eating facility is described in this paragraph (d)(3) if it is described in and meets the requirements of section 132(e)(2).

(4) *Transition rule.* A plan is not required to meet the writing requirement of section 89(k)(1)(A) with respect to the first plan year beginning in 1989. For the subsequent plan year, a plan is not required to meet the writing requirement of section 89(k)(1)(A) before the later of the first day of such plan year, and the day following the end of the 12-month period beginning on the first day of the first plan year in 1989 that the plan is subject to section 89. For purposes of this transition rule, the extension of time due to a notice that is described in paragraph (d)(2)(ii) of this Q&A-3 is not available.

Q-4: When is a plan legally enforceable within the meaning of section 89(k)(1)(B)?

A-4: (a) *In general.* A plan is considered legally enforceable only if the conditions required for an employee to participate, receive coverage and obtain a benefit are definitely determinable under the terms of the plan and an employee satisfying such conditions is able to compel such participation, coverage and benefit.

(b) *Employer discretion*—(1) *Impermissible discretion*—(i) *In general.* A plan generally is not considered legally enforceable if a decision as to whether to grant or deny participation, coverage or a benefit is discretionary with the employer either pursuant to the terms of the plan or through the operation of the plan. Thus, except as provided in paragraph (b)(2) of this Q&A-4, a plan that permits the employer, either directly or indirectly, through the exercise of discretion, to grant or deny an employee the right to participate, receive coverage or obtain a benefit under the plan for which the employee is otherwise eligible or ineligible (but for the employer's exercise of discretion) violates the requirement of section 89(k)(1)(B). An employer is deemed to have exercised discretion in a manner inconsistent with section 89(k)(1)(B) if the employer imposes conditions or limitations on eligibility for coverage that are not contained in the single written document comprising the plan and have not been included in the notice described in paragraph (d)(2)(ii) of Q&A-3 of this section. Likewise, except as provided in paragraph (c) of this Q&A-4, a plan violates section 89(k)(1)(B) if the employer waives an otherwise applicable condition, restriction or other term contained in the plan if the single written document does not contain objective, clearly ascertainable criteria and procedures under which such condition, restriction or term may be waived. Finally, a plan violates section 89(k)(1)(B) if participation, coverage or benefits under the plan are subject to objective conditions that are within the control of the employer.

(ii) *Employer.* For purposes of this Q&A-4, the term "employer" includes the plan administrator, fiduciary, trustee, actuary, independent third party, and other persons. Thus, if a plan grants any person the discretion to deny or limit the availability of a plan benefit for which the employee may otherwise be eligible under the plan (but for the exercise of such discretion), and such exercise is not provided for under the terms of the plan through objective criteria or otherwise permissible under this Q&A-4, then the plan violates section 89(k)(1)(B).

(2) *Permissible discretion*—(i) *In general.* A plan may permit discretion with respect to the administra tion of the plan, including the application of objective criteria specifically set forth in the plan. In addition, a plan does not fail to meet the requirements of this Q&A-4 merely because discretion is exercised in accordance with a qualified medical opinion of a physician. Also, if plan coverage or benefits are limited to those employees who satisfy certain objective conditions that are clearly set forth in the single written document and are not generally subject to the employer's discretion, an employer may exercise discretion to the extent reasonably necessary to determine whether the objective conditions have been met.

(ii) *Administrative discretion.* Administrative discretion means a determination by the employer with respect to participation in, or coverage or benefits under, a plan or with respect to the general operation of a plan to the extent the exercise of such discretion is based exclusively on clearly defined and ascertainable criteria contained in the single written document. The following provisions that permit limited administrative discretion are examples of provisions that do not violate section 89(k)(1)(B), provided that the provisions are described in the single written document prior to the date a claim is incurred by a participant who is affected by the administrative discretion and, when the provisions are made effective, they apply only to claims that have not yet been incurred: a provision allowing for the commencement of benefits under the plan as soon employinistratively feasible after a stated date or event; a provision granting the employer authority to determine whether an employee has satisfied the age and service requirements of the plan or is an excludable employee under section 89(h); and a provision stating that the benefits under the plan are limited to an amount equal to the reasonable and customary charge for such services.

(iii) *Medical discretion*—(A) *In general.* A health plan does not fail to be legally enforceable merely because coverage or benefits under the plan are conditioned on a qualified medical opinion of a physician. For example, the following plan provisions do not violate the requirements of this Q&A-4: the requirement of a qualified medical opinion of a physician that treatment or benefits are medically necessary or appropriate prior to the provision of such treatment or benefits under a health plan; the requirement of a second opinion or other cost-containment feature of a health plan that is conditioned on a qualified medical opinion of a physician; and the inclusion under the plan of a managed care program. This is the case even if the qualified opinion is provided by a physician who is an employee of the employer.

(B) *Managed care programs.* A managed care program is a program that permits the provision of alternative medical care not otherwise available under a health plan for medical conditions that are covered under the plan. A managed care program must operate pursuant to conditions and procedures clearly ascertainable under the plan. That is, the availability of the program as well as a description of the types of cases that may qualify under the program must be contained in the single written document. Also, the provision of alternative medical care must be based on the consent of the employee and a qualified medical opinion of a physician. Such program may also be conditioned upon the consent of the employer.

(iv) *Certain benefit limitations.* A health plan does not include impermissible discretion merely because the plan limits certain benefits, such as reimbursements, for specified medical claims to those benefits that constitute the "prevailing" or "reasonable and customary" charge for the claim if such charge is determined in accordance with a reasonable, uniform, consistent and nondiscriminatory method. In addition, a health plan does not include impermissible discretion merely because such plan reimburses medical claims in excess of a "prevailing" or "reasonable and customary" charge if such reimbursements are authorized in accordance with reasonable, uniform, consistent, and nondiscriminatory claims review and reimbursement procedures set forth in the single written document.

(c) *Certain retroactive modifications in the plan.* A modification to a plan's material terms does not fail to satisfy section 89(k)(1)(B) merely because such modification applies retroactively to periods prior to the date of adoption of such modification if all of the conditions set forth in paragraph (d)(2)(iii) of Q&A-3 of this section are satisfied with respect to such modification.

(d) *Examples.* The requirements of this Q&A-4 are illustrated as follows:

Example 1. A plan does not fail to meet the requirements of section 89(k)(1)(B) because the employer grants benefits to an employee with a pre-existing medical condition in contravention of a specific plan term excluding coverage for any pre-existing conditions if the single written document is amended to reflect such expanded coverage, it is provided in a nondiscriminatory manner, and the expanded coverage continues in effect for a period of at least 12 continuous months from such amendment.

Example 2. A plan includes a managed care program which provides that upon the recommendation of the attending physician and the consent of both the insurer and the participant, the plan will reimburse alternative care (e.g., home health care expenses) instead of continued hospitalization. This program does not cause the plan to fail to meet the requirements of section 89(k)(1)(B).

Example 3. An employer maintains a health plan for former employees who retire from the employer on or after age 55 with at least 10 years of service if the employer consents to such employee's separation from service. Conditioning participation in this health plan on the employer's consent to the employee's separation constitutes impermissible discretion and violates section 89(k)(1)(B).

(e) *Transition rule.* A plan that is otherwise subject to the rules contained in section 89(k) is not required to comply with section 89(k)(1)(B) prior to the first day of the plan year following the first plan year beginning in 1989.

Q-5: What constitutes reasonable notification of employees under section 89(k)(1)(C)?

A-5: (a) *In general.* The employer or, if the plan is a multiemployer plan (within the meaning of section 3(37) of ERISA), the plan administrator must provide reasonable notice of the terms of a plan in order to satisfy section 89(k)(1)(C). Such reasonable notice must be provided to all eligible individuals (other than those individuals deriving their eligibility solely through another individual, such as dependents who derive their eligibility in a health plan through an employee). An eligible individual is an individual who participates under the plan or is described in the plan as eligible to participate. An otherwise eligible individual is an eligible individual even if participation under the plan is conditioned upon an election not yet made by such individual or the passage of a waiting period required by the plan. For purposes of this paragraph (a), an eligible individual also includes an individual who is a qualified beneficiary (as defined in section 4980B(g)(1)) under a health plan by reason of an occurrence of a qualifying event described in section 4980B(f)(3)(A), (C) or (E). Thus, such a qualified beneficiary must receive notice separate from the employee through whom such beneficiary derived eligibility in the health plan. See paragraph (g) of this Q&A-5 for rules regarding the timing of notice.

(b) *Content of reasonable notice.* The notice must contain a fair and complete summary of the material terms of the plan that are reasonably likely to be of significance to an eligible individual. These terms include at least the following: a general description of who is eligible to participate in the plan; a general description of the coverage or coverages offered (including the general types of benefits provided under the plan, basic limitations on such benefits, and required deductibles and co-payments); the timing and method of any election to participate; the cost to the employee relating to the plan, whether by way of salary reduction or employee contributions; the method by which a copy of the plan may be obtained; and the name and means of contacting a person from whom to request further information about the plan.

(c) *Alternative form of compliance.* For any plan other than an accident or health plan, in lieu of a notice meeting the requirements of paragraph (b) of this Q&A-5, the employer (or plan administrator, if the plan is a multiemployer plan) may furnish each eligible individual with a copy of the single written document and all related documents that have been incorporated by reference. This alternative cannot be used unless the single written document complies in all material respects with the requirements of 29 CFR §2520.102-2 (style and format of summary plan description).

(d) *Specific rule as to dependent care assistance programs.* If a plan is a dependent care assistance program described in section 129, any notice to employees that is required for any plan year commencing on or after January 1, 1990, shall include a general description of the dependent care credit (under section 21), the relationship between the credit and participation in the dependent care assistance program, and the general circumstances under which the credit may be more advantageous to a taxpayer than the exclusion. If any other provision of law requires that a notice be provided to individuals eligible to participate in a dependent care assistance program, the requirements of this Q&A-5 are deemed satisfied to the extent such notice meets the requirements of this Q&A-5.

(e) *Maintenance of single written document.* The notice must contain a statement that the employer (or the plan administrator, if the plan is a multiemployer plan) shall make the single written document (including all related documents incorporated therein by reference) available for inspection upon reasonable notice. At a minimum, the following individuals shall be entitled to inspect and copy the single written document: any eligible individual; any other employee of the employer maintaining the plan; and any employee organization that represents employees of such employer. The document must be made available at no cost to the requesting individual at a reasonable time and place and, if a copy of the document is requested, a copy is to be provided at a cost no greater than that prescribed in §601.702(f)(5)(iv)(B) of this Title.

(f) *Method of notification.* Notification to eligible individuals must be provided by the employer (or the plan administrator, if the plan is a multiemployer plan). For purposes of this paragraph (f), notice that otherwise meets the requirements of this Q&A-5 and is provided by an insurance company, health maintenance organization or other health care entity is considered to be provided by the employer. Notice must be provided to all eligible individuals (other than those individuals deriving their eligibility solely through another individual, such as dependents who derive their eligibility in a health plan through an employee). Except as otherwise stated in the final sentence of this paragraph (f), notice must be made in a manner consistent in all material respects with 29 CFR §2520.104b-1(b)(1). If the employer elects to notify eligible individuals through the use of the alternative described in paragraph (c) of this Q&A-5, the notice must be provided to each such eligible individual either by hand or by mail with first class postage prepaid to the last known address of the eligible individual.

(g) *Timing of notice*—(1) *In general.* The notice required under section 89(k) must be provided prior to the first day on which coverage is provided under an insured or insurance-type plan or benefits are available under any other type of plan and prior to the effective date of any material amendment, extension or modification of such coverage or benefits, and no later than a reasonable time prior to the availability of any election with respect to participation under such plan. For purposes of this paragraph (g), the first date on which coverage is provided or benefits are available is the earliest date on which a claim may be incurred and be covered under coverage provided under a written document in existence on the date the claim is incurred.

(2) *Plan modifications.* If there is a modification to a material term of a plan (including any change in plan design that results in a modification of a material term), eligible individuals must be provided with notice of such modification no later than 60 days after the effective date of the modification. In addition, a notice of a retroactive modification will be treated as satisfying this paragraph (g)(2) if all of the conditions set forth in paragraph (d)(2)(iii) of Q&A-3 of this section are satisfied with respect to such modification.

(3) *New employees.* If an employee's participation in a plan is nonelective and begins within the employee's first 60 days of employment, the notice to such employee required under section 89(k)(1)(C) is not required prior to 60 days after the first day such employee is employed.

(4) *Transition rule.* With respect to a plan year beginning on or after January 1, 1989, a plan is not required to comply with this Q&A-5 prior to the later of July 1, 1989, or the first day of such plan year. The transition rule of this paragraph (g)(4) is solely for purposes of compliance with section 89(k)(1)(C). Use of the transition rule of this paragraph (g)(4) does not accelerate the first date by which the plan must meet the writing requirement of section 89(k)(1)(A).

(h) *Examples.* The requirements of this Q&A-5 are illustrated in the following examples:

Example 1. An employer has its open season relating to health plan selection from September 1 to October 1. Because the employer operates at several locations, employees are provided notice at different times. However, the employer ensures that all of its eligible individuals are notified during the period of time beginning 90 days before and ending on the first of September. The employer has notified eligible individuals on a timely basis.

Example 2. An election with respect to a plan is available on a continuous basis throughout the plan year. The employer provides the required notice to all eligible individuals 30 days prior to the beginning of the plan year. The employer has notified eligible individuals on a timely basis.

Example 3. A plan is amended effective June 1 to increase the maximum amount payable for a benefit provided under the plan. The amendment is adopted on May 1 and notice is provided to eligible individuals on that date. The amendment relates to a material term of the plan, and the employer has notified the eligible individuals on a timely basis.

Example 4. An employee begins employment on October 10. Under the terms of the employer's health plan, the employee becomes a participant in the plan as of the beginning of the next calendar month. If notice is provided to the employee no later than December 9, the employer has provided timely notice regardless of the fact that the employee becomes a participant on November 1.

Example 5. The facts are the same as in Example 4 except that the plan is elective. The notice is timely only if the employee is given notice prior to November 1.

Q-6: How does an employer meet the exclusive benefit requirement of section 89(k)(1)(D)?

A-6: (a) *In general.* A plan must be maintained for the exclusive benefit of those employees who participate in the plan. A plan may fail the requirement of this Q&A-6 by reason of its terms or operation. Whether this rule is satisfied is based on all of the facts and circumstances.

(b) *Requirements as to the individuals who may participate in a plan*—(1) *In general.* The exclusive benefit provisions are satisfied only if all of the participants in the plan or plans are common law employees of the employer or employers maintaining the plan. In the case of a voluntary employees' beneficiary association described in section 501(c)(9) (VEBA) that is part of a plan which must satisfy the requirements of section 89(k)(1)(D), those individuals who may participate in the plan include those who may be members of the VEBA under §1.501(c)(9)-2(a).

(2) *Deemed common law employees.* An individual who is not a common law employee of an employer maintaining the plan and who receives coverage or benefits under such plan is deemed to be an employee for purposes of paragraph (b)(1) if the exclusion from gross income that is granted under the relevant provision of the Code (e.g., sections 79, 105, 106, 129 and 132) is available to such individual on the same basis that it is available to a common law employee. In addition, a qualified beneficiary, as defined in section 4980B(g)(1), is treated as a common law employee for purposes of paragraph (b)(1) of this Q&A-6 with respect to a health plan under which the qualified beneficiary receives continuation coverage.

(3) *Certain nonemployees*—(i) *In general.* An individual who is not a common law employee of the employer maintaining the plan, but who performs significant services for the employer in a capacity other than as an employee, and receives coverage or benefits under such plan may be disregarded in applying paragraph (b)(1) of this Q&A-6 if such individual pays for such coverage entirely on an after-tax basis. Thus, a nonemployee participant may be disregarded in applying paragraph (b)(1) of this Q&A-6 with respect to a health plan if the participant performs significant services for the employer and purchases the full coverage under the plan with after-tax contributions.

(ii) *Self-employed individuals.* A self-employed individual who is treated as an employee under section 401(c)(1) is treated as a common law employee of the employer for purposes of applying paragraph (b)(1) of this Q&A-6.

(4) *Examples.* The requirements of this paragraph (b) are illustrated by the following examples:

Example 1. Under section 132(f)(3), certain use of air transportation by a parent of an employee is treated as use by the employee for purposes of determining the excludability of the value of air transportation. The parent of the employee is deemed to be a common law employee for purposes of applying section 89(k)(1)(D) to a plan providing such air transportation because the air transportation provided to the parent is excludable from gross income under section 132.

Example 2. A health plan provides coverage with respect to the spouse and dependents of a common law employee-participant. Because the value of such coverage is excludable under section 106 and the benefits are excludable under section 105(b), the spouse and dependent children are deemed to be common law employees and the plan does not violate the exclusive benefit requirement of section 89(k) by reason of such coverage.

Example 3. An employer allows an independent contractor to purchase health care continuation coverage under section 4980B. The plan does not fail to meet the requirements of section 89(k) by reason of the participation of the independent contractor.

Example 4. A full-time life insurance salesman within the meaning of section 7701(a)(20) participates in an accident or health plan of an insurance company. Since this individual is treated as an employee for purposes of sections 105 and 106, the inclusion of such an individual in the plan does not violate the exclusive benefit requirement of section 89(k).

Example 5. A former employee of Employer X participates in Employer X's accident or health plan. Because this individual is treated as an employee of Employer X for purposes of sections 105 and 106, the former employee's inclusion in the plan does not violate the exclusive benefit requirement of section 89(k).

Example 6. An individual who is a leased employee with respect to the recipient under section 414(n) of the individual's services is treated as an employee of the recipient for purposes of sections 105 and 106, and thus, the inclusion of such leased employee in an accident or health plan of the recipient does not violate the exclusive benefit requirement of section 89(k).

Example 7. An individual who provides significant services to another person for a year but who is not a leased employee under section 414(n) of such person and is not otherwise an employee of such person is not treated as that person's employee for purposes of sections 105 and 106. However, the inclusion of such individual in an accident or health plan maintained by the employer does not violate the exclusive benefit requirement of section 89(k) if such individual's participation in such plan is fully paid for by such individual with after-tax contributions.

(c) *Multiemployer plans.* A multiple employer plan or a multiemployer plan maintained by two or more employers does not fail to satisfy the requirements of section 89(k)(1)(D) merely because employees of contributing employers participate in such plan or because the plan includes employees of an employee organization or of the plan.

(d) *Rules under other sections of the Code relating to the individuals who may participate in a plan.* Nothing in this Q&A-6 modifies any other section of the Code or the regulations specifically relating to who may participate in a plan. To the extent this Q&A-6 is more restrictive than another section of the Code or regulations, this Q&A-6 applies only for purposes of section 89. Notwithstanding the preceding sentence, the rules relating to who may participate in plans provided through organizations to which section 505 applies (i.e., organizations described in sections 501(c)(9) and 501(c)(17)) continue to be applicable to such organizations. Similarly, in addition to the rules contained in this Q&A-6, the rule contained in section 125(c)(1)(A) remains applicable in determining who may participate in a cafeteria plan.

(e) *Example.* The provisions of this Q&A-6 are illustrated in the following example:

Example. A self-insured health plan is funded through a voluntary employees' beneficiary association (within the meaning of section 501(c)(9)) which accepts employee contributions. Under the plan, the experience gain for a year is used to fund a part of the cost of the program for the following year by reducing the employee cost of participation (i.e., employee premiums) for all participants. The provision does not violate the exclusive benefit rule of section 89(k).

(f) *Transition rule.* A plan that is subject to the rules contained in section 89(k) is not required to comply with section 89(k)(1)(D) prior to the first day of the plan year following the first plan year beginning in 1989. Q-7: How is it determined whether a plan is established with the intent of being maintained for an indefinite period of time?

A-7: (a) *In general.* Whether a plan is established with the intent that it will be maintained for an indefinite period of time as required by section 89(k)(1)(E) is to be determined on the basis of all of the facts and circumstances. For purposes of section 89(k)(1)(E), a plan generally is treated as established with the intent that it will be maintained for an indefinite period of time if it is established and maintained for at least a consecutive 12-month period.

(b) *Plan modifications and terminations*—(1) *In general.* Generally, a plan does not fail the requirement of section 89(k)(1)(E) merely because the employer reserves the right to modify or terminate the plan or because the plan is not renewed pursuant to a specific plan provision or is terminated. However, in certain circumstances, significant modifications in the coverage or benefits under the plan or a termination of coverage or benefits raises a presumption that the plan was not established with the intent that it continue for an indefinite period of time. A plan is not considered to be modified or terminated merely because of a change in the insurance carrier or health care provider if the coverage and benefits under the plan are not substantially changed.

(2) *Coverage in effect for at least 12 consecutive months.* The requirement of section 89(k)(1)(E) is not violated by reason of a material modification or termination of a plan, if such material modification or termination is effective on a prospective basis and the affected coverage (or substantially similar coverage) has been in effect for at least a consecutive 12-month period. This paragraph (b)(2) applies even if the plan contains a term specifying the intent of the employer to terminate the plan upon the expiration of a 12-month period.

(3) *Coverage in effect for less than 12 consecutive months.* For plan years beginning after December 31, 1989, special scrutiny will be given with respect to material modifications and terminations of a plan that occur before the terminated or modified coverage or benefits have been in effect for at least 12 consecutive months. Such a termination or modification will not violate the requirement of section 89(k)(1)(E) if the employer can demonstrate that there is a substantial, independent business reason for such termination or modification and that the termination or modification does not discriminate in favor of one or more highly compensated employees.

(4) *Certain modifications.* A retroactive modification to a plan does not cause the plan to fail to satisfy section 89(k)(1)(E) if all of the conditions set forth in paragraph (d)(2)(iii) of Q&A-3 of this section are satisfied with respect to such modification.

(c) *Examples.* The requirements of this Q&A-7 are illustrated in the following examples:

Example 1. An employer merges with another company. Pursuant to the merger and in order to consolidate operations, the surviving employer terminates the health coverage in mid-year for the merged company's employees and adds these employees to the plan maintained by the surviving company. The merger constitutes a valid business purpose for the termination of the health plan of the merged company and, thus, neither plan has failed the requirements of section 89(k)(1)(E).

Example 2. A dental plan is modified on July 1 to include coverage for certain orthodontic benefits. The plan year of the dental plan is the calendar year. The requirements of section 89(k)(1)(E) are not violated if the orthodontic benefits are eliminated from the plan on or after July 1 of the following year because the coverage would have been in effect for at least 12 consecutive months.

Example 3. An employer announces that employees who retire rom the employer on or after age 55 with at least 10 years of service will receive employer-provided health coverage for 1 year after separation if such employees retire during a specified 2-month period. This plan does not fail to satisfy section 89(k)(1)(E) merely because the retirement window is only 2 months long, because such window is a coverage eligibility condition rather than a limitation on the period of coverage under the plan.

Example 4. A health plan with a broad range of coverage provided to all nonhighly compensated employees of an employer is in existence for only one day in a year. The employer designates this day as the testing day for its health plans. Under the facts of the case, a reasonable inference may be made that the intention of the employer in granting the coverage under the health plan in existence only on the testing day is to enhance the likelihood that the employer's other health plan will satisfy the nondiscrimination requirements of section 89. This plan fails the requirement of section 89(k)(1)(E). These circumstances may also result in a finding by the Commissioner that the plan or plans fail the nondiscriminatory provisions test of section 89(d)(1)(C).

Example 5. The requirement of section 89(k)(1)(E) may be violated if a plan is established under circumstances in which it is likely to benefit only one individual. For example, assume that a plan is adopted after an illness is diagnosed with respect to an individual and that the coverage provided relates to this illness. If the plan is terminated after the payment of these expenses, the plan may fail the permanency requirement. If this individual is a highly compensated employee these circumstances may also result in a finding by the Commissioner that the plan fails the nondiscriminatory provisions test of section 89(d)(1)(C).

(d) *Exception for fringe benefits constituting no-additional-cost services and qualified employee discounts.* The requirements of section 89(k)(1)(E) and this Q&A-7 do not apply to any plan providing no-additional-cost services as described in section 132(b) or to any plan providing qualified employee discounts as described in section 132(c).

Q-8: What are the sanctions for failure to meet the qualification requirements of section 89(k)?

A-8: (a) *In general*—(1) *Employer provided benefits.* If a plan subject to section 89(k) fails to satisfy any of the requirements of that section, the employer-provided benefits under the plan generally are not eligible for any exclusion from gross income under Part III, Subchapter B, Chapter 1, Subtitle A, of the Code. For purposes of this Q&A-8, such benefits are termed "nonexcludable benefits". Thus, for example, employer-provided benefits provided under a health plan that fails to satisfy the requirements of section 89(k) are not excludable under section 105. See, however, the limit on the amount of the nonexcludable benefits under paragraph (c)(4) of this Q&A-8. In addition, see section 6652(k) with respect to certain sanctions that may be imposed on the employer with respect to the employer's responsibilities under section 89.

(2) *Employee-provided benefits.* Employee-provided benefits are not subject to section 89(k) and continue to be subject to any applicable exclusion including, for example, the exclusion provided in section 104(a)(3) with respect to accident and health plans.

(3) *Determination of includible benefit.* The includible benefit is determined by calculating the total amount of the benefits provided under the plan and then subtracting the amount of the employee-provided benefit. Determination of the amount of the employee-provided benefit must be made under the provisions of paragraph (d) of this Q&A-8 regarding the allocation of benefits.

(4) *Section 89(b) excess benefits.* Except as provided under paragraph (e) of this Q&A-8, benefits received under a plan that fails to satisfy section 89(k) include those benefits received under coverage that constitutes an excess benefit under section 89(b). That is, for example, sections 101 and 105(b) and (c) are not applicable to benefits received under a discriminatory accident or health plan that also fails to satisfy section 89(k). In addition, a plan's failure to satisfy section 89(k) does not, in and of itself, affect the extent to which the coverage provided with respect to such plan (as opposed to the benefits under the plan) is eligible for an exclusion from gross income. Thus, for example, coverage under a health plan does not fail to be excludable under section 106 merely because the plan fails to satisfy section 89(k).

(b) *De minimis failures to comply with section 89(k)(1)(A) and (C)*—(1) *In general.* If a plan fails to satisfy the writing or notice requirements of section 89(k) and such failure constitutes a de minimis failure (as defined in paragraph (b)(2) of this Q&A-8), then the plan will be deemed to have complied with the requirements of section 89(k) with respect to the failed requirement, provided that such failure is corrected within 90 days after the employer has notice of such failure.

(2) *Definition of de minimis failure to comply*—(i) *In general.* A failure constitutes a de minimis failure to comply only if the failure meets all of the requirements of paragraph (b)(2)(ii) of this Q&A-8. Whether a failure to comply is described in paragraph (b)(2)(ii) of this Q&A-8 is determined under all of the facts and circumstances.

(ii) *Requirements for qualifying as a de minimis failure*—(A) *Good faith effort.* The employer must have acted in good faith and must have made a reasonable effort to comply with the applicable requirement.

(B) *No discriminatory effect.* The failure must not have had the effect of causing the plan to discriminate in favor of one or more highly compensated employees.

(C) *No retroactive reduction of coverage.* Correction of the failure cannot require that coverage be reduced under the single written document (as that plan existed at the time of the failure). That is, a failure is not a de minimis failure if its correction requires that the coverage described in the single written document be reduced with retroactive effect to conform to the previous operation of the plan.

(iii) *Examples.* The requirements of paragraph (b)(2)(ii) of this Q&A-8 are illustrated by the following examples:

Example 1. An employer provides notice to its employees regarding a health plan. Despite the employer's good faith and reasonable efforts to provide timely notice, the notice is 1 week late. The notice complies with all other requirements of section 89(k). Provided that no facts or circumstances suggest otherwise, this is a de minimis failure to comply. The correction occurred when the notice was provided.

Example 2. Despite the employer's good faith and reasonable efforts, an employer fails to give notice to its employees with respect to nonelective coverage under a dental plan that has been added to the employer's health program. The employer has no knowledge (constructive or otherwise) of such failure. Only one employee incurs a covered expense under the dental program and the employee submits a claim to the employer notwithstanding the fact that the employee is not sure whether the claim is covered. If within 90 days of receiving notice of the failure the employer follows the single written document, reimburses the expense, and gives notice relating to such coverage (including the effective date of the dental plan), then the employer has corrected the failure to comply with the notice requirements.

(3) *Correction.* The terms "correct" and "correction" mean, with respect to a de minimis failure to comply, that the employer performs all the necessary acts in order to comply with section 89(k) and places the affected employees in a financial position not worse than that in which they would have been if the employer had been in full compliance with section 89(k). If a subsequent notice is given to correct a de minimis failure, such notice must reflect the original effective date relating to the coverage, benefit or other material term that is the subject of the notice and must indicate that the employer will honor (and the

employer must in fact honor) claims incurred after such effective date (including those prior to the date of such correcting notice). This paragraph (b)(3) is illustrated in the following example:

Example. Despite the good faith and reasonable efforts of the employer, a benefit is denied by a plan administrator in contravention of the written terms of the plan. If at a later date payment is made under the plan and the employer otherwise places the participant in a financial position no worse than if the employer had complied (e.g., by paying the benefit, interest if applicable and any fees incurred in compelling payment), then the failure is a de minimis failure and there has been correction. If the employee cannot be put in the same financial position as if the employer had complied, the failure cannot be corrected and the employer has failed to meet the requirements of section 89(k).

(c) *Determination of the amount of nonexcludable benefit*—(1) *In general*. The amount of a nonexcludable benefit with respect to an employee under a plan that fails to satisfy section 89(k) (including any insurance-type plan) is the value of the benefits (rather than the coverage) either received by the employee under the plan during the plan year or received thereafter but incurred under coverage in effect during the plan year. Thus, the calculation of the amount of the nonexcludable benefit under section 89(k) is based on the plan year of the failed plan and not, as is the case with the determination of excess benefit under section 89(b), on the testing year of the employer. To the extent that the single written document does not reflect a plan year, the determination of the plan year shall be based on paragraph (b) of Q&A-10 of §1.89(a)-1. Nonexcludable benefits under section 89(k) are treated as received by an employee at the time such benefits are actually received or, but for the employee's election to defer the receipt of such benefits, first become available for receipt. In no case, however, will the amount of a nonexcludable benefit with respect to an employee exceed the limit for such employee determined under paragraph (c)(4) of this Q&A-8.

(2) *Definition of plan*—(i) *In general*. The nonexcludable benefits with respect to a plan that fails to satisfy section 89(k) include all benefits received under such plan. Unless the special definition of plan set forth in paragraph (c)(2)(ii) of this Q&A-8 applies, the nonexcludable benefits are those benefits described in the single written document that relates to the failure under section 89(k).

(ii) *Severable coverage*. To the extent that the failure of a plan to satisfy section 89(k) is directly and exclusively related to a specific portion or aspect of coverage provided in a plan, such portion or aspect of the coverage may be treated as a separate plan for purposes of determining the nonexcludable benefits under a plan that fails to satisfy section 89(k). In such a case, the coverage remaining under the single written document after the severance of the coverage providing nonexcludable benefits does not fail to satisfy the requirements of section 89(k) solely by reason of the failure related to the severed coverage. This paragraph (c)(2)(ii) does not permit the severance of coverage of one individual from similar coverage provided to other individuals under the single written document.

(3) *Examples*. The requirements of paragraph (c)(1) and (2) of this Q&A-8 are illustrated by the following examples:

Example 1. An employer maintains a single health plan. During the plan year, the employer allows a claim for a pre-existing condition in direct contravention of a provision in the plan. If the plan is not modified in accordance with paragraph (d)-(2)(iii) of Q&A-3 of this section and if no correction occurs, coverage for that benefit is deemed to constitute a separate plan and the benefit thereunder is nonexcludable. However, unless a pattern or practice indicates that this provision was intended to be a part of the employer's health plan (e.g., by continuous operation in a similar manner), benefits properly paid with respect to the plan are not taxable by reason of the above described failure.

Example 2. An employer fails to notify certain eligible individuals who are not highly compensated employees concerning their eligibility to elect to have coverage under a health plan. Certain of the individuals fail to receive coverage under the plan and incur medical expenses that are not reimbursed due to the fact that the insurance company refuses to retroactively cover these individuals. The plan relating to the notice fails to comply with section 89(k) and all benefits described in the single written document that relates to the failure are nonexcludable to the recipients.

Example 3. A health program contained in a single written document is terminated. The plan provided core coverage and dental care. The portion of the program containing dental coverage recently became effective and the termination with respect to such coverage fails to meet the permanence requirement of section 89(k)(1)(E). The failed coverage under the dental program can reasonably be severed from the balance of the program. Thus, the dental coverage is treated as a separate plan and the benefits that were provided under such plan are nonexcludable. Other benefits provided under the single written document which relates to the failed plan however, are not affected by such failure.

Example 4. A benefit is mistakenly granted to a participant in that the benefit amount exceeds the dollar limitation described in the single written document. Unless the plan is modified in accordance with paragraph (d)(2)(iii) of Q&A-3 of this section, the operation of the plan in a manner inconsistent with the single written document violates the writing requirement of section 89(k). The amount of the benefit in excess of the dollar limitation may be treated as severable coverage and thus be nonexcludable without adverse impact upon the balance of the program.

Example 5. An employer maintains a core health plan. A participant incurs an expense that is determined by the plan administrator to be incurred for a benefit not covered by the plan. The benefit is denied by the plan administrator in contravention of the terms of the plan. Coverage for such benefit is actually available under the terms of the insurance contract that describes medical benefits and coverage. However, if the employer is not able to correct the failure on a timely basis, all benefits described in the single written document that relates to the failure are nonexcludable because the coverage involved is not reasonably severable from the general core coverage under the plan.

Example 6. A notice sent to participants fails to satisfy section 89(k). The notice contains a modification of a material term relating to cosmetic surgical procedures coverage. If the failure is not corrected, benefits received under the coverage of the type described in the notice are nonexcludable.

Example 7. A notice is sent to employee participants failing to disclose a material term of the plan. The material term does not relate to a particular coverage or benefit, but rather applies to all benefits under the plan. All benefits provided under the single written document related to the notice are nonexcludable unless such failure is corrected on a timely basis.

(4) *Limit on nonexcludable amount*. Notwithstanding any other provision of this Q&A-8, the amount of the employer-provided portion (see paragraph (d)(2) of this Q&A-8) of the nonexcludable benefits received by an employee (and the employee's spouse and dependents) during a taxable year of the employee under one or more accident and health plans that fail to satisfy section 89(k) (but do not fail to be accident or health plans under section 105 and 106) shall not exceed the sum of the following 4 amounts: 10 percent of the employee's compensation (before inclusion of the employer-provided benefit) from the employer maintaining the plan for the employee's taxable year, up to and including the dollar amount in effect for such year under section 414(q)(1)(C); 25 percent of the employee's compensation in excess of such dollar amount up to and including 200 percent of such dollar amount; 75 percent of the employee's compensation in excess of 200 percent of such dollar amount up to and including 300 percent of such dollar amount; and 100 percent of the employee's compensation in excess of 300 percent of such dollar amount. The limitation under this paragraph (c)(4) is applied after the determination of the employer-provided portion of the nonexcludable benefits described in paragraph (d)(2) of this Q&A-8, but before the coordination of nonexcludable benefits with excess benefits as described in paragraph (e) of this Q&A-8. Compensation of an employee as used in this paragraph (c)(4) is compensation as determined under section 414(q)(7) and with respect to the taxable

year of the employee in which the nonexcludable benefit is received. Thus, for example, if an employee with compensation from the employer of $25,000 for a calendar year also receives $20,000 in employer-provided benefits under a health plan that fails to satisfy section 89(k), the maximum amount of nonexcludable benefit for such employee for such year is $2,500 (i.e., 10 percent of $25,000). The remaining $17,500 in benefits under the plan that failed to satisfy section 89(k) may be excludable from gross income under section 105. Finally, this paragraph (c)(4) does not apply if, in addition to failing one or more of the requirements of section 89(k), a plan also fails to be an accident or health plan under sections 106 and 105.

(d) *Allocation between employer and employee contributions*—(1) *In general.* Section 89(k) generally eliminates the otherwise available exclusions only with regard to benefits attributable to the employer-provided portion of the benefits received. Thus, for example, if a portion of the coverage provided under a plan is attributable to after-tax employee contributions, an allocation of the benefits under such plan must be made on the basis of the relative cost to the employer and the employee for the plan. Allocation is permitted, however, only to the extent that a nonexcludable benefit is directly related to the portion of the coverage under the plan that is attributable to employee contributions.

(2) *Accident or health plans.* If coverage provided under an accident or health plan is partially attributable to after-tax employee contributions, an allocation of the benefits under such plan is made in accordance with a method set forth in paragraphs (c), (d) or (e) of § 1.105-1 and the method permitted to determine the applicable premium for a group health plan under section 4980B(f)(4) to determine the cost of a health plan. For purposes of this paragraph, coverage that is taxable by reason of being considered an excess benefit (as defined in section 89(b)) is not considered to be attributable to employee contributions to the plan. See paragraph (e) of this Q&A-8 for rules regarding coordination of sanctions.

(3) *Group-term life insurance plans.* The portion of coverage under a plan to which section 79 applies that is attributable to employee contributions must be computed in the manner set forth in § 1.79-3(e). In addition, the rule of paragraph (d)(1) of this Q&A-8 does not apply to certain benefits received under a group-term life insurance program subject to section 79. Thus, while the table value of coverage over $50,000 is taxable without regard to section 89, such coverage is not attributable to employee contributions for purposes of the rule in this paragraph (d). Similarly, coverage that is taxable by reason of being considered excess benefit (as defined in section 89(b)) is not considered to be attributable to employee contributions to the plan. See paragraph (e) of this Q&A-8 for rules regarding coordination of sanctions.

(4) *Example.* The following example illustrates the rule contained in this paragraph (d):

Example. Employer A maintains a plan under which it pays two-thirds of the annual premium cost on individual policies of accident and health insurance for its employees. The remainder of each employee's premium is paid through after-tax payroll deduction from the wages of the employee. The annual cost of coverage determined by the method permitted to determine the applicable premium (as defined in section 4980B(f)(4) for plans to which that section applies) for Employee X is $240, of which $160 is paid by the employer. Thus, two-thirds (160/240) of all amounts received by Employee X under such insurance policy are attributable to the contributions of the employer and are nonexcludable if the plan fails to meet the requirements of section 89(k).

(e) *Coordination rules*—(1) *Relationship between statutory employee benefit plans that fail to meet the section 89(k) requirements and nondiscrimination tests.* The employer-provided benefit (as defined in §1.89(a)-1 for purposes of the section 89 nondiscrimination tests) with respect to a statutory employee benefit plan must be taken into account for purposes of nondiscrimination testing under section 89 even though the plan has failed the requirements of section 89(k). That is, unless the coverage under a statutory employee benefit plan is purchased by the employee with after-tax employee contributions (or is treated as having been purchased with after-tax employee contributions), the coverage is subject to section 89 nondiscrimination testing. For the purposes of this paragraph (e), coverage that is taxable by reason of being an excess benefit under section 89(b) is not treated as purchased with after-tax employee contributions. Thus, employer-provided benefits (as defined in paragraph (b) of Q&A-1 of this section) that are attributable to such excess benefits are nonexcludable benefits if the plan also fails section 89(k). Also, a groupterm life insurance plan subject to section 79 must be considered for purposes of section 89 without regard to the fact that the cost of coverage is currently taxable to the extent provided in section 79 (those amounts in excess of $50,000) or by reason of being considered excess benefit under section 89(b).

(2) *Coordination of sanctions where there is a failure of section 89(k) related to discriminatory coverage*—(i) *In general.* If an individual has a nonexcludable benefit by reason of section 89(k), the treatment of that benefit and the related excess benefit under section 89(b) are coordinated by limiting the taxable amount of any employee to the greater of either the nonexcludable benefit or the excess benefit.

(ii) *Nonexcludable benefit must be related to discriminatory coverage.* Coordination of sanctions with respect to a nonexcludable benefit under section 89(k) and a discriminatory excess benefit under section 89(b) is available only when the nonexcludable benefit under section 89(k) is related to the excess benefit that is taxable by reason of its being contained in a discriminatory employee benefit plan under section 89(c). For this purpose, a plan means any specific option under the health program. The determination of relatedness is made on the basis of all of the facts and circumstances. Generally, if an employee is treated as having received an excess benefit under section 89(b) and the excess benefit relates to a failure to meet the requirements of paragraph (d)(2) (the 90 percent/50 percent eligibility test) or (d)-(4) (the 75 percent benefits test) of Q&A-1 of §1.89(a)-1, there is a presumption that such excess benefit does employlate to a plan (or portion thereof) that fails section 89(k). Thus, for example, an employee who receives employer-provided coverage with a value of $2,500 under an indemnity plan and employer-provided coverage with a value of $750 under a dental plan and who is treated as receiving an excess benefit of $1,000 under section 89(b) because these health plans fail to meet the requirements of the 75 percent benefits test or the 90 percent/50 percent eligibility test, and a nonexcludable benefit of $600 because the dental plan fails section 89(k), the entire $1,000 excess benefit is treated as attributable to the indemnity plan and the total includible amount would be $1,600 ($1,000 plus $600). If the employee received an excess benefit of $3,000 under section 89(b), then $500 of such excess benefit would be allocated to the dental plan and the total includible amount would be $3,100. If the dental plan failed the 50 percent eligibility test, then $750 of the excess benefit or the higher of the excess benefit if less than $750 of the excess benefit related to the dental plan under Q&A-9 of §1.89(a)-1) or the $600 nonexcludable benefit would be includible in the employee's gross income.

(iii) *Coordination where nonexcludable benefit received in taxable year other than the taxable year in which testing year ends.* If a nonexcludable benefit under section 89(k) is received in a taxable year of the employee other than that taxable year in which ends the testing year for which there is a related excess benefit under section 89(b) (including any additional time permitted by reason of an election under section 89(a)(2)(B)) and if the benefits otherwise qualify for the coordination described in this paragraph (e), the rules of this paragraph (e)-(2)(iii) apply. If the testing year ends in a later taxable year of the employee than the taxable year in which the nonexcludable benefit is received, the amount of the excess benefit that is included in gross income for the later taxable year is reduced (but not below zero) by the amount of nonexcludable benefit included in gross income for the earlier taxable year. Similarly, where the nonexcludable benefit is received in a later taxable year of the employee than the taxable year in which the testing year ends, the amount of the nonexcludable benefit included in gross income for the later year is reduced (but not below zero) by the amount of the excess benefit included for the earlier taxable year to which the nonexcludable benefit relates.

(iv) *Examples.* The provisions of this paragraph (e)(2) are illustrated by the following examples:

Example 1. Assume that an employer's testing year under section 89(a) is the calendar year. Plan A has a plan year beginning on July 1 and has an employer-provided benefit, based on its annual applicable premium, of $2,000. Employee X receives a reimbursement under Plan A on July 10 in the amount of $500. Assume that Plan A fails section 89(k). Assume further that Employee X has received $1,000 in excess benefit for the testing year, all of which relates to the total value of coverage under Plan A. For this calendar year, Employee X must include in gross income $1,000.

Example 2. Assume the same facts as in Example 1, except that the $500 reimbursement is $1,500. Employee X must include in income $1,500.

Example 3. Assume that an employer's testing year begins on July 1. Plan A has an applicable premium of $2,000 and its plan year is the 1991 calendar year. Employee X receives a reimbursement of $500 under Plan A on July 10, 1991. Assume that Plan A fails section 89(k). The employer determines that Employee X has $2,000 in excess benefit in the testing year that begins July 1, 1991, related to Plan A. For 1991, Employee X must include $500 in gross income. However, for 1992, Employee X may use that $500 as an offset against the amount of excess benefit related to the coverage under which the benefit was granted. Thus, Employee X is only required to include $1,500 in gross income for 1992 ($2,000 $500).

Example 4. Assume the same facts as Example 3, except that Employee X received the reimbursement on June 10, 1991. Unless other facts indicate otherwise, no offset is available since the reimbursement did not relate to excess benefit calculated with regard to the 1991 testing year.

(f) *Authority to limit nonexcludable benefits.* The Commissioner, in revenue rulings, notices and other publications of general applicability, may limit the nonexcludable benefit that would otherwise be determined under section 89(k) and this proposed regulation to the extent the facts and circumstances indicate that the elimination of the otherwise available exclusions from gross income would be inconsistent with the purposes underlying the requirements of section 89(k). Among the facts and circumstances to be taken into account are the relationship between the plan's failure under section 89(k) and the employee's receipt of benefits under such plan, the extent to which the plan's failure was attributable to a reckless or intentional disregard of the requirements of section 89(k), and whether the imposition of the full sanction under section 89(k) would impose a hardship on the employee that is not justified by the nature and degree of the plan's failure.

Par. 3. Proposed §1.125-1 as published in the Federal Register on May 7, 1984 (49 FR 19321), and amended on December 31, 1984 (49 FR 50733) [1985-1 C.B. 603], is amended by adding a new Q&A-30 at the end, to read as follows:

§1.125-1 Questions and Answers relating to cafeteria plans. * * * * *

Q-30: Are there additional rules for cafeteria plans?

A-30: Yes. Additional rules for cafeteria plans are contained in §1.125-2 and take effect as set forth in Q&A-1 of §1.125-2. To the extent that §1.125-2 and this §1.125-1 are inconsistent, §1.125-2 supersedes this §1.125-1.

Par. 4. New §1.125-2 is added to read as follows: §1.125-2 Miscellaneous Cafeteria Plan Questions and Answers

The following is a list of the questions addressed in this section.

Q-1: What are the effective dates of these cafeteria plan rules?

Q-2: What does section 125 of the Code provide?

Q-3: What is a cafeteria plan under section 125?

Q-4: What benefits constitute qualified benefits and what benefits constitute cash under a cafeteria plan?

Q-5: May a cafeteria plan include a benefit that defers the receipt of compensation?

Q-6: In what circumstances may participants revoke existing elections and make new elections under a cafeteria plan?

Q-7: How do the rules governing the tax-favored treatment of employer-provided benefits apply to plans that are flexible spending arrangements?

Q-1: What are the effective dates of these cafeteria plan rules?

A-1: Q&A-1 through Q&A-6 of this §1.125-2 apply to plan years of cafeteria plans as set forth in Q&A-10 of §1.89(a)-1 (regarding the effective date of section 89). Q&A-7 of this §1.125-2 (relating to flexible spending arrangements) applies to plan years beginning after December 31, 1989.

Q-2: What does section 125 of the Code provide?

A-2: In general, an employee who has an election among nontaxable benefits and taxable benefits (including cash) must include in gross income any taxable benefits that the employee could have actually received pursuant to the employee's election. The amount of these benefits is included in the employee's income in the year in which the employee would have actually received the taxable benefits if the employee had elected such benefits. This generally is the result even if the employee's election between the nontaxable benefits and taxable benefits is made prior to the year in which the employee would have actually received the taxable benefits. However, section 125 provides that cash (including certain taxable benefits) provided under a nondiscriminatory cafeteria plan will not be included in a participant's gross income merely because the participant has the opportunity, before the cash becomes currently available to the participant, to choose among cash and the nontaxable benefits under the cafeteria plan.

Q-3: What is a cafeteria plan under section 125?

A-3: A cafeteria plan is a plan maintained by an employer for the benefit of its employees that satisfies the requirements of section 89(k), under which all participants are employees, and under which each participant has the opportunity to choose among cash and qualified benefits. Additionally, a cafeteria plan satisfies the written plan document requirement of clause (v) of Q&A-3 of §1.125-1 only if the plan describes the maximum amount of elective contributions available to any employee under the plan either by stating the maximum dollar amount or maximum percentage of compensation that may be contributed as elective contributions under the plan by employees or by stating the method for determining the maximum amount or percentage of elective contributions that employees may make under the plan. The meaning of "elective contributions" under a cafeteria plan is the same as the meaning of "salary reduction contributions" under a cafeteria plan. See also paragraph (a)(2) of Q&A-8 of §1.89(a)-1.

Q-4: What benefits constitute qualified benefits and what benefits constitute cash under a cafeteria plan?

A-4: (a) *Qualified benefits*—(1) *In general.* A benefit is a qualified benefit under a cafeteria plan if the benefit does not defer the receipt of compensation and the benefit is not includible in an employee's gross income by reason of an express provision of Chapter 1 of the Code. In the case of insurance-type benefits, such as benefits provided under accident or health plans (sections 106 and 105) and group-term life insurance plans (section 79), the benefit is the coverage under the plan.

(2) *Items that constitute qualified benefits*—(i) *Accident or health plans.* Coverage under an accident or health plan is a qualified benefit to the extent that such coverage is excludable from income under section 106. Thus, for example, coverage under a long-term disability plan and coverage under an accidental death and dismemberment policy may be qualified benefits.

(ii) *Group-term life insurance.* Group-term life insurance coverage that is excludable from gross income under section 79 and group-term life insurance coverage that is includible in gross income solely because the death benefit payable thereunder is in excess of the dollar limit of section 79 are qualified benefits.

(iii) *Certain discriminatory benefits.* Accident or health plan coverage, group-term life insurance coverage, and benefits under a dependent care assistance employm do not fail to be qualified benefits under a cafeteria plan merely because they are includible in gross income solely because of section 89 or any other applicable nondiscrimination requirement (e.g., section 129(d)).

(iv) *Certain dependent care assistance benefits.* Benefits under a dependent care assistance program that would have been excludable from gross income under section 129 but for the elimination of overnight camp expenses from dependent care assistance under such section (effective January 1, 1988) or the reduction of the age limit on children qualifying as dependents under such section (effective January 1, 1989) do not fail to be qualified benefits merely because such changes in law cause such benefits to be taxable. However, the preceding sentence applies only if the benefits are provided under a program that otherwise qualifies as a dependent care assistance program under section 129, are taxable to the employee upon receipt, and are provided by the December 31 next following the effective date of the applicable change in law. After such date, such benefits will not constitute qualified benefits but may be treated as cash pursuant to paragraph (b) of this Q&A-4.

(b) *Currently taxable benefits treated as cash.* In general, a benefit is treated as cash if such benefit does not defer the receipt of compensation and an employee who receives such benefit purchases such benefit with after-tax employee contributions or is treated, for all purposes under the Code (including, for example, reporting and withholding purposes), as receiving, at the time that such benefit is received, cash compensation equal to the full value of such benefit at such time and then purchasing such benefit with after-tax employee contributions. Thus, for example, long-term disability coverage is treated as cash if the cafeteria plan provides that an employee may purchase the coverage under the plan with after-tax employee contributions, or provides that the employee receiving such coverage is treated as having received cash compensation equal to the value of the coverage and then as having purchased the coverage with after-tax employee contributions. Any taxable benefit that is not described in paragraph (a) of this Q&A-4 and is not treated as cash under this paragraph (b) may not be included in a cafeteria plan.

(c) *Qualified cash or deferred arrangements.* Elective contributions to a qualified cash or deferred arrangement (section 401(k)) are permitted under a cafeteria plan. In addition, after-tax employee contributions under a qualified plan subject to section 401(m) are permitted under a cafeteria plan. The right to make such contributions will not cause a plan to fail to be a cafeteria plan merely because, under the qualified plan, employer matching contributions are made with respect to elective or after-tax employee contributions.

(d) *Benefits that do not constitute qualified benefits or cash.* Benefits of the type described in section 117 or 132 do not constitute qualified benefits or cash and thus may not be included in a cafeteria plan regardless of whether any such benefit is purchased with after-tax employee contributions or on any other basis. Thus, for example, health diagnostic or examination plans are qualified benefits under a cafeteria plan because such plans are accident or health plans that are eligible for the exclusion under section 106 and are not, in any case, eligible for the exclusion under section 132.

Q-5: May a cafeteria plan include a benefit that defers the receipt of compensation?

A-5: (a) *In general.* A cafeteria plan may not include any plan that offers a benefit that defers the receipt of compensation. In addition, a cafeteria plan may not operate in a manner that enables employees to defer compensation. For example, a plan that permits employees to carry over unused elective contributions or plan benefits (e.g., accident or health plan coverage) from one plan year to another operates to defer compensation. This is the case regardless of how the contributions or benefits are used by the employee in the subsequent plan year (e.g., whether they are automatically or electively converted into another taxable or nontaxable benefit in the subsequent plan year or used to provide additional benefits of the same type). Similarly, a cafeteria plan operates to permit the deferral of compensation if the plan permits participants to use contributions for one plan year to purchase a benefit that will be provided in a subsequent plan year (e.g., life, health, disability, or long-term care insurance coverage with a savings or investment feature, such as whole life insurance). For example, a cafeteria plan operates to permit the deferral of compensation if the cafeteria plan includes a health plan that is a flexible spending arrangement (as defined in Q&A-7 of this section) and such health plan may reimburse participants' premium payments for other accident or employ coverage extending beyond the end of the plan year. See Q&A-7 of this section for the treatment of experience gains under a health plan that is a flexible spending arrangement.

(b) *Exceptions.* A plan does not fail to be a cafeteria plan merely because the plan permits participants to make elective contributions under a qualified cash or deferred arrangement under section 401(k) or permits participants employed by certain educational institutions to purchase retiree group-term life insurance. Similarly, a cafeteria plan does not include a benefit that defers the receipt of compensation merely because the cafeteria plan provides the opportunity to make after-tax employee contributions subject to section 401(m) under a qualified plan. In addition, a cafeteria plan will not be treated as including a benefit that defers the receipt of compensation merely because, under the qualified plan, employer matching contributions (as defined in section 401(m)-(4)(A)) are made with respect to such elective contributions or after-tax employee contributions. Finally, reasonable premium rebates or policy dividends paid with respect to benefits provided under a cafeteria plan do not constitute impermissible deferred compensation if such rebates or dividends are paid before the close of the 12-month period immediately following the plan year to which such rebates and dividends relate.

(c) *Treatment of paid vacation days under a cafeteria plan*—(1) *In general.* A cafeteria plan may include elective, paid vacation days by permitting participants to receive either additional or fewer paid vacation days than the employer otherwise provides to the employees on a nonelective basis, if the inclusion of elective vacation days under the plan does not operate to permit the deferral of compensation.

(2) *Ordering of elective and nonelective vacation days.* In determining whether a plan that provides for paid vacation days operates to permit the deferral of compensation, and thus fails to be a cafeteria plan, a participant is deemed to use nonelective vacation days (i.e., the vacation days with respect to which the employee had no election) before elective vacation days.

(3) *Cashing out unused elective vacation days.* A plan does not operate to permit the deferral of compensation merely because the plan permits a participant who has not used all elective, paid vacation days for a plan year to receive in cash the value of such unused days in exchange for such days if the participant receives the cash on or before the earlier of the last day of the plan year of the cafeteria plan or the last day of the employee's taxable year to which the elective contributions used to purchase the unused days relate.

(4) *Examples.* The following examples illustrate the rules of this paragraph (c):

Example 1. Assume that an employer provides an employee with 2 weeks of paid vacation for each calendar year and maintains a calendar year cafeteria plan that permits the employee to "purchase," with elective contributions, an additional week of paid vacation. Assume further that Employee A, with a calendar tax year, purchases 1 additional week of vacation. If Employee A uses only 2 weeks of vacation during the year, the employee is treated as having used the 2 nonelective weeks and as having retained the 1 elective week. If the 1 remaining week (i.e., the elective week) may be carried over to the next year (or the value thereof used for any other purpose in the next year), the plan operates to permit the deferral of compensation and thus is not a cafeteria plan. However, the cafeteria plan may permit the employee to receive the value of the unused elective vacation week in cash before the end of the applicable calendar year.

Example 2. The facts are the same as set forth in Example 1, except that Employee A uses only 1 week of vacation during the year. Thus, Employee A is treated as having used 1 nonelective week and as having retained 1 nonelective week as well as 1 elective week of vacation. Because the nonelective vacation days are not part of the cafeteria plan (i.e., the employer or plan does not permit participants to exchange regular vacation days for other benefits), Employee A may be permitted to carry over the 1 nonelective week of vacation to the next year. In addition, under the terms of the cafeteria plan, Employee A must either forfeit the remaining elective vacation week or receive in cash the value of such unused days before the end of the applicable calendar year.

Q-6: In what circumstances may participants revoke existing elections and make new elections under a cafeteria plan?

A-6: (a) *In general.* A plan is not a cafeteria plan unless the plan requires that participants make elections among the benefits offered under the plan. In general, an election will not be deemed to have been made if, after a participant has elected and begun to receive a benefit under the plan, the participant is permitted to revoke the election during the period of coverage under the plan, even if the revocation relates only to the remaining portion of the coverage period with respect to the benefit and even if the revocation is in response to a change in the tax treatment of such benefit. However, in the circumstances specified in paragraphs (b) through (g) of this Q&A-6, notwithstanding Q&A-8 of §1.125-1, the terms of a cafeteria plan may permit a participant to revoke an existing election and, in some cases, to make a new election with respect to the remaining portion of the period of coverage. If a new election is permitted under this Q&A-6, then such new election must be consistent with the reason that such change was permitted. In addition, a cafeteria plan may permit an election change to the extent required under paragraph (c)(6) of Q&A-3 of §1.89(a)-1. Such election changes will not cause taxable benefits offered under the cafeteria plan to be treated as currently available to employees. See Q&A-7 of this section for certain additional limits on election changes that relate to certain flexible spending arrangements.

(b) *Significant cost or coverage changes*—(1) *Cost changes.* If the cost of a health plan provided by an independent, third- party provider under a cafeteria plan increases or decreases during a plan year and under the terms of the cafeteria plan, employees are required to make a corresponding change in their premium payments, the cafeteria plan may, on a reasonable and consistent basis, automatically increase or decrease, as the case may be, all affected participants' elective contributions or after-tax employee contributions for such health plan. Alternatively, if the premium amount significantly increases, a cafeteria plan may permit participants either to make a corresponding change in their premium payments or to revoke their elections and, in lieu thereof, to receive on a prospective basis, coverage under another health plan with similar coverage. No elective adjustments of participants' contributions or revocations of participants' elections other than those provided for in the preceding sentence may be permitted under a cafeteria plan on account of changes in the cost of a health plan.

(2) *Coverage changes.* If the coverage under a health plan provided by an independent, third-party provider is signifiemploy curtailed or ceases during a period of coverage, a cafeteria plan may permit all affected participants to revoke their elections of the health plan and, in lieu thereof, to receive on a prospective basis coverage under another health plan with similar coverage.

(c) *Certain changes in family status.* 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 (d), 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. Election changes are also permitted where there has been a significant change in the health coverage of the employee or spouse attributable to the spouse's employment. 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.

(d) *Separation from service.* 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 of the coverage period. However, in such case, 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.

(e) *Cessation of required contributions.* A cafeteria plan may provide that a benefit will cease to be provided to an employee if the employee fails to make the required premium payments with respect to the benefit (e.g., employee ceases to make premium payments for health plan coverage after a separation from service). However, in such case, the plan must prohibit the employee from making a new benefit election for the remaining portion of the period of coverage.

(f) *Elective contributions under a qualified cash or deferred arrangement.* A cafeteria plan may permit a participant who has elected to make elective contributions under a qualified cash or deferred arrangement (within the meaning of section 401(k)) to modify or revoke the election as permitted under section 401(k). Similarly, a cafeteria plan may permit a participant who has elected to make after-tax employee contributions subject to section 401(m) to modify or revoke the election as permitted under section 401(m). Thus, for example, a cafeteria plan may include a benefit option providing for elective contributions under a qualified cash or deferred arrangement which requires that, as a condition of a hardship distribution, the employee receiving the distribution cease making elective contributions under the arrangement for a specified period.

Q-7: How do the rules governing the tax-favored treatment of employer-provided benefits apply to plans that are flexible spending arrangements?

A-7: (a) *In general.* Health plans that are flexible spending arrangements as defined in paragraph (c) of this Q&A-7 (health FSAs) must conform to the generally applicable rules under sections 105 and 106 in order for the coverage and reimbursements under such plans to qualify for tax-favored treatment under such sections. Thus, health FSAs must qualify as accident or health plans. This means that, in general, while the health coverage under the FSA need not be provided through a commercial insurance contract, health FSAs must exhibit the risk-shifting and risk-distribution characteristics of insurance. Similarly, reimbursements under health FSAs must be paid specifically to reimburse the participant for medical expenses incurred previously during the period of coverage. employrmore, a health FSA cannot operate under a cafeteria plan in a manner that enables participants to receive coverage only for periods for which the participants expect to incur medical expenses if such periods constitute less than a plan year. A reimbursement is not paid specifically to reimburse the participant for medical expenses if the participant is entitled to these amounts, in the form of cash or any other taxable or nontaxable benefit (including health coverage for an additional period), without regard to whether or not the employee incurs medical expenses during the period of coverage. A health FSA will not qualify for tax-favored treatment under sections 105 and 106 of the Code if the effect of the reimbursement arrangement eliminates all, or substantially all, risk of loss to the employer maintaining the plan or other insurer. These rules apply with respect to a health plan without regard to whether the plan is provided through a cafeteria plan. See Q&A-17 of §1.125-1.

(b) *Special requirements*—(1) *In general.* A health FSA must satisfy the requirements set forth in this paragraph (b) in order for the employer-provided health coverage provided through the health FSA to qualify for the exclusion from income under section 106 and for the reimbursements and other benefits pursuant to the health FSA coverage to qualify for the exclusion from income under section 105.

(2) *Uniform coverage throughout coverage period.* The maximum amount of reimbursement under a health FSA must be available at all times during the period of coverage (properly reduced as of any particular time for prior reimbursements for the same period of coverage). Thus, the maximum amount of reimbursement at any particular time during the period of coverage cannot relate to the extent to which the participant has paid the required premiums for coverage under the health FSA for the coverage period. Similarly, the payment schedule for the required premiums for coverage under a health FSA may not be based on the rate or amount of covered claims incurred during the coverage period. Reimbursement will be deemed to be available at all times if it is paid at least monthly or when the total amount of the claims to be submitted is at least a specified, reasonable minimum amount (e.g., $50). If the employee revokes existing elections, the employer must reimburse the employee for any amount previously paid for coverage or benefits relating to the period after the date of the employee's separation from service regardless of the employee's claims or reimbursements as of such date. The following examples illustrate the rules of this paragraph (b)(2):

Example 1. Assume that an employee elects coverage under a health FSA providing coverage of up to $300 in medical expenses and the annual premium for a calendar year of coverage is $300. Assume also that the employee is permitted to pay the $300 premium through salary reduction of $25 per month throughout the coverage period. The employee must be eligible to receive the maximum amount of reimbursement of $300 at all times throughout the coverage period (reduced by prior reimbursements). Thus, if the employee incurs $250 of medical expenses in January, the full $250 must be available for reimbursement even though the employee has made only one premium payment. If the employee incurs another $50 in health expenses in February, the remaining $50 of the $300 maximum must be available for reimbursement. The employer or plan may not provide for an acceleration of the required premium payments based on the employee's incurred claims and reimbursements.

Example 2. Assume that an employee elects coverage under a health FSA with a maximum reimbursement limit of $500 for a calendar year of coverage and is required to pay the $450 premium for such coverage in two equal $225 installments, one at the beginning of the period of coverage and the second installment by the beginning of the sixth month of coverage. Assume further that the employee incurs a $400 medical expense in February and the FSA makes a $400 reimbursement to the employee in March. The employee does not incur any additional medical expenses before the end of June, at which time the employee separates from service. If the employee fails to make the second premium installment, the employee's coverage under the FSA may be terminated as of the end of June so that medical expenses incurred after June are not covered. If the employee pays the second premium installment, the employee's coverage under the FSA must continue, so that additional medical expenses (up to the remaining $100) incurred before the end of December are covered.

(3) *Twelve-month period of coverage.* The period of coverage under a health FSA must be 12 months or, in the case of a short first plan year or a short plan year of a cafeteria plan where the plan year is being changed, the entire short plan year. Election changes to increase or decrease the level of coverage under a health FSA during the 12-month period of coverage are not permitted with respect to health FSAs. However, a cafeteria plan may permit participants to make health FSA election changes for the remaining portion of the 12-month period of coverage on account of and consistent with certain family status changes. See Q&A-6 of this section. In addition, a cafeteria plan may provide that the period of coverage under a health FSA terminates if the employee ceases to make required premium payments; however, such employee may not be permitted to make a new health FSA benefit election for the remaining portion of the original coverage period. Also, 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 receipt of benefits, including coverage under the health FSA. For the application of the health care continuation rules of section 4980B of the Code to health FSAs, see the regulations under section 4980B or its predecessor section 162(k) of the Code. The requirements of this paragraph (b)(3) are illustrated by the following example:

Example. Assume that an employee has elected a $300 calendar year health FSA, with monthly premium payments of $25 during the 12-month period of coverage. Such employee separates from service for the employer at the end of June and ceases to make additional premium payments. The cafeteria plan may provide that the FSA's period of coverage does not extend beyond June if the employee does not continue to make the required premium payments. However, if the employee makes the total premium payment for the 12-month period of coverage, the cafeteria plan may not terminate the FSA's period of coverage merely because the employee separated from service before the end of the coverage period.

(4) *Prohibited reimbursement.* A health FSA can only reimburse medical expenses as defined in section 213. Thus, for example, a health FSA cannot reimburse dependent care expenses. In addition, a health FSA may not treat participants' premium payments for other health coverage as reimbursable expenses. Thus, for example, a health FSA may not reimburse participants for premiums paid for other health plan coverage, including premiums paid for health coverage under a plan maintained by the employer of the employee's spouse or dependent. (See also Q&A-5 of this section with respect to whether the reimbursement of other premiums constitutes impermissible deferred compensation.) This paragraph (b)(4) does not prevent premiums for current health plan coverage (including coverage under a health FSA) from being paid on a salary reduction basis through the ordinary operation of the cafeteria plan.

(5) *Claims substantiation.* A health FSA may reimburse a medical expense only if the participant provides a written statement from an independent third party stating that the medical expense has been incurred and the amount of such expense and the participant provides a written statement that the medical expense has not been reimbursed or is not reimbursable under, any other health plan coverage. Thus, for example, as with any other flexible spending arrangement, a health FSA cannot make advance reimbursements of future or projected expenses. In determining whether, under all the facts and circumstances, employees are being reimbursed for inadequately substantiated claims, special scrutiny will be given to other arrangements such as employer-to-employee loans that are related to the employee premium payments or actual or projected employee claims.

(6) *Claims incurred.* Medical expenses reimbursed under a health FSA must be incurred during the participant's period of coverage under the FSA. Expenses are treated as having been incurred when the participant is provided with the medical care that gives rise to the medical expenses, and not when the participant is formally billed or charged for, or pays for the medical care. Also, expenses are not treated as incurred during a period of FSA coverage if such expenses are incurred before the later of the date the health FSA is first in existence or the participant first becomes enrolled under the health FSA.

(7) *FSA experience gains.* If a health FSA has an experience gain with respect to a year of coverage, the excess of the premiums paid (e.g., employer contributions, including salary reduction contributions and after-tax employee contributions) and income (if any) of the FSA over the FSA's total claims reimbursements and reasonable administrative costs for the year may be used to reduce required premiums for the following year or may be returned to the premium payers (the participants for premiums paid by salary reduction or employee contributions) as dividends or premium refunds. Such experience gains must be allocated among premium payers on a reasonable and uniform basis. It is permissible to allocate such amounts based on the different coverage levels under the FSA received by the premium payers. However, in no case may the experience gains be allocated among premium payers based (directly or indirectly) on their individual claims experience. The requirements of this paragraph (b)(7) are illustrated in the following example:

Example. Assume that an employer maintains a cafeteria plan under which its 1,200 employees may elect one of several different annual coverage levels under a health FSA in $100 increments from $500 to $2,000. For a plan year, 1,000 employees elect levels of coverage under the health FSA. For such year, the FSA has an experience gain of $5,000 (i.e., premium payments for the year exceed reimbursed claims plus administrative costs by $5,000). The $5,000 may be allocated to all premium payers for the year, as a premium refund, on a per capita basis weighted to reflect the participants' elected levels of coverage. Alternatively, the $5,000 may be used to reduce the required premiums under the health FSA for all eligible employees for the next plan year (e.g., a $500 health FSA for the next year might be priced at $480) or to reimburse claims incurred above the elective limit in such year as long as such reimbursements are made in a nondiscriminatory manner.

(8) *Dependent care assistance.* Analogous rules to this paragraph (b), with the exception of paragraph (b)(2) relating to uniform coverage throughout the coverage period, are applicable to dependent care assistance provided under section 129. See Q&A-18 of §1.125-1.

(c) *Definition of flexible spending arrangement.* A flexible spending arrangement (FSA) generally is a benefit program that provides employees with coverage under which specified, incurred expenses may be reimbursed (subject to reimbursement maximums and any other reasonable conditions) and under which the maximum amount of reimbursement that is reasonably available to a participant for a period of coverage is not substantially in excess of the total premium (including both employee-paid and employer-paid portions of the premium) for such participant's coverage. A maximum amount of reimbursement is not substantially in excess of the total premium if such maximum amount is less than 500 percent of the premium. A single FSA may provide participants with different levels of coverage and maximum amounts of reimbursement. However, for purposes of section 89, each different level of coverage under a FSA is a separate plan.

(d) *Effective date*. This Q&A-7 is effective for plan years beginning after December 31, 1989.

(e) *Authority to issue additional requirements*. The Commissioner, in revenue rulings, notices and other publications of general applicability, may make any modification to, or issue such additional requirements for the application of, the rules contained in this Q&A-7 as may be necessary to insure proper compliance with the intent of such rules.

(f) *Example*. The provisions of paragraph (c) of this Q&A-7 are illustrated by the following example:

Example 1. Assume that an employer with 1,000 employees maintains a cafeteria plan under which the employees may elect among several benefit options, including insured health plans and HMOs. The plan provides that the required premiums or contributions for the benefits are to be made by salary reduction. Even though the plan may characterize employees' premium payments and other contributions as flexible spending contributions or credits, the operation of a cafeteria plan to permit employees' contributions to be made on a salary reduction basis does not, standing alone, cause the plan (or any benefit thereunder) to be treated as a flexible spending arrangement.

Example 2. Assume that an employer with 1,000 employees maintains a cafeteria plan under which the employees may elect, among other benefits, a level of coverage under an arrangement that will reimburse medical expenses incurred during a year up to the specified amount elected by the employee. The maximum amount of reimbursement that can be deducted for a year is $5,000. Each employee's premium for such coverage is equal to the maximum reimbursement amount selected by the employee. Such an arrangement is a health FSA.

Lawrence B. Gibbs,
Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on March 2, 1989, 8:45 a.m., and published in the issue of the Federal Register for March 7, 1989, 54 F.R. 9460)

Notice of Proposed Rulemaking

Minimum Participation

EE-44-87

AGENCY: Internal Revenue Service, Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations relating to minimum participation standards under section 401(a)(26) of the Internal Revenue Code of 1986. They reflect changes made by section 1112(b) and (e) of the Tax Reform Act of 1986 [Pub. L. 99-514, 1986-3 (Vol. 1) C.B. 361]. These regulations will provide the public with guidance on the minimum participation standards and will affect sponsors of, and participants in, qualified pension, profit-sharing and stock bonus plans.

DATES: Written comments and requests for a public hearing must be delivered or mailed by April 17,1989. The proposed amendments generally apply to plan years beginning after December 31, 1988, except as otherwise specified in the Tax Reform Act of 1986.

ADDRESS: Send comments and requests for a public hearing to: Commissioner of Internal Revenue, Attention: CC:LR:T (EE-44-87), Washington, DC 20224.

SUPPLEMENTARY INFORMATION:

BACKGROUND

This document contains proposed amendments to the Income Tax Regulations (26 CFR Part 1) under section 401(a)(26) of the Internal Revenue Code of 1986 (Code). These amendments are proposed to conform the regulations to section 1112(b) and (e) of the Tax Reform Act of 1986. (TRA '86) (100 Stat. 2444).

AMENDMENTS TO QUALIFIED PLANS

Generally, section 401(a)(26) imposes new minimum participation requirements that plans must meet in order to be qualified under section 401(a). These rules are, in general, operational. To the extent that a plan does not meet the requirements of section 401(a)(26), the plan must be amended as of the date provided herein in order to retain qualification, such amendment to be effective as of the first day of the first plan year to which section 401(a)(26) applies.

ANALYSIS

In General

Section 401(a)(26) requires that a qualified plan benefit at least the lesser of 50 employees or 40 percent of all employees of the employer. Section 401(a)(26) applies separately to an employer's active employees and the employer's former employees. In addition, to the extent determined by the Secretary, section 401(a)(26) applies separately to certain separate benefit structures, trusts, and other arrangements. The minimum participation requirement may not be satisfied by aggregating separate plans, even if such plans are identical in all respects or are treated as a single plan for coverage and nondiscrimination purposes and, as such, are treated as providing nondiscriminatory employer contributions or benefits.

Pursuant to the grant of regulatory authority to provide that certain separate benefit structures may be treated as separate plans subject to section 401(a)(26), the proposed regulation provides that a plan satisfies section 401(a)(26) only if each current benefit structure under the plan satisfies section 401(a)(26) and, in the case of a defined benefit plan (but not a defined contribution plan), the plan's prior benefit structure satisfies section 401(a)(26). Under the regulation, a single current benefit structure exists with respect to each portion of a uniform benefit formula (either a formula for allocating contributions and forfeitures under a defined contribution plan or a formula for determining an employee's benefit attributable to the current year under a defined contribution plan) to the extent that subsidies, optional forms of benefit, rights and features are provided on a uniform basis to employees eligible to participate under such formula. Finally, each defined benefit plan (but not a defined contribution plan) includes a single prior benefit structure that includes all benefits accrued under the plan as of the end of the prior year.

Section 401(a)(26) generally is effective with respect to plan years beginning after December 31, 1988. A deferred effective date applies with respect to certain collectively bargained plans.

Significant Special and Transitional Rules

The proposed regulation includes a variety of permanent special rules designed to facilitate the application of and compliance with section 401(a)(26), and includes several transition rules for plan years beginning in 1989. The most significant of the special permanent rules are as follows:

1. A current benefit structure satisfies section 401(a)(26) even though the structure benefits less than 50 employees and less than 40 percent of the employer's employees as long as the structure benefits at least 20 employees who primarily are nonhighly compensated employees and the structure is included in a plan that currently provides meaningful benefit ac-

cruals to at least 50 total employees. If such a current benefit structure benefits only employees who become employed by the employer in connection with a corporate acquisition or similar transaction, the structure is treated as satisfying section 401(a)(26) for 5 plan years after the transaction even though the structure benefiting such employees may benefit fewer than 20 employees.

2. A current benefit structure satisfies section 401(a)(26) without regard to the number of employees that it benefits as long as such structure benefits only employees who are not, and have never been, highly compensated employees of the employer, and such structure (and the benefits thereunder) are not relied upon by any other plan or current benefit structure to satisfy sections 410(b) or 401(a)(4).
3. A defined contribution plan's prior benefit structure is deemed to satisfy section 401(a)(26). Thus, a frozen defined contribution plan satisfies section 401(a)(26) without regard to the number of employees who have benefits under the plan.
4. A defined benefit plan's prior benefit structure satisfies section 401(a)(26) if at least 100 active and former employees have more than de minimis benefits under the plan and no three highly compensated employees have more than 25 percent of the total accrued benefits under the plan.
5. A defined benefit plan's prior benefit structure satisfies section 401(a)(26) if the plan provides additional, meaningful benefit accruals under one or more current benefit structures for at least 50 employees or 40 percent of the employer's employees.
6. Most defined benefit plans that satisfy section 401(a)(26) with respect to prior benefit structures because the plans provide additional meaningful current benefit accruals will satisfy section 401(a)(26) in subsequent years with respect to the plan's prior structure without any requirement for retesting as long as the current benefit formula (including the rate of accrual) relied on remains in effect and continues to provide benefit accruals to a group of employees that satisfies the requirements of section 401(a)(26).

The most significant of the transition rules included in the proposed regulation for plan years beginning in 1989 are as follows:

1. A simplified definition of current benefit structure applies for the 1989 plan year so that only major plan benefit features need to be taken into account.
2. A reasonable compliance standard applies for the 1989 plan year for determining whether a defined benefit plan's prior benefit structure satisfies section 401(a)(26).
3. Certain plans may be terminated on or before May 31, 1989, without being amended to comply with section 401(a)(26).
4. Employer reversions with respect to certain defined benefit plans may qualify for the waiver of the excise tax under section 4980 even though the date of plan termination occurs after section 401(a)(26) becomes effective with respect to the plan as long the date of plan termination occurs on or before May 31, 1989, and plan assets are distributed to participants within a reasonable time after such termination.

Separate benefit structures

The proposed regulation provides that each single plan within the meaning of section 414(l) is a separate plan for purposes of section 401(a)(26) that must satisfy section 401(a)(26). In addition, the regulation provides that each separate benefit structure under a plan must satisfy section 401(a)(26).

The rules in the proposed regulation that govern the identification and testing of separate benefit structures are designed to reflect three basic policy objectives of section 401(a)(26):

1. Promote the integrity of the distinctions in the deduction limits and the contribution and benefit limits as they apply to defined benefit plans and defined contribution plans by limiting the extent to which a defined benefit plan generally may operate as an individual account for one or a small group of employees.
2. Promote the nondiscriminatory provision of benefits by limiting the extent to which an employer is able to design different benefit formulas for different employees in order to maximize benefit disparities in favor of highly compensated employees.
3. Limit the extent to which an employer maintaining a defined benefit plan that is not providing active employees with meaningful, additional benefits (e.g., a frozen or substantially frozen defined benefit plan) is able to delay plan termination in order to (i) increase the amount of its reversion upon plan termination, (ii) delay its receipt of the reversion to maximize its own benefit, or (iii) delay a benefit increase to favor a small group of highly compensated employees who remain with benefits under the plan.

The proposed regulation thus exercises the grant of regulatory authority to provide that certain separate benefit structures are to be treated as separate plans subject to section 401(a)(26). Instead of providing that such separate benefit structures are to be treated as separate plans, the proposed regulation directly applies section 401(a)(26) to such separate benefit structures. Thus, the proposed regulation provides that each current benefit structure that is included in a single plan (within section 414(l)) is a separate benefit structure that must satisfy section 401(a)(26). In addition, each defined benefit plan (within section 414(l)) includes a single prior benefit structure that must satisfy section 401(a)(26).

Pursuant to the proposed regulation, a single current benefit structure under a defined contribution plan comprises a uniform formula under which contributions and forfeitures are allocated among employees for the current year and uniform subsidies, optional forms of benefits, rights and features are provided. In the case of a defined benefit plan, a single current benefit structure comprises a uniform benefit formula under which an employee's benefit attributable to the current year of service is determined and uniform subsidies, optional forms of benefits, rights and features are provided to the participants benefiting under such structure. Thus, for example, a defined benefit plan that currently provides three different benefit formulas for determining the benefits of three different groups of employees is treated as having three separate current benefit structures each of which must separately satisfy section 401(a)(26). Similarly, a defined benefit plan which provides for a single benefit formula but makes a single sum distribution available to division A employees and not to division B employees is treated as having two separate current benefit structures each of which must separately satisfy section 401(a)(26). A current structure exists whenever there is an increase in accruals whether as a result of additional years of service, changes in compensation, or other factors. Such increases are treated as benefits attributable to the year of service in which they accrue.

Multiple employer plans must satisfy the requirements of section 401(a)(26) on an employer-by-employer basis rather than on the basis of participating employers in the aggregate. Failure to satisfy the requirements of section 401(a)-(26) with respect to any component of this testing process may result in disqualification of the plan for all participating employers. The proposed regulation does not provide an exception to this rule. However, in a proper case, the Commissioner could retain the plan's qualified status for innocent employers by requiring corrective and remedial action with respect to the plan such as allowing the withdrawal of an offending employer, allowing a disqualifying defect to be cured within a reasonable period of time after the plan administrator has or should have had knowledge of such disqualifying event or was otherwise notified by the Internal Revenue Service of the disqualifying defects, or requiring plan amendments to prevent future disqualifying events. To the extent that coverage under a multiemployer plan is treated as being provided, in whole or in part, under a multiple employer plan, this relief is applicable to the multiemployer plan.

Finally, the proposed regulation provides that a separate current benefit structure exists if any person has any priority, either under the terms of the plan or under any arrangement outside of the plan, with respect to any assets of a defined benefit plan, such as the right to some or all of a possible reversion. Essentially, the proposed regulations provide that if, under all the facts and circumstances, an arrangement (either under or outside the plan) has the effect of modifying any feature under the plan taken into account in determining an employee's benefit, providing any employee with any priority or greater interest in a portion of the assets in the plan, or linking any financial matter involving an employee to all or a portion of the assets in the plan in a way that has the effect of creating separate accounts, such arrangement will be treated as creating a separate current benefit structure within the plan.

Current benefit structure requirements

The proposed regulation provides that, in order for a plan to satisfy section 401(a)(26), each current benefit structure that benefits any active employee in the plan must benefit at least the lesser of 50 active employees or 40 percent of an employer's active employees. Similarly, a current benefit structure that benefits any former employee must benefit at least the lesser of 50 former employees or 40 percent of the employer's former employees. This approach to separate benefit structures is equivalent to providing that each current benefit structure is a separate plan that, as such, must satisfy section 401(a)(26).

The proposed regulation includes a special restructuring rule under which an employer may, solely for purposes of testing under section 401(a)(26), treat a benefit formula under a plan that would be a single current benefit structure but for differences in the rate of benefit accrual or contribution allocation into restructured separate benefit structures, one consisting of the lesser included portion of the formulas common to each of the benefit structures and one or more consisting of the portion(s) of the formula(s) that is not common to each of the benefit formulas. An employer may apply the rules of section 401(a)(26) to a plan's current benefit structures on the basis of this restructuring rule without amending the plan in any respect to reflect such restructuring. Thus, for example, a defined contribution plan that has a 10 percent of compensation allocation formula for one group of employees and a 15 percent of compensation allocation formula for another group of employees may be treated, under the restructuring rule, as having a 10 percent of compensation formula applicable to both groups of employees and a 5 percent of compensation formula applicable only to the group of employees subject to the explicit, 15 percent plan formula. Even though the plan explicitly includes the 10 percent and 15 percent formulas, the plan may be tested under section 401(a)(26) on the basis of the restructured 10 percent and 5 percent formulas.

The proposed regulation provides a special rule permitting a current benefit structure to satisfy section 401(a)(26) if such structure benefits at least the lesser of 20 active employees (rather than 50 active employees) or 40 percent of the employer's active employees. This special rule is available only if certain coverage and nondiscrimination requirements are satisfied and, in addition, the plan that includes the current benefit structure provides meaningful benefits (determined under the minimum current benefit structure test applicable with respect to prior benefit structures) to at least the lesser of 50 active employees or 40 percent of the employer's active employees.

The proposed regulation also includes special rules for certain current benefit structures that benefit only nonhighly compensated employees and for certain current benefit structures that benefit only employees "acquired" in connection with a merger or acquisition.

Prior benefit structure requirements

Under the proposed regulation, a defined benefit plan (but not a defined contribution plan) is required to satisfy section 401(a)(26) with respect to the plan's prior benefit structure. As it does with current benefit structures, the proposed regulation does not provide that a prior benefit structure is a separate plan that, as such, must satisfy section 401(a)(26). Rather, the proposed regulation provides that each defined benefit plan has a single prior benefit structure that is treated as satisfying section 401(a)(26) only if at least one of several alternative tests is satisfied. This approach to separate benefit structures does not result in the application of any requirement that could not also have been applied by providing a narrower definition of separate prior benefit structures and then providing that such structures are separate plans subject to section 401(a)(26).

For example, in lieu of providing that a defined benefit plan's prior benefit structure satisfies section 401(a)(26) if the plan provides meaningful, additional benefit accruals to active employees, the proposed regulation could have been drafted to accomplish the same result by providing that a defined benefit plan does not have a prior benefit structure if the plan provides additional, meaningful benefits to active employees. Similarly, in lieu of providing that a frozen plan's prior benefit structure satisfies section 401(a)(26) if there are at least 50 active and former employees or 40 percent of the employer's active and former employees with meaningful benefits under the plan, the proposed regulation could have been drafted to provide that the portion of the frozen plan that includes employees with meaningful benefits is a separate benefit structure and that such separate structure is a separate plan which must benefit at least the lesser of 50 employees or 40 percent of the employer's employees.

The regulation includes six alternative tests under which a defined benefit plan's prior benefit structure may satisfy section 401(a)(26). These tests are designed to reflect the policy objectives of section 401(a)(26) without also requiring employers to track the many different benefit structures that may have been in effect at various times under their plans or to determine whether employees continue to have benefits under such different benefit structures.

A defined benefit plan need only satisfy one of the six alternative tests set forth in the proposed regulation. Thus, for example, in accordance with one of the alternative tests, if at least 100 active and former employees have at least de minimis benefits under a defined benefit plan and no three highly compensated employees have benefits in excess of 25 percent of the total benefits under the plan, the defined benefit plan's prior benefit structure satisfies section 401(a)(26). The employer need not satisfy any of the other alternative tests with respect to such plan's prior benefit structure.

The prior benefit structure tests fall into two general categories. The first category reflects the view that a defined benefit plan that is providing additional, meaningful, benefit accruals to active employees should not be forced either to improve benefits or to terminate simply because there is only a small number of employees with prior accrued benefits under the plan. The tests in this category thus provide that if a plan includes one or more current benefit structures for active employees that provide current benefit accruals that are meaningful relative to the benefits that have otherwise accrued under the plan, the plan's prior benefit structure is deemed to satisfy section 401(a)(26). (This is equivalent to providing that such plan does not include a prior benefit structure that must be treated as a separate plan subject to section 401(a)(26).)

The prior benefit structure tests in the second category are designed to determine whether a plan that does not include a meaningful current benefit structure (e.g., a frozen or substantially frozen defined benefit plan) nevertheless includes meaningful or more than de minimis accrued benefits for sufficient numbers of active and former employees. (These tests are equivalent to defining a plan's prior benefit structure to include only those employees with prior accrued benefits equal to or above a meaningful or de minimis level of benefits and then treating only such portion of the plan as a separate benefit structure that must separately satisfy section 401(a)(26).)

The first category of prior benefit structure tests includes four alternative tests. Under the minimum current accrual rate test, a defined benefit plan's prior benefit structure satisfies section 401(a)(26) if at least 50 active employees or 40 percent of the employer's active employees have current accrual rates for the current year of service that are at least equal to 0.75 percent of final average compensation or 1.1 percent of career average compensation. Under the nondecreasing current benefit structure test, a defined benefit plan's prior benefit structure satisfies section 401(a)(26) if at least 50 active employees or 40 percent of the employer's active employees (including the top three highly compensated employees of the employer) have hypothetical accrued benefits (determined by assuming that current benefit structures under the plan have always been in effect) equal to or greater than their actual accrued benefits under the plan. Under the minimum current benefit structure test, a defined benefit plan's prior benefit structure satisfies section 401(a)(26) if the plan includes at least one current benefit structure that provides active employees with at least a minimum benefit accrued, which is determined by reference to the largest benefits under the plan for the highly compensated employees. Finally, under the benefit ratio test, a defined benefit plan's prior benefit structure satisfies section 401(a)(26) if the sum of the accrued benefits of all active employees under the plan is less than 60 percent of the sum of the projected accrued benefits of all active employees under the plan and if the plan satisfies the concentration test (described below).

The second category of prior benefit structure tests includes two alternative tests, which are designed for plans that do not satisfy at least one of the four preceding tests. Under the minimum accrued benefit test, a defined benefit plan's prior benefit structure satisfies section 401(a)(26) if there are at least 50 active and former employees or 40 percent of the employer's active and former employees with at least a minimum benefit, which is determined by reference to the largest benefits under the plan for the highly compensated employees. Under the minimum employee coverage test, a defined benefit plan's prior benefit structure satisfies section 401(a)(26) if at least 100 active and former employees of the employer have more than de minimis benefits under such plan and the plan satisfies the concentration test.

The concentration test, which applies under both the benefit ratio and the minimum employee coverage tests, is satisfied by a plan only if the sum of the benefits of the three highly compensated active and former employees of the employer with the largest benefits under the plan does not constitute more than 25 percent of the sum of the total benefits of all active and former employees under the plan.

In making these prior benefit structure determinations, an employee's accrued benefit under the plan being tested is the employee's actual accrued benefit under such plan. Thus, benefits provided under social security or similar Federal or state law, the permitted disparity under section 401(l), and benefits provided under any other plan generally are disregarded. However, the method for determining whether an employee's benefit is at least a minimum benefit relative to either the largest or other benefits under a plan is designed to take into account the permitted disparity under section 401(l) without regard to whether the plan being tested actually uses such permitted disparity.

Finally, the proposed regulation contains a delegation of authority to the Commissioner to prescribe additional tests under which a plan's prior benefit structure will satisfy section 401(a)(26). This delegation of authority, and similar delegations of authority in other sections of the proposed regulation, states that the delegation may be exercised only in the form of revenue rulings, notices or other documents of general applicability. No inferences should be drawn with respect to the manner in which the Commissioner may exercise other delegations of authority provided for in this or other regulations.

Exceptions

The proposed regulation includes three exceptions under which a plan is deemed to satisfy section 401(a)(26). First, the proposed regulation includes the statutory rule under which the portion of a multiemployer plan that benefits employees who are covered pursuant to a collective bargaining agreement is deemed to satisfy section 401(a)(26). However, this exception does not apply with respect to any collective bargaining agreement if more than two percent of the employees covered pursuant to such agreement are professional employees (e.g., doctors, lawyers, architects, and investment bankers).

In addition, the proposed regulation adopts a special rule described in the legislative history under which a plan is deemed to satisfy section 401(a)(26) if such plan does not benefit, either for the current year or for any of the five immediately preceding plan years, any employee who is or ever has been a highly compensated employee. This special rule is available only if the plan is not aggregated with any other plan for purposes of applying the minimum coverage or nondiscrimination rules to any such plan (including the average benefit test in section 410(b)(2)(A)(ii)).

Finally, the proposed regulation includes a limited exception for certain underfunded defined benefit plans. As set forth previously, if a defined benefit plan is frozen and does not include meaningful benefits for sufficient numbers of employees, section 401(a)(26) generally should operate to force the employer to wind up the plan when the number of employees with meaningful benefits under the plan is less than 50 employees or 40 percent of the employees of the employer. However, the proposed regulation provides that, in general, a defined benefit plan is deemed to satisfy section 401(a)(26) if such plan is subject to Title IV of ERISA or primarily benefits nonhighly compensated employees; the plan does not contain sufficient assets to satisfy all liabilities under the plan; all benefit accruals under the plan have ceased; and the plan does not rely on this rule for more than three years. In addition, a plan covered by Title IV of ERISA that would have failed section 401(a)(26) for the plan year containing August 16, 1986, if such section had been in effect for such year, can rely on this rule for plan years commencing before January 1, 1994.

RELIIANCE ON THESE PROPOSED REGULATIONS

Taxpayers may rely on these proposed regulations for guidance pending the issuance of final regulations. Because these regulations are generally effective for plan years beginning after 1988, the Service will apply these proposed regulations in issuing rulings and in examining returns with respect to taxpayers and plans. If future regulations are more restrictive, such guidance will be applied without retroactive effect.

SPECIAL ANALYSES

The Commissioner of Internal Revenue has determined that this proposed rule is not a major rule as defined in Executive Order 12291 and that a regulatory impact analysis is therefore not required. Although this document is a notice of proposed rulemaking which solicits public comments, the Internal Revenue Service has concluded that the regulations proposed herein are interpretative and that the notice and public procedure requirements of 5 U.S.C 553 do not apply. Accordingly, the proposed regulations do not constitute regulations subject to the Regulatory Flexibility Act (5 U.S.C. Chapter 6).

COMMENTS AND REQUESTS FOR PUBLIC HEARING

Before adopting these proposed regulations, consideration will be given to any written comments that are submitted (preferably eight copies) to the Commissioner of Internal Revenue. All comments will be available for public inspection and copying. A public hearing will be held upon written request to the Commissioner by any person who has submitted written comments. If a public hearing is held, notice of the time and place will be published in the FEDERAL REGISTER.

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Proposed Amendments to the Regulations

The proposed amendments to 26 CFR Part 1 are as follows:

INCOME TAX REGULATIONS (26 CFR Part 1)

Paragraph 1. The authority citation for Part 1 is amended by adding the following citation:

Authority: 26 U.S.C. 7805 * * * Section 1.401(a)(26)-1 through-8 also issued under 26 U.S.C. 401(a)(26).* * *

Par. 2. The following new sections §1.401(a)(26)-0 through §1.401(a)(26)-8 are added to read as follows:

§1.401(a)(26)-0 Table of contents.

The following sections provide rules under section 401(a)(26):

§1.401(a)(26)-1 Minimum participation rule.

(a) *General rules.* A plan is a qualified plan (and a trust related to a plan is a qualified trust) for a plan year only if such plan satisfies section 401(a)(26) for such year. Generally, a plan will satisfy section 401(a)(26) only if the plan satisfies paragraph (b)(1) of this section with respect to each current benefit structure for active employees. Paragraph (c) of this section contains special rules regarding the application of paragraph (b) of this section to current benefit structures. If a plan includes a current benefit structure for former employees, the plan also must satisfy paragraph (b)(2) of this section with respect to such current benefit structure. Also, a defined benefit plan (but not a defined contribution plan) must satisfy the requirements of §1.401(a)(26)-6 with respect to its prior benefit structure. Finally, paragraph (d) of this section provides exceptions to section 401(a)(26) for plans that do not benefit any highly compensated employees, multiemployer plans, and underfunded defined benefit plans.

(b) *Current benefit structures*—(1) *Active employees*—(i) *General rule.* A plan satisfies this paragraph (b) for a plan year only if each current benefit structure included in the plan and benefiting active employees benefits at least the lesser of—

(A) 50 active employees of the employer, or

(B) 40 percent of the active employees of the employer. See paragraph (c) of this section for additional rules regarding the application of this paragraph (b)(1).

(ii) *Example.* The rule in this paragraph (b) is illustrated by the following example:

Assume that employer A employs 100 active employees and maintains one defined contribution plan (plan X) and one defined benefit plan (plan Y). All 100 employees benefit under plan X's current benefit structure, which provides all employees under the plan with a contribution allocation of 5 percent of compensation. This current benefit structure satisfies this paragraph (b) and plan X thus satisfies section 401(a)(26). Plan Y includes two current benefit structures, one of which (Y1) provides for a benefit of 1 percent per year of service times final average compensation, and the other of which (Y2) provides for a benefit of 2 percent per year of service times career average compensation. Current benefit structure Y1 benefits 75 active employees and thus satisfies this paragraph (b). Current structure Y2, however, benefits only 25 active employees and thus fails to satisfy this paragraph (b). Accordingly, defined benefit plan Y fails to satisfy section 401(a)(26) for the year.

(2) *Former employees.* A plan satisfies this paragraph (b)(2) for a plan year only if each current benefit structure included in the plan and benefiting former employees benefits at least the lesser of—

(i) 50 former employees of the employer, or

(ii) 40 percent of the former employees of the employer. See paragraph (c) of this section for additional rules regarding the application of this paragraph (b)(2).

(c) *Special rules for testing current benefit structures*—(1) *Restructured current benefit formulas*—(i) *In general.* In testing current benefit structures under paragraphs (b)(1) and (b)(2) of this section, an employer may, in certain circumstances, restructure two or more current benefit formulas under a plan that would constitute a single structure but for differences in the rate of benefit accrual or contribution allocation into restructured separate benefit structures, one consisting of the portion of the formulas that is common to each of the benefit structures and one or more consisting of the portion(s) of the formula that is not common to each of the benefit formulas. Each of the resulting restructured benefit structures must satisfy paragraph (b)(1) or (b)(2) of this section, whichever is applicable. See §1.401(a)(26)-2(e)(1) for rules governing the restructuring of current benefit formulas.

(ii) *Example.* The rule in paragraph (c)(1)(i) of this section may be illustrated by the following example.

Example. Defined benefit plan A includes two current benefit structures—one of which benefits the 200 active employees of division X and provides a benefit of 1½ percent times years of service times final average compensation, and the other of which benefits the 30 active employees of division Y and provides a benefit of 1 percent times years of service times final average compensation. In all other respects, employees have identical rights under the plan. Division X's current benefit structure satisfies paragraph (b)(1) of this section, but division Y's current benefit structure fails to satisfy such paragraph. However, the two current benefit structures may be retested on the basis of two restructured current benefit structures. (Under §1.401(a)-(26)-2(e)(1), an employer is not required to amend a plan to reflect the restructured current benefit structures in order to be able to use the restructuring method of testing under section 401(a)(26)). One restructured current benefit structure, which provides a benefit of 1 percent times years of service times final average compensation, benefits all 230 active employees of divisions X and Y. The other restructured current benefit structure, which provides a benefit of ½ percent times years of service times final average compensation, benefits division X's 200 active employees. Both of the restructured current benefit structures thus satisfy paragraph (b)(1) of this section.

(2) *Current benefit structures that benefit at least 20 active employees*—(i) *In general.* A plan may apply paragraph (b)(1)(i) of this section for a plan year by substituting "20 active employees" for "50 active employees" if the tests in paragraphs (c)(4)(ii) and (c)(4)(iii) of this section are satisfied for such plan year.

(ii) *Minimum nonhighly compensated employee test.* This test is satisfied for a plan year only if at least 70 percent of the active employees who benefit under the current benefit structure being tested are nonhighly compensated employees.

(iii) *Minimum participation test*—(A) *Defined benefit plans.* This test is satisfied with respect to a defined benefit plan for a plan year only if, as of the close of such year, at least the lesser of 50 active employees or 40 percent of the employer's active employees have future service benefit rates (or current accrual rates) under the plan that includes the current benefit structure being tested that are at least the minimum benefit rate (or the minimum current accrual rate) for such plan. See §1.401(a)(26)-6(b)(2)(iv)-(B) and (c)(2) for the definitions of future service benefit rate and minimum benefit rate. See §1.401(a)(26)-6(b)(2)-(ii)(C) and (D) for the definition of current accrual rate and minimum current accrual rate. This test is deemed to be satisfied for a plan year if, as of the close of such year, at least 100 active employees of the employer are currently accruing greater than de minimis benefits under an ongoing benefit formula under the plan that includes the current benefit structure being tested and the plan satisfies the concentration test set forth in paragraph (b)(4) of §1.401(a)(26)-6.

(B) *Defined contribution plans.* This test is satisfied with respect to a defined contribution plan for a plan year only if, for such plan year, at least the lesser of 50 active employees or 40 percent of the employer's active employees receive contribution allocations or, in the case of a plan subject to section 401(k) or 401(m), are eligible to receive contribution allocations, under the plan that includes the current benefit structure being tested, that are greater than de minimis allocations.

(3) *Current benefit structures that do not benefit any highly compensated employees.* A current benefit structure is deemed to satisfy paragraph (b)(1) of this section for a plan year if such current benefit structure does not benefit any active employee who is or ever has been a highly compensated employee of the employer. This paragraph (c)(5) is available to a current benefit structure only if such structure is included in a plan that benefits at least the lesser of 50 employees or 40 percent of the employer's employees, and all plans of the employer (including the plan that includes the current benefit structure being tested) would satisfy sections 401(a)(4) and 410(b) (including the average benefit test of section 410(b)(2)(A)-(ii)) if the employees benefiting under the current benefit structure being tested were treated as accruing no benefits under such structure. For purposes of this paragraph (c)(5), employees who were highly compensated employees only for plan years ending before January 1, 1984, are treated as not having been highly compensated employees.

(4) *Qualified cash or deferred arrangements maintained by employers that include certain governmental or tax-exempt entities*—(i) *General rule.* In the case of a plan including a qualified cash or deferred arrangement under section 401(k) that is maintained by an employer which employs employees precluded from being eligible employees under the arrangement by reason of section 401(k)-(4)(B), the current benefit structure consisting of elective contributions under the arrangement is deemed to satisfy paragraph (b)(1) of this section if more than 95 percent of all active employees of the employer benefit under such current benefit structure. Solely for purposes of this determination, employees precluded from being eligible employees under the qualified cash or deferred arrangement by reason of section 401(k)(4)(B) are to be treated as excludable employees. This paragraph (c)(6) applies also to employer matching contributions that are subject to section 401(m) and are geared to elective contributions under a qualified cash or deferred arrangement that satisfies this paragraph (c)(6).

(ii) *Example.* The rule in this paragraph (c)(6) can be illustrated by the following example:

Assume that an employer (determined after application of sections 414(b), (c), (m), (o), and (r)) consists of one taxable entity that has 30 active employees and several tax-exempt entities that have, in the aggregate, 500 active employees. Assume further that the employer maintains a plan including a qualified cash or deferred arrangement for the 30 active employees of the taxable entity, and that section 401(k)(4)(B) precludes all of the 500 active employees of the tax-exempt entities from eligibility under the arrangement. Because 30 active employees is less than the lesser of 50 active employees or 40 percent of the employer's 530 active employees (i.e., 212 employees), the current benefit structure consisting of the cash or deferred arrangement fails to satisfy paragraph (b)(1) of this section. However, under this paragraph (c)(6), this current benefit structure is deemed to satisfy paragraph (b)(1) of this section because the current benefit structure benefits 100 percent of the employer's active employees, determined by disregarding all of the 500 active employees of the tax-exempt entities who are precluded from eligibility by reason of section 401(k)(4)(B).

(5) *Current benefit structures for former employees.* In the case of a plan that includes a current benefit structure for former employees (e.g., a plan that is amended to provide an ad hoc cost-of-living adjustment to the benefit provided former employees under the plan), such current benefit structure is deemed to satisfy paragraph (b)(2) of this section if at least five former employees benefit under such current benefit structure and either more than 95 percent of all former employees with benefits under the plan benefit under such current benefit structure or at least 60 percent of the former employees who benefit under such current benefit structure are not highly compensated former employees. Solely for purposes of this determination, a former employee who has a vested accrued benefit under the plan and is an excludable former employee under §1.401(a)-(26)-4(c)(3) solely because such employee's vested accrued benefit is not in excess of $3,500 is not treated as an excludable former employee.

(6) *Certain acquisitions or dispositions*—(i) *In general.* Under section 401(a)(26), rules similar to rules prescribed under section 410(b)(6)(C)(i) shall apply.

(ii) *Transition rule.* Where there has been a transaction described in section 410(b)(6)(C) in the year prior to the first year in which section 401(a)(26) becomes effective with respect to a plan, affected by such transaction, which plan includes a current benefit structure, the current benefit structure will satisfy section 401(a)(26) for the transition period commencing on the date of the transaction and ending on the last day of the first plan year beginning after the date of the transaction if either of the following two requirements is met:

(A) The current benefit structure satisfies section 401(a)(26) immediately before the transaction on the basis of only the applicable statutory provisions, without regard to the regulations under section 401(a)(26), in the manner provided in §1.401(a)(26)-8(c)(3). Thus, a current benefit structure satisfies the requirements of section 401(a)(26), immediately prior to the transaction, if such structure was part of a plan that benefited 50 employees or 40 percent of the employees of the employer without regard to current or prior benefit structures existing under the plan.

(B) The current benefit structure affected by the transaction satisfies the rule in paragraph (c)(7) of this section.

(7) *Acquisition current benefit structures.* A current benefit structure under a defined benefit plan that benefits only employees (acquisition employees) who become employed by the employer in connection with a corporate acquisition, merger or similar transaction (transaction) is deemed to satisfy paragraph (b)-(1) of this section for a plan year if all of the following requirements are satisfied for the plan year:

(i) The current benefit structure includes the same benefit formula that existed in the benefit structure under which such acquisition employees were benefiting immediately prior to the transaction or, if different, any difference reflects changes necessitated by changes in the applicable qualification requirements;

(ii) Immediately after the transaction, the current benefit structure satisfies the test of paragraph (c)(4)(ii) of this section;

(iii) The current benefit structure is included in a defined benefit plan that, as of the current plan year, satisfies the test of paragraph (c)(4)(iii) of this section; and

(iv) The transaction occurred either in the current plan year or any of the immediately preceding five plan years.

In the case of a transaction occurring prior to the effective date of section 401(a)(26) with respect to the plan, the requirements of paragraph (c)(3)(ii) of this section may be applied either immediately after the transaction or as of the first day of the first plan year for which section 401(a)(26) is effective, and the requirements of paragraph (c)(3)(iv) of this section may be applied as if the transaction occurred on December 31, 1988.

(d) *Exceptions*—(1) *Plans that do not benefit any highly compensated employees*—(i) *General rule.* A plan is deemed to satisfy section 401(a)(26) for a plan year if such plan is not a top-heavy plan under section 416 and such plan (and any predecessor plan) does not benefit, for such plan year and for any of the immediately preceding five plan years, any active or former employee who is or ever has been a highly compensated employee of the employer (either as an active employee, former employee, or both). This paragraph (d)-(1) is available to a plan being tested under section 401(a)(26) only if all other plans of the employer would satisfy sections 401(a)(4) and 410(b) (including section 410(b)(2)(A)(ii)) if the employees under the plan being tested are treated as though they have no benefits under such plan. For purposes of applying this rule, employees who were highly compensated employees only for plan years ending before January 1, 1984, are not treated as highly compensated employees.

(ii) *Example.* This paragraph (d)(1) can be illustrated by the following example:

Assume that an employer has 100 employees, only 5 of whom are highly compensated employees. The employer maintains two defined benefit plans during a particular year: plan X has a uniform, unit benefit formula and benefits the employer's 5 highly compensated employees and 70 of the nonhighly compensated employees, and plan Y benefits the remaining 25 nonhighly compensated employees. Plan X satisfies the ratio coverage test of section 410(b)(1)(B) and section 401(a)(4) without regard to plan Y. Also, plan X is not top-heavy. If none of the nonhighly compensated employees benefit under plan Y have ever been highly compensated employees of the employer, plan Y is deemed to satisfy section 401(a)(26) for the year even though only 25 employees benefit under such plan.

(2) *Multiemployer plan exception*—(i) *In general.* The portion of a multiemployer plan that, for a plan year, benefits only employees included in a unit of employees covered by a collective bargaining agreement is deemed to be a separate plan that satisfies section 401(a)-(26) for such plan year. If a multiemployer plan also benefits employees who are not included in any collective bargaining unit, the portion of the plan benefiting such employees must separately satisfy section 401(a)(26).

(ii) *Covered by a collective bargaining agreement.* An employee is covered by a collective bargaining agreement only if such employee is represented by a bona fide employee representative that is a party to the collective bargaining agreement or agreements under which the multiemployer plan is maintained.

Thus, for example, an employee of either the multiemployer plan or the employee representative is not included in a unit of employees covered pursuant to the collective bargaining agreement under which the plan is maintained merely because the employee is covered under the plan pursuant to an agreement entered into by the multiemployer plan or employee representative on behalf of the employee (other than in the capacity of an employee representative with respect to such employee). This is the case even if all such employees covered under the plan constitute only a de minimis percentage of the total employees benefiting under the plan.

(iii) *Multiemployer plans covering professional employees*. This paragraph (d)(2) does not apply for a plan year with respect to a collective bargaining agreement if, for such year, more than 2 percent of the employees who are covered pursuant to such agreement are professionals as defined in §1.401(a)(26)-7(g). This paragraph (d)(2)(iii) is applied separately with respect to each collective bargaining agreement. Thus, for example, if a multiemployer plan benefits a group of employees covered by collective bargaining agreement X and a group of employees covered by collective bargaining agreement Y and if more than 2 percent of the employees covered pursuant to agreement X are professionals (but not agreement Y), this paragraph (d)(2) applies with respect to employees covered pursuant to agreement Y, but not with respect to employees covered pursuant to agreement X.

(3) *Certain underfunded defined benefit plans*—(i) *In general*. A defined benefit plan is deemed to satisfy section 401(a)(26) for a plan year if all of the conditions of paragraphs (d)(3)(ii) through (d)(3)(v) of this section are satisfied with respect to such plan for such year.

(ii) *Eligible plans*. This condition is satisfied for a plan year only if the defined benefit plan is subject to Title IV of ERISA for such year or if, as of the close of such year, the sum of the accrued benefits of the nonhighly compensated employees under the plan is at least 50 percent of the sum of the accrued benefits for all employees under the plan. See paragraph (c)(1) of §1.401(a)(26)-6 for the definition of accrued benefit.

(iii) *Actuarial certification*. This condition is satisfied for a plan year only if an enrolled actuary provides the employer with an actuarial certification that, as of the last day of the immediately preceding plan year, the defined benefit plan does not have sufficient assets to satisfy all liabilities under the plan (determined in accordance with section 401(a)(2)). Such certification must be included with a timely filed actuarial report as required under section 6059.

(iv) *Cessation of all benefit accruals*. This condition is satisfied for a plan year only if, for such year, no employees accrue any additional benefits under the plan (including benefits attributable to increases in compensation or in the section 415 or section 401(a)(17) limits), except for the minimum benefits for non-key employees required by section 416.

(v) *Plan year limitation*. This condition is satisfied for a plan year only if the defined benefit plan does not rely on this paragraph (d)(3) to satisfy section 401(a)(26) for more than three plan years (including the current plan year). For plan years commencing before January 1, 1994, this condition may be applied by substituting "five plan years" for "three plan years" in the preceding sentence if the plan being tested was in existence on August 16, 1986; the plan would have failed to satisfy section 401(a)(26) for the plan year including August 16, 1986, if such section had applied with respect to such year; the plan fails to satisfy section 401(a)(26) for the first plan year for which section 401(a)(26) applies with respect to such plan; and the plan has not been involved in a plan merger, spinoff, asset or liability transfer or any similar transaction since August 16, 1986. The determination of whether a plan would have failed to satisfy section 401(a)(26) for the plan year including August 16, 1986 is to be made under the rules in §1.401(a)-(26)-8(c)(3).

§1.401(a)(26)-2. Definitions of plan, current benefit structure, and prior benefit structure.

(a) *Plan*. In general, the term "plan" refers to a plan described in section 401(a) that includes one or more trusts intended to be exempt from tax under section 501(a), and an annuity plan described in section 403(a). As described in paragraph (b) of this section, each single plan under section 414(l) is treated as a plan for purposes of section 401(a)-(26). Under paragraph (c) of this section, in certain cases (including certain outside arrangements), a plan that is a single plan under paragraph (b) may be treated as comprising separate plans for purposes of section 401(a)(26). Furthermore, in accordance with section 401(a)-(26)(I), section 401(a)(26) also must be satisfied with respect to current benefit structures and, in the case of defined benefit plans, prior benefit structures. Paragraphs (d) and (e) of this section set forth rules for identifying a plan's current benefit structures and prior benefit structure.

(b) *Separate asset pools are separate plans*. Each single plan within the meaning of section 414(l) is a separate plan for purposes of section 401(a)(26). See §1.414(l)-1(b). For example, if only a portion of the assets under a defined benefit plan is available, on an ongoing basis, to provide the benefits of certain employees and the remaining assets are available only in certain limited cases to provide such benefits (but are available, in all cases, for the benefits of other employees), there are two separate plans. A single plan under section 414(l) is a plan for purposes of section 401(a)(26) notwithstanding that such plan comprises separate, written plan documents and separate trusts, each of which have received separate determination letters from the Internal Revenue Service. A defined contribution plan does not comprise separate plans merely because it includes more than one trust or it provides for separate accounts and permits employees to direct the investment of the amounts allocated to their accounts. Further, a plan does not comprise separate plans merely because assets are invested in individual insurance or annuity contracts for employees.

(c) *Disaggregation of certain plans*—(1) *Plans that include individual account and defined benefit components*. The portion of a plan that provides benefits that are based solely on the contributions and other amounts allocated to employees' individual accounts (determined in accordance with section 414(i)) and the portion of the plan that provides benefits that are not based solely on the contributions and other amounts allocated to employees' individual accounts are to be treated as separate plans for purposes of section 401(a)(26). Thus, for example, a plan that provides benefits partly on the basis of defined benefits and partly on the basis of employees' individual accounts is to be treated as including both an individual account plan (with respect to those benefits based solely on employees' individual accounts) and a defined benefit plan (with respect to those benefits that are not based solely on employees' individual accounts), each of which must separately satisfy section 401(a)(26).

(2) *Plans benefiting collective bargaining employees.* An employer may treat the portion of a plan that benefits employees who are included in a unit of employees covered by a collective bargaining agreement and the portion of a plan that benefits employees who are not included in such a collective bargaining unit as separate plans for purposes of section 401(a)(26). Thus, for example, if a plan benefits employees who are included in collective bargaining unit A and employees who are not included in any collective bargaining unit, the employer may treat such plan as two separate plans for purposes of section 401(a)(26), even if all of such employees benefit under identical current benefit structures. This paragraph (c)(2) applies separately with respect to each collective bargaining agreement. Thus, for example, the portion of a plan that benefits employees included in a unit of employees covered by one collective bargaining agreement may be treated as a plan that is separate from the portion of the plan that benefits employees included in a unit of employees covered by another collective bargaining agreement.

(3) *ESOPS.* The portion of a plan that is an employee stock ownership plan described in section 4975(e)(7) (an ESOP) and the portion of such plan that is not an ESOP are to be treated as separate plans for purposes of section 401(a)-(26). An employer may treat the rule in this paragraph (c)(3) as effective for plan years commencing on or after January 1, 1990.

(4) *Plans benefiting otherwise excludable employees.* If, in accordance with §1.401(a)(26)-4(b)(1)(ii), an employer elects to apply section 401(a)(26) separately to the portion of a plan that benefits only employees who have failed to satisfy the highest minimum age and/or service conditions permissible under section 410(a)(1), such portion is to be treated as a separate plan for purposes of section 401(a)(26).

(5) *Plans maintained by more than one employer*—(i) *Multiple employer plans.* If a plan benefits employees of more than one employer and such employees are not included in a unit of employees covered by one or more collective bargaining agreements (a multiple employer plan), the plan is to be treated as comprising separate plans each of which is maintained by a separate employer and must separately satisfy section 401(a)(26) by reference only to such employer's employees.

(ii) *Multiemployer plans.* The portion of a multiemployer plan that benefits employees who are included in one or more units of employees covered by one or more collective bargaining agreements and the portion of such plan that benefits employees who are not included in a unit of employees covered pursuant to any collective bargaining agreement are to be treated as separate plans for purposes of section 401(a)(26). See §1.401(a)-(26)-1(d)(2) for a multiemployer plan exception. The portion of a multiemployer plan that benefits employees who are not included in a unit of employees covered by a collective bargaining agreement is to be treated as plan maintained by one or more employers, depending on whether such employees are employed by one or more employers. See §1.401(a)(26)-1(d)(2)(ii) for purposes of determining whether an employee is included in a unit of employees covered pursuant to a collective bargaining agreement.

(d) *Current benefit structures*—(1) *In general.* One or more current benefit structures exist whenever there is an allocation or benefit accrual whether as a result of additional years of service, changes in compensation, or other factors. Any such increases are treated as benefits attributable to the year of service in which they accrue. A single current benefit structure exists with respect to each portion of a uniform benefit formula (under which contributions and forfeitures are allocated with respect to a plan year in a defined contribution plan or under which an employee's benefit attributable to the current year of service is determined in a defined benefit plan) to the extent that subsidies, optional forms of benefits, rights and features (e.g. social security supplements, ancillary benefits, loans and investment options) are provided on a uniform basis to employees eligible to participate under such formula. To the extent that subsidies, optional forms of benefits, rights and features are not provided on a uniform basis, two or more single current benefit structures exist. An otherwise single current benefit structure comprises separate current benefit structures to the extent it is included in separate plans (as determined under paragraphs (b) and (c) of this section). See §1.401(a)(26)-8(b)-(1) for a transition rule with respect to the provisions taken into account in identifying a plan's current benefit structures for plan years beginning before January 1, 1990.

(2) *Uniform formula*—(i) *In general.* In determining whether a benefit formula is uniform all features in the plan affecting the availability of the benefit and the amount of benefits or contributions accrued must be taken into account. Factors taken into account in making this determination include the rate of accrual in a defined benefit plan and the basis of and conditions to contributions or benefits (e.g. hour-of-service minimums, year-of service requirements and limits, compensation definitions, benefit limits, employment conditions, vesting schedules, levels of mandatory employee contributions, eligibility requirements for participation).

(ii) *Difference in rates of allocation or benefit accrual.* In general, differences in rates of allocations or benefit accruals for different participants under plan will result in separate benefit structures under the plan. However, a formula does not fail to be a uniform formula merely because the rate of contribution allocations or benefit accruals (expressed as percentages of compensation or flat dollar amounts) varies, on a uniform basis for all employees, with years of service or participation (as, for example, in a formula that is backloaded to the extent permitted under section 411(b)(1)-(B)) or varies with entry age (as, for example, with a formula under which benefits accrue under the fractional rule of section 411(b)(1)(C)). Similarly, a formula does not fail to be uniform merely because the rate at which benefits accrue above a stated compensation level differs from the rate at which benefits accrue below such level, without regard to whether such formula satisfies the requirements of section 401(l). A formula does not fail to be a uniform formula merely because it provides that an employee will receive the greatest contribution allocation or benefit accrual produced under one of several formulas that are reasonably available to all employees covered by the formula. In addition, a formula does not fail to be uniform merely because it provides for an allocation on the basis of account balances.

(iii) *Permitted disparity.* A benefit formula under a plan does not fail to be uniform merely because of differences under the formula that are permissible under section 401(l) and, under such rules, are treated as uniform. Thus, for example, if the rates under a defined benefit excess plan's benefit formulas differ based solely on employees' social security retirement ages such that the disparities under such formulas are treated as uniform under section 401(l), such differences are disregarded in determining whether the benefit formulas constitute one or more current benefit structures.

(3) *Uniform subsidies, optional forms of benefits, rights and features*—(i) *In general*. Subsidies, optional forms of benefit, rights and features are provided on a uniform basis with respect to a benefit formula if each such subsidy, optional form of benefit, right and feature is provided on a uniform basis to all participants eligible to benefit under such benefit formula. A subsidy, optional form of benefit, right and feature is provided on a uniform basis only if it is identical with respect to its terms (i.e. frequency of use, dollar limitations, actuarial assumptions). In addition, in the case of a subsidy, optional form of benefit, right or feature, the availability of which is conditioned, the subsidy, optional form of benefit, right or feature is provided on a uniform basis only with respect to those participants with respect to whom the conditions are identical and who satisfy the conditions.

(ii) *Conditions on availability*—(A) *In general*. Whether a participant satisfies conditions on availability of a subsidy, optional form of benefit, right or feature is determined on the basis of the current facts and circumstances with respect to the employee (e.g. the employee's current job classification, division of employment or net worth). Thus, for example, the fact that an employee may, in the future satisfy a condition on availability generally does not cause the conditioned benefit, right or feature to be treated as currently available to such employee. However, to the extent provided in paragraphs (d)(3)(ii)(B) and (C) and subject to the limitations in paragraph (d)(12) with respect to individualized formulas, certain conditions on availability are treated as currently satisfied for purposes of determining whether a subsidy, optional form of benefit, right or feature is provided on a uniform basis.

(B) *Age and service conditions*. In general, for purposes of the rules in this paragraph (d)(3), age conditions and service conditions are treated as satisfied. This exception is not applicable to age or service conditions with respect to optional forms of benefit, rights and features that must be satisfied within a specified period of time, other than termination of employment. However, availability of an optional form of benefit, right or feature subject to such a limited age or service condition may be determined by projecting the age and service of employees to the last date on which such formula, right or feature is available under the plan. An employer's ability to project age and service to the last date on which the formula, right or feature is available under the plan is not cut off by a plan termination occurring prior to that date. Those employees who are not eligible for a benefit because they do not satisfy any applicable conditions during a specified time period are not treated as benefiting under a separate benefit structure.

(C) *Certain other conditions*. Conditions on the availability of benefit formulas, optional forms of benefit, rights or features requiring termination of employment, death, satisfaction of a specified health condition (or failure to meet such condition), disability, hardship, marital status, default on a plan loan secured by a participant's account balance, or execution of a covenant not to compete are treated as satisfied in determining the group of employees benefiting under the current benefit structure containing such formula, right or feature.

(4) *Sections 401(k) and 401(m)*—(i) *In general*. A plan (or portion thereof) that is subject to section 401(k) or 401(m) includes separate current benefit structures to the extent that there are differences in the availability and/or maximum rates of elective contributions subject to section 401(k), after-tax employee contributions subject to section 401(m), or matching contributions subject to section 401(m). Similarly, a plan (or portion thereof) that includes matching contributions subject to section 401(m) includes separate current benefit structures to the extent that the matching contributions are not allocated under a uniform formula with respect to employees' elective contributions or after-tax employee contributions.

(ii) *Elective contributions, employee contributions and matching contributions*. The portion of a plan to which elective contributions under a qualified cash or deferred arrangement (defined under section 401(k)) may be made is a separate benefit structure for purposes of section 401(a)(26). Similarly, the portion of a plan to which employee contributions subject to section 401(m) may be made is a separate benefit structure for purposes of section 401(a)(26). Finally, the portion of a plan to which matching contributions subject to section 401(m) may be made is a separate benefit structure for purposes of section 401(a)(26).

(iii) *Exceptions*. A plan (or portion thereof) that is subject to section 401(k) or 401(m) does not include separate current benefit structures merely because of differences in the allocation of elective contributions or after-tax employee contributions and matching contributions that are solely the result of employees' elections. Similarly, a plan (or portion thereof) that is subject to section 401(k) or 401(m) does not comprise separate current benefit structures merely because the plan imposes uniform limits on the elective contributions or employee contributions that may be made by highly compensated employees to facilitate compliance with the applicable nondiscrimination rules or imposes uniform limits on the elective contributions that any employee can make to assure compliance with the limits under section 402(g) and section 415. Also, separate current benefit structures do not arise merely because of the allocation of qualified nonelective contributions to some or all nonhighly compensated employees eligible under the plan (or portion thereof) subject to section 401(k) or 401(m) if such nonelective contributions both are taken into account for purposes of determining whether elective contributions, employee contributions, or matching contributions satisfy the requirements of section 401(k) or 401(m), as applicable, and are not taken into account in determining whether any other employer contributions satisfy sections 401(a)(4) and 410(b) (other than section 410(b)(2)(A)(ii)). The preceding sentence applies with respect to allocations of qualified nonelective contributions to nonhighly compensated employees without regard to whether such allocations are under a uniform formula.

(5) *Top-heavy contributions and benefits*—(i) *General rule*. A plan does not fail to provide a single current benefit structure merely because the plan includes a formula that provides non-key employees with contributions or benefits required under section 416.

(ii) *Examples*. This paragraph (d)(5) can be illustrated by the following examples:

Example 1. Assume that a defined benefit plan provides that all employees will receive a normal retirement benefit of 1 percent times years of service times final average compensation. However, the plan also provides that non-key employees who perform at least 1000 hours of service will receive a benefit of at least 2 percent times top-heavy years of service (not in excess of 10 years of service) times top-heavy compensation. In determining this plan's current benefit structures, the portion of the benefit formula that is required to comply with section 416 may be disregarded. Thus, this plan has one current benefit structure.

Example 2. Assume the same facts set forth in *Example 1*, except that the plan provides that, whether or not the plan is top-heavy, all employees (rather than only non-key employees) who perform at least 1000 hours of service will receive a benefit of at least 2 percent times years of service (not in excess of 10 years) times compensation. The portion of the formula that reflects the top-heavy requirements must be taken into account in determining this plan's current benefit structure. In this case, the plan is treated as including only one current benefit structure under which each employee earns the greater benefit under the two parts of the formula.

(6) *Contributions for participants who are permanently and totally disabled.* A plan does not fail to provide a single current benefit structure merely because the plan includes a formula that uniformly provides nonhighly compensated employees with contributions pursuant to the provisions of section 415(c)(3)(C).

(7) *Grandfathered benefits*—(i) *General rule.* A defined benefit plan's benefit formula does not fail to be a single current benefit structure merely because such formula provides that an employee will not accrue additional benefits under the current portion of the benefit formula until such employee has accrued under such portion a benefit in excess of such employee's benefit under one or more formulas in effect for prior years that are based wholly on prior years. Such prior benefit may have accrued under the same or a separate plan and may relate to service with the same or prior employers. Benefits fail to be treated as based wholly on prior years if they are based, directly or indirectly, on compensation earned after such prior years (including compensation earned in the current year). Benefits do not fail to be treated as based wholly on prior years merely because such benefits (e.g., early retirement benefits) are subject to an age or years-of-service condition and, in applying such condition or conditions, the current and prior years are taken into account. In addition, if a plan eliminates a right or feature (e.g., single sum distribution option or loan) with respect to future benefits, and provides that such right or feature remains available with respect to benefits accrued as of the date of elimination, the plan's grandfather of such right or feature with respect to prior accrued benefits does not create separate current benefit structures.

(ii) This paragraph (d)(7) can be illustrated by the following examples:

Example 1. Assume that an employer maintains a defined benefit plan under which an employee receives a benefit equal to 2 percent times years of service times final average compensation. Effective January 1, 1990, the plan is amended to provide that an employee receives the greater of (A) 2 percent times years of service up to January 1, 1990, times final average compensation as of December 31, 1989, and (ii) 1½ percent times all years of service times final average compensation as of separation from service. Even though the employees with service prior to 1990, are a closed group and may not accrue additional benefits under this two-part formula for one or more years after 1989 and the other employees will benefit immediately and in full under the latter part of the formula, this is a uniform formula that is a single current benefit structure.

Example 2. Assume the same facts set forth in *Example 1*, except that final average compensation under the former part of the two-part formula is determined based on compensation as of separation from service (i.e., final average compensation is determined by reference to compensation after 1989). Because employees with service prior to 1990, may accrue additional benefits under the former part of the formula, this formula comprises two current benefit structures, one for employees with pre-1990 service and one for employees without any pre-1990 service.

(8) *Benefit offset arrangements*—(i) *General rule.* A plan's contribution or benefit formula that provides for a benefit under the positive portion of the formula that is offset or reduced by contributions or benefits under another plan maintained by the same employer does not fail to comprise a single current benefit structure to the extent that all of the conditions of paragraph (d)(8)(i)(A) through (d)(8)(i)(C) of this section are satisfied. To the extent that these conditions are not satisfied, the contribution or benefit formula will not be treated as uniform and will comprise two or more current benefit structures. See §1.401(a)-(26)-3(b)(6) for the determination of who is benefiting under a current benefit structure that includes an offset or reduction.

(A) *Offset condition.* This condition is satisfied only if the formula being tested provides that contributions or benefits under its positive portion are offset or reduced by contributions or benefits accrued under another plan maintained by the same employer, and the contributions or benefits used to offset or reduce the contributions or benefits under the positive portion of the formula being tested were originally accrued under such other plan (or a predecessor plan). Thus, contributions or benefits transferred or rolled over to the other plan generally may not be used to offset the benefit under the positive portion of the formula being tested.

(B) *Benefiting condition.* This condition is satisfied only if the employees who benefit under the formula being tested also benefit, with respect to those contributions or benefits that are used to offset or reduce contributions or benefits under the formula being tested, under the other plan on a reasonable and uniform basis. If, with respect to employees who benefit under the formula being tested, some employees benefit and some employees do not benefit under the other plan, the formula being tested fails to be a single current benefit structure. Similarly, employees under the formula being tested do not benefit under the other plan on a reasonable and uniform basis if, for any year, the contributions or benefits used to offset or reduce contributions or benefits under the formula being tested are attributable to a benefit structure that is not uniform with respect to all such employees. Finally, employees do not benefit on a reasonable or uniform basis under the other plan if the method and assumptions for calculating the extent to which contributions or benefits under the other plan offset or reduce contributions or benefits under the formula being tested are not uniform with respect to such employees.

(C) *Anti-multiple use condition.* This condition is satisfied only if the contributions or benefits under the plan that are used to offset or reduce the contributions or benefits under the formula being tested are not used to offset or reduce contributions or benefits under any other plan or any other formula.

(D) *Examples.* This paragraph (d)(8) can be illustrated by the following examples.

Example 1. Assume that all 100 active employees in defined benefit plan A benefit under a benefit formula that provides a benefit equal to 1½ percent times years of service times final average compensation. However, with respect to 30 active employees, the benefit under this positive benefit of the formula is offset by the benefit under a single formula in plan B of the employer. With respect to another 25 active employees, the positive plan A benefit is offset by the benefit under a separate formula in plan C, and with respect to the remaining 45 participants, the positive plan A benefit is not offset by any other benefit. The benefit formula in plan A comprises three separate current benefit structures for purposes of section 401(a)-(26).

Example 2. Employer X, a partnership with two partners and seven common law employees, maintains two defined benefit plans (X and Y) and one defined contribution plan (Z). Partner X and the seven employees participate in defined benefit plan X, which has a single benefit formula that provides for an offset by any benefit provided under defined contribution plan Z. Partner Y and the seven employees participate in defined benefit plan Y, which has a single benefit formula (different from plan X's formula) that also provides for an offset by any benefit provided under plan Z. The seven employees (but not the partners) also participate in plan Z, which provides a uniform contribution allocation formula for all participants. Plans X and Y violate both the benefiting condition and the anti-multiple use condition. For both reasons, Plans X and Y each provide two separate benefit structures, one for the participating partner and another for the seven employees.

(9) *Exception for certain section 414(n) recipient employers.* For purposes

of the benefit-offset rule in paragraph (d)(8)(i) of this section, an employer-recipient within the meaning of section 414(n) and (o) that maintains a defined contribution plan covering leased employees (which employees are treated as employees of such employer-recipient within the meaning of section 414(n)(2) and 414(o)(2)) that is offset or reduced by contributions to defined contribution plan maintained by the leasing organization may treat such contributions as contributions to a plan maintained by the recipient organization for purposes of this paragraph (d)(8)(i)(A) and may treat employees of the recipient organization as benefiting under the plan of the leasing organization for purposes of this paragraph (d)(8)(i)(B) only if the following requirements are satisfied: the contributions relate to service with the recipient organization; the contributions are made to a money purchase plan that would be a safe-harbor plan within the meaning of section 414(n)(5) without regard to the 20-percent requirement applicable to such determination; and, the requirements in paragraph (d)(8)(i)(A) through (d)(8)(i)(C) of this section are otherwise satisfied with respect to such benefit offset arrangement. In applying the requirements of paragraph (d)(8)(i)(B) of this section, employees of the recipient who are not leased from the leasing organizations are not required to benefit under the plan of the leasing organization.

(10) *Inactive benefit formulas*—(i) *General rule.* If a plan includes a benefit formula but no employee is currently eligible to accrue any additional benefits under the formula, such formula is not a current benefit structure under the plan. Similarly, if a plan includes a benefit formula with respect to which one or more employees are eligible, but the benefit formula does not provide any additional benefit to such employees, such formula is not a current benefit structure.

(ii) *Certain profit-sharing plans.* A profit-sharing plan or stock bonus plan does not fail to have a current benefit structure merely because there is no allocation in the current year because the employer maintaining the plan fails to make a contribution. Any employee covered by such a profit-sharing or stock bonus plan is treated as benefiting under a current benefit structure in the profit-sharing plan for a plan year if such employee both satisfies all of the applicable conditions to receiving a maximum contribution allocation under such current benefit structure for such year and fails to receive such allocation merely because the employer fails to make a contribution to the plan for such year and there are no forfeited amounts for reallocation for such year.

(11) *Other arrangements that create separate current benefit structures*—(i) *In general.* If, under all the facts and circumstances, an arrangement (either under or outside the plan) has the effect of modifying any feature under the plan taken into account in determining an employee's benefit, providing any employee with any priority or greater interest in a portion of the assets in the plan, or linking any financial matter involving an employee to all or a portion of the assets in the plan in a way that has the effect of creating separate accounts, such arrangement will be treated as creating a separate current benefit structure within the plan. However, separate current benefit structures do not arise merely because a partnership agreement provides for allocation of the cost of funding a defined benefit plan or the allocation of surplus assets upon termination of such plan among partners in proportion to their partnership interest.

(ii) *Examples.* The following examples illustrate certain situations in which other arrangements will or will not be treated as creating separate benefit structures:

Example 1. Employer A maintains a defined benefit plan under which each highly compensated employee has the discretion and authority to direct the investment of a portion of the plan's assets that represent the accumulated contributions with respect to that employee's plan benefits. In addition, by agreement outside the plan, if the product of the employee's investment direction exceeds the value needed to fund that employee's benefits, Employer A agrees to make a special payment to the participant. In this case, each separate portion of the pool of assets over which an employee has investment authority is considered a separate current benefit structure for such employee.

Example 2. Employer B is a partnership that maintains a defined benefit plan. Under the partnership agreement, the cost of providing the current benefit accrual for each partner is allocated to such partner in determining such partner's distributive share of profit or loss. This plan does not include separate plans merely because of this arrangement.

Example 3. Employer C is a partnership that maintains a defined benefit plan. The partnership agreement provides that, upon termination of the plan, a special allocation is to be made to a partner representing the amount of the excess plan assets in proportion to such partner's accrued benefit under the plan. This arrangement results in the defined benefit plan being treated as including a separate current benefit structure for each partner. The same agreement modified to allocate excess plan assets after reversion to the partnership on the basis of partnership share does not create a separate benefit structure with respect to the partner.

(12) *Examples*—(i) *Defined contribution plans.* The following examples illustrate the meaning of current benefit structure with respect to defined contribution plans. Assume that the plans in the following examples provide identical benefits with respect to all participants except to the extent specifically described in the example. Also, assume that, based on all of the facts and circumstances, none of the formulas described in these examples comprise individualized formulas.

Example 1. Plan A allocates contributions and forfeitures uniformly on the basis of the ratio of each participant's compensation to the total compensation of all participants under the plan using the same definition of compensation for all participants. Plan A has one current benefit structure.

Example 2. Plan B benefits two categories of plan participants, category 1 and category 2. Category 1 participants are allocated contributions equal to 4 percent of compensation, while category 2 participants are allocated contributions equal to 10 percent of compensation. Plan B has two current benefit structures.

Example 3. All participants in Plan C receive contribution allocations equal to 5 percent of current compensation. However, forfeitures are allocated among category 1 participants on the basis of compensation and among category 2 participants on the basis of account balances. Plan C has two current benefit structures. The result would be the same if the allocation of forfeitures in plan C for category 1 participants was on the basis of the ratio of the participant's current compensation to the current compensation of all category 1 participants and among category 2 participants on the basis of the ratio of the participant's current compensation to the current compensation of all category 2 participants.

Example 4. Under Plan D, the employer contributions for category 1 participants and category 2 participants are determined separately—the contribution for category 1 participants is based on the profits in division A, while the contribution for category 2 participants is based on the profits in division B. The employer contributions for each category of participants are allocated among participants on a uniform basis. Plan D has two current benefit structures.

Example 5. Plan E allocates contributions among all participants under a uniform allocation formula which is based, in part, on a participant's years of service with the employer. Participants with 10 or fewer years of service receive allocations equal to 5 percent of compensation, and participants with additional years of service receive an additional allocation of 1 percent of compensation for every 2 additional years of service (in excess of 10 years) with the employer. Plan E has one current benefit structure.

Example 6. Plan F allocates contributions among all participants on the basis of units. Participants are credited with one unit for each $2500 of compensation and one unit for each year of service with the employer. Also, plan F allocates forfeitures among all participants on the basis of the ratio of a participant's compensation to the total compensation of all participants. Plan F has one current benefit structure.

Example 7. Plan G allocates contributions among all participants equal to 5 percent of compensation, but in no event less than $300. Plan G has one current benefit structure even though the actual allocation for particular participants may vary as a percentage of compensation due to the minimum allocation provision.

Example 8. Plan H is a target benefit plan that allocates contributions among all participants based on a uniform unit benefit formula providing a retirement benefit of 1 percent of compensation per year of service. A uniform method is used to derive the contribution allocation for each employee. Plan H has one current benefit structure, even though the contribution allocations for participants are not a uniform percentage of compensation.

(ii) *Defined benefit plans.* The following examples illustrate the meaning of current benefit structure with respect to defined benefit plans. Assume that the plans in the following examples provide identical benefits with respect to all participants except to the extent specifically described in the example. Also, assume that, based on all of the facts and circumstances, none of the formulas described in these examples comprise individualized formulas.

Example 1. Plan A has a uniform, unit benefit formula that provides an annual benefit commencing at normal retirement age of 1 percent of final average pay per year of service. Plan A has one current benefit structure.

Example 2. Plan B's benefit formula provides a benefit of $10 per month for each of a participant's first 10 years of service, $11 per month for each of the second 10 years of service, $12 per month for each of the next 10 years of service, and no additional benefit for any additional years of service. Because plan B's benefit formula provides for a uniform schedule of benefit accruals for all participants, plan B has one current benefit structure.

Example 3. Plan C's formula provides each employee with a benefit equal to 2 percent per year of service times final average pay for the first 15 years of service and 1 percent per year of service times final average pay for each additional year of service beyond 15 years. Plan C has one current benefit structure even though, under the formula for a year, different employees have different accrual rates.

Example 4. Plan D's benefit formula provides an annual pension amount for life for every participant equal to the greatest of (A) $500 for each year of service; (B) 2 percent of each year's compensation times years of service; or (C) $3,000. Plan D has one current benefit structure even though participants may benefit under different parts of the formula.

Example 5. Plan E's benefit formula provides all participants with a benefit of 35 percent of final average pay, which is accrued ratably under the fractional rule over years of plan participation until normal retirement age. Plan E has one current benefit structure even though the rates of annual accrual for participants differ.

Example 6. Plan F's benefit formula provides all participants with an annual benefit for life of 2 percent of average annual pay times years of service. Plan F also provides an unreduced joint and survivor annuity for married participants. Plan F has one current benefit structure, even though some participants are married and some participants are not married, because all participants are accruing benefits under a single benefit structure.

Example 7. Plan G's benefit formula provides all participants with an annual benefit for life equal to 2½ percent of compensation per year of service for compensation above covered compensation and 2 percent of compensation per year of service for compensation below covered compensation. Plan G has one current benefit structure even though the actual benefit rates for participants will differ based on the amounts of a participant's compensation above covered compensation.

Example 8. Plan H's benefit formula provides all participants an annual benefit for life of 45 percent of final average pay. Such benefit is accrued under the fractional rule for category 1 participants, with a 15 year minimum accrual period. For category 2 participants, the benefit is accrued under a unit benefit formula that provides an annual accrual of 3 percent times years of service (not in excess of 15 years) times final average pay. Plan H has two current benefit structures.

Example 9. Plan I's benefit formula provides for all participants an annual retirement benefit for life of 50 percent of final average pay. The retirement benefit is payable to category 1 participants at normal retirement age, with an actuarial reduction for early commencement. For category 2 participants, there is no actuarial reduction for early commencement if a participant has 30 years of service and has attained age 55. Plan I has two current benefit structures.

Example 10. Plan J's benefit formula provides for all participants an annual benefit for life of 2 percent of the participant's compensation times years of service. For category 1 participants, the compensation taken into account is career average compensation, while for category 2 participants the compensation is the annual average of the participant's final 5 years of service. Plan J has two current benefit structures.

Example 11. Plan K is a contributory defined benefit plan with a benefit formula that provides an annual benefit of 1 percent of final average compensation for each year of service for which the participant makes an employee contribution of one percent of compensation, and an additional ½ percent of final average compensation for each year of service for which the participant makes an additional employee contribution of 1 percent of compensation. Participants may make employee contributions of 0 percent, 1 percent, 2 percent, or 3 percent of compensation. Plan K does not separately account for the employee contributions. Because the special rule for plans subject to section 401(m) does not apply with respect to the employee contributions under plan K, such plan has three current benefit structures (i.e., employee contributions of 1 percent, 2 percent, and 3 percent). (In accordance with §1.401(a)(26)-1(c)(1), these three current benefit structures may be restructured as three current benefit structures, each one providing for an employee contribution of 1 percent.)

Example 12. Plan L is a defined benefit plan under which all participants earn an annual benefit for life, commencing at age 65, equal to 1 percent times years of service times final average compensation. In January 1990, the employer amends the plan to provide that any employee who is at least 55 years of age, has at least 25 years of service, and separates from service between July 1 and October 1 of 1990, may receive an unreduced annual benefit commencing upon separation from service. Plan L has two current benefit structures for 1990.

(13) *Retroactive benefits.* A benefit increase provided with respect to active employees in the current year is one or more current benefit structures even if the benefit increase is based on prior years of service. Similarly, a benefit increase provided to former employees (including, for example, ad hoc cost-of-living increases) is one or more current benefit structures for the year in which the increase is provided. Also, a provision that provides for the allocation, among employees under a terminating defined benefit plan, of assets in excess of the amount necessary to satisfy all of the plan's liabilities is one or more current benefit structures in the year of allocation, depending on the uniformity and characteristics of the allocation formula. A formula providing a retroactive benefit increase that differs with respect to years prior to a specified date (e.g., December 31, 1989, or plan years beginning before the first plan year beginning after December 31, 1989) and years after a specified date comprises two current benefit structures because all portions of the formula are not reasonably available to all employees.

(14) *Individualized formulas*—(i) *General rule.* Notwithstanding the rules provided in this section, an otherwise uniform formula, subsidy, optional form of benefit, right or feature may be treated as comprising separate current benefit structures if, under the facts and circumstances, the formula, subsidy, optional form of benefit, right or feature is based on significantly individualized factors or the effect of such formula, right or feature with respect to employees' allocation or benefit rates, or other rights under the plan is similar to the effect of separate formulas, rights or features.

(ii) *Examples.* This paragraph (d)(14) may be illustrated by the following examples:

Example 1. Assume that an employer with 500 active employees maintains a defined contribution plan under which contributions are allocated among all of the employer's active employees based on their years of service with the employer. Under the allocation formula, each employee receives a contribution allocation for a plan year equal to 5 percent of compensation, plus an additional 1 percent of compensation for each year of service with the employer. The maximum allocation for any year is 20 percent of compensation. Because, in this case, the number of employees under the plan substantially exceeds the number of different allocation rates under the plan's allocation formula and all allocation rates are reasonably available to all employees, the facts and circumstances indicate that the plan's formula does not comprise separate, individualized formulas.

Example 2. Assume that an employer with 5 active employees maintains a defined contribution plan under which contributions are allocated among all of the active employees based on their years of service with the employer. Under the allocation formula, each employee with fewer than 10 years of service receives an allocation of 7 percent of compensation and each employee with 10 or more years of service receives an allocation of 10 percent of compensation. One employee, who is the sole highly compensated employee of the employer, has over 10 years of service; the other four employees each have fewer than 5 years of service. In addition, no employees have separated from service with more than 10 years of service and, based on the facts and circumstances, it is not reasonable to expect that the four employees will remain with the employer for a full 10 years of service. Thus, these facts and circumstances indicate that this allocation formula comprises two individualized formulas and accordingly is treated as two separate current benefit structures.

(e) *Restructuring current benefit formulas*—(1) *General rule*. If two or more current benefit structures under a plan would constitute a single structure but for differences in the benefit formulas, and the formulas are identical in all respects except that the rates of accrual or contribution allocation are different (thus, for example, the formulas use the same compensation base, credit service in the same manner and have the same vesting schedule), an employer may restructure the benefit structures as two or more separate benefit structures, one including the portion of the formulas that is common to each of the benefit structures, and one or more benefit structures including the portion of the formula that is not common to each of the original benefit structures. For purposes of this paragraph (e), the common or lesser included benefit formula within a plan must be treated as a single current benefit structure with respect to such plan and each restructured benefit structure must be uniform with respect to the benefit formula. Thus, if a plan that is otherwise uniform with respect to all benefits, rights and features, provides a benefit of 50% final average pay for division A, 55% final average pay for division B, and 60% final average pay for division C, restructuring under this rule would result in a benefit structure of 50% of final average pay for employees of divisions A, B and C, 5% of final average pay for employees of division B and C, and 5% of final average pay for employees of division C. Restructuring under this paragraph (e) does not require that the employer actually amend a plan's provisions to reflect the restructuring. Rather, restructuring is merely one method of testing current benefit structures under section 401(a)(26). See §1.401(a)(26)-1(c)(1) for rules about testing two or more restructured current benefit formulas.

(2) *Examples*. The rule in this paragraph (e) may be illustrated by the following examples:

Example 1. Assume that a defined benefit plan includes two current benefit formulas—one of which benefits the 300 active employees of division A and provides a benefit of 1¼ percent times years of service times final average compensation, and the other of which benefits the 30 active employees of division B and provides a benefit of 1 percent times years of service times final average compensation. Solely for purposes of testing these current benefit structures under section 401(a)(26), such formulas may be restructured as one restructured current benefit formula providing a benefit of 1 percent times years of service times final average compensation (and benefits all 330 active employees of divisions A and B), and one restructured current benefit formula providing a benefit of ¼ percent times years of service times final average compensation (and benefits division A's 300 active employees).

Example 2. Employer B maintains a defined contribution plan that provides a 5 percent contribution for 100 Division A employees, and a 4 percent contribution for 30 Division B employees. All other rights and features under the plan are identical with respect to all employees. Solely for purposes of testing these current benefit formulas under section 401(a)(26), such formulas may be restructured the following two benefit formulas: A separate formula providing a 4 percent contribution to the 100 Division A employees and the 30 Division B employees, and a separate formula providing an additional 1 percent contribution to the 100 Division A employees.

Example 3. Employer C maintains a plan including a qualified cash or deferred arrangement in which both 70 division A employees and 30 division B employees are eligible to participate. Under the plan, the employer makes a matching contribution with respect to the first six percent of elective contributions: In the case of Division A employees the employer matching contribution is 50 percent of an employee's elective contributions, in the case of Division B employees, the employer matching contribution is 30 percent of an employee's elective contributions. In all other respects, all employees have identical rights under the plan. The plan includes three separate benefit structures: a cash or deferred arrangement benefiting 100 employees, a 50 percent matching arrangement benefiting 70 Division A employees, and a 30 percent matching arrangement benefiting 30 Division B employees. The 30 percent matching benefit structure fails to satisfy section 401(a)(26) because it benefits only 30 employees. The plan may be restructured and treated as if it contained the following three separate benefit formulas: a cash or deferred arrangement benefiting 100 employees, a 30 percent matching feature benefiting 100 employees (including the 30 division B employees and the 70 Division A employees), and an additional 20 percent matching feature benefiting the 70 Division A employees. As restructured, all three separate structures benefit at least 50 employees, and thus satisfy section 401(a)(26).

Example 4. Employer D maintains a defined benefit plan under which 100 employees benefit. The plan provides a normal retirement benefit of 2 percent of pay times final average compensation times years of service. All employees under the plan have identical rights except that the plan provides for an unreduced early retirement benefit for employees with at least 20 years of service and such early retirement benefit is available only to a group of 80 employees. The plan contains two separate benefit structures: one structure benefits 80 employees and includes the early retirement benefit, the second structure has no early retirement benefit and benefits 20 employees. The plan cannot be restructured and treated as if it contained two separate benefit structures, one benefit structure including all rights and features under the plan that benefits all 100 employees, and the other benefit structure including only the early retirement benefit that benefits 80 employees because rights and features cannot be restructured.

Example 5. Employer E maintains a defined contribution plan providing a 6 percent contribution for 30 division A employees, and a 3 percent contribution for 50 division B employees. The plan contains two separate benefit formulas, a 6 percent benefit formula, benefiting 30 employees, and a 3 percent benefit formula benefiting 50 employees. The 6 percent benefit formula fails to satisfy section 401(a)(26). Assume that the 6 percent formula does not satisfy the requirements of §1.401(a)-(26)-1(c)(4). The plan cannot be restructured into benefit structures that satisfy 401(a)(26). The plan can be restructured into a 3 percent benefit formula that benefits all 80 Division A and B employees, and a 3 percent benefit formula that benefits 30 Division A employees. Under this restructuring, the latter 3 percent benefit formula would fail to satisfy section 401(a)(26).

Example 6. Employer F maintains a defined benefit plan covering 100 employees that provides a benefit equal to 1 percent of final average compensation times years of service to 50 category 1 employees, and a benefit equal to 2 percent times career average compensation times years of service to 50 category 2 employees. A lump sum distribution option is available to 50 employees, including 25 category 1 employees and 25 category 2 employees. The plan includes four separate benefit structures: one benefiting 25 employees under the final average compensation formula who cannot receive a lump sum; one benefiting 25 employees under the final average compensation formula who may receive a lump sum; one benefiting 25 employees under the career average compensation formula who cannot receive a lump sum; and one benefiting 25 employees under the career average compensation formula who may receive a lump sum. The plan cannot be restructured in a manner that establishes that the plan satisfies section 401(a)(26) even though 50 employees benefit under the final average compensation formula and so under the career average compensation formula, and 50 employees may receive a lump sum.

(f) *Prior benefit structure*. The prior benefit structure under a defined benefit plan includes all benefit structures that, for prior years, were (or, prior to the first day for which section 401(a)(26) applies to such plan, would have been) current benefit structures under the plan (or under any other plan) and are or were taken into account at any time in determining any employee's benefit under the plan (including benefits originally accrued under another plan). This is the case even if the plan's prior benefit structure is identical to the plan's current benefit structure. Each defined benefit plan has only one prior benefit structure and all accrued benefits under the plan as of the beginning of a plan year (including benefits rolled over or transferred to such plan) are included in such prior benefit structure for such year.

(g) *Additional rules*. The Commissioner may, only in revenue rulings, notices or other documents of general applicability, prescribe such additional guidance as may be necessary or appropriate with respect to the application of this section.

§1.401(a)(26)-3 Employees who benefit under a plan and current benefit structure.

(a) *In general.* An employee is treated as benefiting under a current benefit structure under a plan only in accordance with the rules of paragraph (b) of this section. Also, in certain situations, it is necessary to determine whether an employee is benefiting under a plan (rather than under the plan's current benefit structure). Such determination may be made only in accordance with the rules of paragraph (c) of this section.

(b) *Benefiting under a current benefit structure*—(1) *Maximum benefit accrual rule*—(i) *General rule.* Except as otherwise provided in this paragraph (b), an employee is treated as benefiting under a current benefit structure for a plan year only if the employee actually accrues the maximum benefit that is available to such employee under the current benefit structure for such year. In the case of a defined contribution plan, an employee is treated as accruing the maximum benefit under a current benefit structure only if such employee actually receives the maximum contribution allocation that is available to such employee under the current benefit structure for such year. The maximum benefit or allocation under a current benefit structure for an employee for a plan year is to be determined under the structure by assuming that the employee satisfied all of the applicable accrual or allocation conditions relating to the current year (e.g., hour-of-service or employment conditions, and mandatory employee contributions). Failure to receive a maximum contribution or benefit allocation that arises solely because of a uniform and otherwise permissible entry date provision under a plan will not result in an employee being treated as failing to benefit under a current benefit structure.

(ii) *Examples.* The following are examples of benefiting within the meaning of paragraph (b)(1) of this section:

Example 1. An employer maintains a defined benefit plan under which all active employees accrue a benefit equal to 2 percent times years of service times final average compensation by making a mandatory employee contribution equal to 1 percent of compensation. Employees who fail to make the mandatory employee contribution, and thus do not accrue the benefit under the current benefit structure, are not treated as benefiting under the current benefit structure for the year.

Example 2. An employer maintains a defined benefit plan under which all employees who perform at least 1000 hours of service during the plan year accrue a benefit of 2 percent times years of service times final average compensation for the year. Only those employees who perform at least 1000 hours of service during the plan year are treated as benefiting under the current benefit structure for the year.

Example 3. An employer maintains a defined contribution plan under which all employees who are employed by the employer on the last day of the plan year receive a 10 percent of compensation allocation under a current benefit structure. Only employees who are employed by the employer on the last day of the plan year, and who thus receive an allocation, are treated as benefiting under the current benefit structure for the year.

Example 4. Plan M is a defined benefit plan under which all employees earn an annual benefit for life, commencing at age 65, equal to 1 percent times years of service times final average compensation. In January 1990, the employer amends the plan to provide that any employee who is at least 55 years of age, has at least 25 years of service, and separates from service between July 1 and October 1 of 1990, may receive an unreduced annual benefit commencing upon separation from service. Plan M has two current benefit structures for 1990. An employee who satisfies the applicable age and service eligibility conditions and thus who would receive the unreduced early retirement benefit if such employee separated from service during the applicable window period is treated as benefiting under the current benefit structure providing the unreduced early retirement benefit, without regard to whether the employee actually separates from service and receives the unreduced early retirement benefit.

(2) *Partial benefit accruals*—(i) *In general.* An employee is treated as benefiting under a current benefit structure under a defined benefit plan even though such employee fails to accrue the maximum benefit under the plan for the current year of service, if such failure was merely because the employee performed fewer than the required minimum number of hours of service for the maximum benefit for the year and, instead, the employee accrued a pro rata portion of the maximum benefit for such year. For purposes of this rule, in determining the pro rata portion of the maximum benefit for an employee for a year, the maximum benefit for the year is the maximum benefit available under the formula determined by assuming that all hour-of-service requirements are satisfied. Also, the pro rata portion of this maximum benefit must be determined as if such maximum benefit were available for the lesser of the actual number of hours of service required under the plan or 2080 hours of service.

(ii) *Examples.* The following are examples of the partial benefit accrual rules of this paragraph (b)(2):

Example 1. Defined benefit plan X's benefit formula provides that a participant who performs fewer than 1000 hours of service for a year does not accrue any benefit for such year, a participant who performs at least 2000 hours of service for a year accrues the maximum benefit for such year (i.e., 1 percent times final pay times years of service), and a participant who performs between 1000 and 2000 hours of service for a plan year accrues a partial benefit in such year based on a fraction, the numerator of which is the number of hours performed by the participant and denominator of which is 2000 hours. (An employee's pay is annualized under the plan formula.) Plan X has one current benefit structure. Participant A performs 900 hours of service for the year and thus does not accrue any benefit under the plan for such year. Participant B performs 1000 hours of service and, thus, accrues 50 percent of the maximum benefit. Participant C performs 1500 hours and thus accrues 75 percent of the maximum benefit for the year. Participant D performs over 2000 hours and thus accrues the maximum benefit for the year. Participant A is treated as not benefiting under the current benefit structure for such year, while participants B, C, and D are treated as having accrued the maximum benefit for the current year and thus as having benefited under the current benefit structure.

Example 2. Assume the same facts as in *Example 1*, except that the defined benefit plan's formula also provides that each participant accrues a minimum benefit of ¼ percent times career average compensation times years of service regardless of the participant's number of hours of service for any year. Such formula continues to be a single current benefit structure because each participant will accrue the greater of the benefit based on the participant's hours of service (in excess of 1,000 hours) or the minimum ¼ percent benefit. Nevertheless, even if participant A accrues an additional benefit for the current year, such participant did not accrue the maximum benefit and thus is not treated as benefiting for the year.

Example 3. Assume the same facts as in *Example 1*, except that the plan provides that a participant who performs at least 100 hours of service for a year will accrue a pro rata portion of the maximum benefit available under the formula, which is a full 1 percent for participants with at least 2000 hours. Participant A performed 900 hours of service and thus receives a benefit equal to 0.45 percent times final average pay for the current year. Participant A thus may be treated as benefiting under the plan's current benefit structure.

(3) *Section 401(k) and section 401(m).* (i) An employee is treated as benefiting under a current benefit structure that is subject to either section 401(k) or section 401(m) for a plan year only if such employee is an eligible employee with respect to such current benefit structure for such year. For example, an employee is treated as benefiting under a current benefit structure that is a qualified cash or deferred arrangement only if the employee is an eligible employee with respect to such arrangement for the year. This is the case without regard to whether the employee has a benefit under the plan and without regard to whether the employee makes elective contributions under the arrangement for such year. Similarly, an employee is treated as benefiting under a current benefit structure of a plan that accepts after-

tax employee contributions subject to section 401(m) only if such employee is an eligible employee with respect to such current benefit structure for such year.

(ii) *Example.* Defined contribution plan Z permits eligible employees to make after-tax employee contributions and provides for employer matching contributions equal to employee contributions up to 6 percent of compensation. This plan has two current benefit structures. For the current year, employee A is eligible to make employee contributions but declines to do so and, thus, is not credited with any employer matching contributions. Employee A may be treated as benefiting under both current benefit structures for the year.

(4) *Section 415 limits.* An employee may be treated as benefiting under a current benefit structure for a plan year if such employee both satisfies all of the applicable conditions for accruing the maximum benefit under the current benefit structure for such year and fails to accrue the maximum benefit merely because of the section 415 limits on annual contributions and benefits.

(5) *Certain plan limits.* (i) An employee may be treated as benefiting under a current benefit structure for a plan year if such employee both satisfies all of the applicable conditions to accruing the maximum benefit under such current benefit structure for such year and fails to accrue such maximum benefit merely because of a uniformly applicable benefit limit under the plan's current benefit structure.

(ii) The following example illustrates the rule of this paragraph (b)(5):

Example. Defined benefit plan Y has one current benefit structure that provides for an annual benefit for life equal to 1 percent times final average compensation times years of service. However, only an employee's first 30 years of service are taken into account under this formula. For the current year, employee Z is age 60 and has performed over 30 years of service. Employee Z may be treated as benefiting under the current benefit structure for the year even though Z is not credited with an additional year under the plan's current benefit structure because of the 30-year limit on years of service taken into account under plan.

(6) *Benefit offset arrangements.* In the case of a current benefit structure under a plan that provides that the benefit determined under the positive portion of the formula is offset or reduced by contributions or benefits under another plan, an employee is treated as accruing the maximum benefit under such structure for a plan year only if the current benefit structure that includes an offset or reduction for other benefits satisfies §1.401(a)(26)-2(d)(8), and the employee would have accrued the maximum benefit if the offset or reduction portion of the benefit formula were disregarded.

(7) *Certain grandfathered benefits.* An employee is treated as accruing the maximum benefit under a current benefit structure under a defined benefit plan that includes an offset or reduction for grandfathered benefits and satisfies §1.401(a)(26)-2(d)(7)(i) only if such employee accrues the maximum benefit under such current benefit structure for such year, or if such employee would have accrued the maximum benefit if the offset or reduction portion of the benefit formula were disregarded.

(c) *Benefiting under a plan.* An employee is treated as benefiting under a plan for a plan year only if the employee has a benefit under the plan at some time during the year. An employee who does not have a benefit under a plan at any time during the year is not treated as benefiting under the plan for such year. This is the case even if the employee is eligible to (but does not) accrue a benefit for the plan year and without regard to the reason for the failure of an employee to accrue a benefit. Thus, for example, an employee who, at the beginning of a plan year, does not have an accrued benefit will be treated as benefiting under the plan only if, during such year, the employee actually accrues a benefit under the plan. Similarly, an employee who, as of the beginning of a plan year, has an accrued benefit under a plan is treated as benefiting under the plan for the plan year even though such employee does not accrue, or is not eligible to accrue, an additional benefit under the plan for such year. An employee who receives a total distribution of his benefit during a plan year is treated as benefiting under the plan for such year.

(d) *Additional rules.* The Commissioner may, only in revenue rulings, notices or other documents of general applicability, prescribe such additional guidance as may be necessary or appropriate with respect to the application of this section.

§1.401(a)(26)-4 Excludable employees.

(a) *Employees*—(1) *In general.* Except as specifically provided otherwise in this section, in applying section 401(a)(26) with respect to either active employees, former employees, or both active and former employees, as applicable, all active employees (other than excludable active employees described in paragraph (b) of this section), all former employees (other than excludable former employees described in paragraph (c) of this section), or both, as the case may be, are to be taken into account.

(2) *Rules of application.* Except as specifically provided otherwise in this section, the rules of this section are to be applied by reference only to the plan, or current benefit structures, or prior benefit structure being tested. See §1.401(a)-(26)-2 for rules governing the identification of the plan, current benefit structures, and prior benefit structure for purposes of section 401(a)(26).

(b) *Excludable active employees.* An active employee is an excludable active employee if such employee is covered by one or more of the following exclusions:

(1) *Minimum age and service exclusions*—(i) *In general.* An employee who is excluded from consideration under section 410(b)(4)(A) (relating to employees not satisfying certain minimum age and service requirements) for purposes of determining whether a plan satisfies section 410(b) may be treated as an excludable employee with respect to such plan and the current and prior benefit structures included therein.

(ii) *Coverage extended to otherwise excludable employees.* An active employee who would be excludable under paragraph (b)(1)(i) of this section but for the fact that the employee (or another employee with the same age and service) is not excluded from coverage under the plan (i.e., an otherwise excludable employee) may nevertheless be treated as an excludable employee with respect to such plan and the current benefit structures and prior benefit structure included therein if each of the following conditions is satisfied:

(A) The plan under which the otherwise excludable employee benefits also benefits active employees who are not otherwise excludable.

(B) The plan and current benefit structure under which the otherwise excludable employee benefits satisfy §1.401(a)(26)-1(b), both by reference only to otherwise excludable employees and by reference only to active employees who are not otherwise excludable.

(C) The contributions or benefits provided to the otherwise excludable employees (expressed as percentages of compensation) are not greater than the contributions or benefits provided to the employees who are not otherwise excludable under the plan.

(D) No highly compensated employee is included in the group of otherwise excludable employees for more than one plan year.

(iii) *Examples.* The following examples illustrate certain of the minimum age and service exclusion requirements:

Example 1. Employer Y maintains Plan Y under which employees who have not completed 1 year of service are not eligible to participate. Employer Y has six employees, two of whom participate in Plan Y and four of whom have not completed 1 year of service and are, therefore, not eligible to participate in Plan Y. The four employees who have not completed 1 year of service are excludable employees and may be disregarded for purposes of applying the minimum participation test. Therefore, Plan Y meets the minimum participation requirements because both of the two employees who must be considered are participants in Plan Y.

Example 2. Employer X has 100 employees and maintains two plans, Plan 1 and Plan 2. Plan 1 has a minimum age and service requirement and Plan 2 does not. Twenty of X's employees do not meet the minimum age and service requirement under Plan 1. Each plan satisfies the 70-percent ratio test under section 410(b)(1)(B). In testing Plan 1 to determine whether it satisfies the minimum participation requirements, the 20 employees not meeting the minimum age and service requirement under Plan 1 are treated as excludable employees to the same extent that they are treated as excludable employees under section 410(b)(1). In testing Plan 2 to determine whether it satisfies the minimum participation requirements, no employees are treated as excludable employees because they are not treated as excludable employees in testing Plan 2 under section 410(b)(1).

Example 3. Employer Z has 10 employees and maintains a defined benefit plan that has no minimum age and service requirement. However, the plan provides for a lesser accrual for Z's 7 employees who have not met the minimum age and service requirements described in section 410(a)(1)(A). The plan is treated as consisting of two separate benefit structures. In general, none of Z's employees would be treated as excludable in determining whether each separate benefit structure satisfies the minimum participation requirements. However, Z may elect, under paragraph (b)(1) of this section, to exclude the 7 employees not meeting the minimum age and service requirements of the greater benefit structure, provided that the requirements of that section are met.

(2) *Certain air pilots*. An employee who is to be excluded from consideration under section 410(b)(3)(B) (relating to certain air pilots) with respect to a plan may be treated as an excludable employee with respect to such plan and the current and prior benefit structures included therein.

(3) *Certain nonresident aliens*. An employee who is to be excluded from consideration under section 410(b)(3)(C) (relating to certain nonresident aliens) with respect to a plan may be treated as an excludable employee with respect to such plan and the current and prior benefit structures included therein.

(4) *Certain employees covered pursuant to a collective bargaining agreement*—(i) *In general*. An employee who may be excluded from consideration under section 410(b)(3)(A) with respect to a plan (or with respect to any portion of a plan that is treated as a separate plan under paragraph (c) of §1.401(a)(26)-2) may be treated as an excludable employee with respect to such plan (or portion thereof) and the current and prior benefit structures included therein. This rule may be applied separately with respect to each collective bargaining agreement. See §1.401(a)(26)-1(d)(2)(ii) with respect to whether employees are covered pursuant to a collective bargaining agreement.

(ii) *Exception for professionals*. Paragraph (b)(4)(i) of this section does not apply to a collective bargaining agreement if more than 2 percent of the employees of the employer who are covered pursuant to such agreement are professionals (as defined in §1.401(a)(26)-7(g)).

(5) *Certain employees not covered pursuant to a collective bargaining agreement*. An employee who is not included in any group of employees who are covered under any plan pursuant to any collective bargaining agreement may be treated as an excludable employee with respect to any plan (including any portion of a plan that is treated as a separate plan under §1.401(a)(26)-2) that covers only employees who are included in a group of employees who are covered pursuant to one or more collective bargaining agreements.

(6) *Examples*. The following examples illustrate the excludable employee rules that relate to employees covered pursuant to collective bargaining agreements:

Example 1. Employer Z has 70 collectively bargained employees and 30 non-collectively bargained employees. Under Plan Z, only non-collectively bargained employees are eligible to participate. The 70 collectively bargained employees are treated as excludable employees and thus may be disregarded in applying section 401(a)(26) to Plan Z.

Example 2. Assume the same facts as *Example 1*, except that the Commissioner has determined that the employee representative is not a bona fide employee representative under section 7701(a)(46) and thus there are no "collectively bargained employees." In this case, all employees of Z must be considered in determining whether section 401(a)(26) is met.

Example 3. Employer X has 30 collectively bargained employees and 70 non-collectively bargained employees and maintains Plan X, which benefits only the 30 collectively bargained employees. Employer X may elect to treat the non-collectively bargained employees as excludable employees and disregard such excludable employees in applying section 401(a)(26) to the collectively bargained plan.

Example 4. Assume the same facts as *Example 3*, except that the Commissioner has determined that the employee representative is not a bona fide employee representative under section 7701(a)(46) and thus there is no recognized collective bargaining agreement. In this case, the employer may not elect to treat the non-collectively bargained employees of X as excludable employees.

Example 5. Assume the same facts as *Example 3*, except that 3 percent of the 30 collectively bargained employees are professionals. In this case, the employer may not elect to treat the non-collectively bargained employees of X as excludable employees.

Example 6. Employer W has 100 collectively bargained employees. Thirty of W's employees are represented by Collective Bargaining Unit 1 and covered under Plan 1. Seventy of W's employees are represented by Collective Bargaining Unit 2 and covered under Plan 2. In this case, the employees of each collective bargaining unit are tested separately. Thus, in testing Plan 1, only the 30 employees represented by Collective Bargaining Unit 1 are considered. In testing Plan 2, only the 70 employees represented by Collective Bargaining 2 are considered.

(c) *Excludable former employees*. A former employee is an excludable former employee with respect to a plan if such employee is within one or more of the following exclusions. Excludable former employees may be disregarded in determining the number of former employees that is equal to 40 percent of the former employees of the employer for purposes of applying §1.401(a)(26)-1(b)(2) and §1.401(a)(26)-6(b).

(1) *Minimum age and service and collective bargaining rules*. A former employee is an excludable former employee if the employee was excluded (or, if section 401(a)(26) was in effect, would have been excluded) from consideration under paragraph (b)(1)(i) of this section (relating to employees not satisfying certain minimum age and service requirements) at all times as an active employee or under paragraph (b)(4) of this section (relating to certain employees covered pursuant to collective bargaining agreements) at substantially all times as an active employee.

(2) *Rules analogous to excludable active employee rules*. A former employee is an excludable former employee if the former employee would qualify as an excludable active employee under rules of paragraphs (b)(1)(ii), (b)(2), (b)(3), or (b)(5) of this section if such former employee were an active employee. Thus, for example, a former employee who was a nonresident alien and received no earned income (under section 911(d)(2)) from the employer which constituted income from sources within the United States (within section 861(a)(3)) qualifies as an excludable former employee under this test.

(3) *Vested accrued benefits eligible for mandatory distribution*. A former employee is an excludable former employee if the present value of the former employee's vested accrued benefit is not in excess of $3,500. This determination

is to be made in accordance with the rules of sections 411(a)(11) and 417(e).

(d) *Special rule for governmental plans*—(1) *Grandfathered participants.* In the case of a governmental plan (within the meaning of section 414(d)) for plan years beginning before January 1, 1993, an employee who became a plan participant before July 15, 1988, may be treated as an excludable employee with respect to such plan and the current and prior benefit structures included therein. Consequently, a governmental plan will be deemed to satisfy section 401(a)(26) with respect to such participants for such years, and such participants need not be taken into account in determining whether or not any plan satisfies section 401(a)(26) with respect to other plan participants.

(2) *Special rule for certain police or firefighters.* An employer may apply section 401(a)(26) separately with respect to any classification of qualified public safety employees for whom a separate plan is maintained. Consequently, all employees other than those in that classification of qualified public safety employees are treated as excludable employees. Also, such employees need not be taken into account in determining whether or not any plan satisfies section 401(a)(26) with respect to other plan participants. For purposes of this paragraph (d)(2) the term "qualified public safety employee" means any employee of any police department or fire department organized and operated by a State or political subdivision if the employee provides police protection, firefighting services, or emergency medical services for any area within the jurisdiction of such State or political subdivision.

(e) *Additional rules.* The Commissioner may, only in revenue rulings, notices or other documents of general applicability, prescribe such additional guidance as may be necessary or appropriate with respect to the application of this section. §1.401(a)(26)-5 Testing methods.

(a) *Testing period*—(1) *Each day of the plan year.* A plan will satisfy section 401(a)(26) for a plan year only if such plan satisfies section 401(a)(26) on each day of the plan year. An employee benefits on a day if the employee is an active participant for such day and benefits under the plan for the year under the rules in §1.401(a)(26)-3(b).

(2) *Retroactive correction.* (i) If a plan fails to satisfy section 401(a)(26) for one or more days during a plan year, such plan may be amended by the last day of such plan year to retroactively satisfy section 401(a)(26), based on the facts as they existed on the day or days of failure, by expanding coverage or by improving benefits or contributions or by modifying eligibility conditions under the plan or a current benefit structure. Plans that are merged will not be treated as failing to satisfy section 401(a)(26) solely because the plans failed to satisfy §1.401(a)(26)-2(b) prior to the merger. The need to retroactively amend to satisfy section 401(a)(26) does not constitute a basis for eliminating or reducing a benefit in violation of section 411(d)-(6).

(ii) *Example.* Assume that an employer with 500 active employees maintains two defined benefit plans that each include one current benefit structure. During a plan year, only 45 active employees benefit under the current benefit structure under Plan A. Immediately before the end of the year, however, the employer expands the coverage of Plan A to include 20 additional active employees under the current benefit structure for the year. Thus, Plan A's current benefit structure satisfies paragraph (b)(1) of this section for the plan year. Alternatively, before the end of the year, the employer could merge Plan A with the other defined benefit plan and then, under the merged plan, either expand the coverage of active employees under Plan A's current benefit structure or, if Plan A's current benefit structure provides for a lower benefit than the current benefit structure of the other defined benefit plan, provide that the active employees who had been benefiting under Plan A will benefit for the year under the such more valuable current benefit structure.

(b) *Additional rules.* The Commissioner may, only in revenue rulings, notices or other documents of general applicability, prescribe such additional guidance as may be necessary or appropriate with respect to the application of this section, including additional guidance for testing compliance with section 401(a)(26) for a plan year.

§1.401(a)(26)-6 Testing of prior benefit structures in defined benefit plans.

(a) *General rule.* A defined benefit plan (but not a defined contribution plan) that does not satisfy section 401(a)(26) by means of satisfying the rules in §1.401(a)(26)-1(d) must satisfy the requirements of paragraph (b) of this section with respect to its prior benefit structure. Paragraph (c) of this section contains definitions and special rules regarding the application of paragraph (b) of this section with respect to prior benefit structures.

(b) *Prior benefit structure under a defined benefit plan*—(1) *General rules*—(i) *In general.* If the benefits currently accruing under a defined benefit plan for active employees for a plan year are meaningful relative to the benefits accrued under the plan, the defined benefit plan's prior benefit structure satisfies this paragraph (b) for the plan year. Whether the benefits currently accruing are meaningful relative to the benefits accrued under the plan is to be determined in accordance with paragraph (b)-(2) of this section. If the benefits currently accruing under a defined benefit plan for active employees are not meaningful relative to the benefits accrued under the plan, the plan's prior benefit structure satisfies paragraph (b) for a plan year only if the group of active and former employees with meaningful benefits under the plan satisfies section 401(a)(26). Whether the group of active and former employees with meaningful benefits under the plan satisfies section 401(a)(26) is to be determined in accordance with paragraph (b)(3) of this section. See paragraph (c) of this section for definitions of accrued benefit, minimum benefit rate, and compensation. Also, see §1.401(a)(26)-8(b)(2) for a transition rule with respect to the prior benefit structure determination for plan years beginning before January 1, 1990.

(ii) *Application of prior benefit structure requirements.* If a defined benefit plan satisfies any one of the six alternative tests set forth in paragraph (b)(2)(ii), (iii), (iv) and (v) of this section and paragraph (b)(3)(ii) and (iii) of this section for a plan year, the defined benefit plan satisfies this paragraph (b) with respect to its prior benefit structure for such plan year. For example, if, in accordance with the minimum employee coverage test of paragraph (b)(3)(iii) of this section, at least 100 employees have greater than de minimis accrued benefits under a defined benefit plan and the three highly compensated employees with the largest benefits under the plan do not have more than 25 percent of the total benefits under the plan, the defined benefit plan's prior benefit structure satisfies this paragraph (b). This is the case without regard to whether the defined benefit plan satisfies any of the other tests relating to prior benefit structures under this paragraph (b).

(2) *Meaningful current benefit accruals*—(i) *In general.* A defined benefit plan is treated as providing current benefit accruals for active employees that are meaningful relative to the benefits accrued under the plan only if the plan satisfies at least one of the tests set forth in paragraphs (b)(2)(ii), (b)(2)(iii), (b)(2)-(iv), and (b)(2)(v) of this section.

(ii) *Minimum current accrual rate test*—(A) *In general.* A plan satisfies this test for a plan year only if, as of the close of such year, at least the lesser of 50 active employees or 40 percent of the employer's active employees have current accrual rates that are equal to or greater than the minimum current accrual rate. Employees who do not have either greater than de minimus accrued benefits or greater than de minimus accrued benefit rates under the plan are treated as not having current accruals under the plan.

(B) *Deemed satisfaction of minimum current accrual rate test.* A plan that satisfies the minimum current accrual rate test in this paragraph (b)(2)(iii) for a plan year will be deemed to continue to satisfy such test with respect to its prior benefit structure on an ongoing basis without any requirement for retesting as long as both the current benefit formula and the rate of accrual relied on remain in effect and continue to provide benefit accruals to a group of employees that satisfies the requirements of section 401(a)(26).

(C) *Current accrual rates.* The current accrual rate for an active employee is the additional accrued benefit (expressed either as a percentage of final average compensation or as a percentage of career average compensation consistent with the plan's method of computing benefits) attributable to the employee's current year of service under a current benefit structure under the plan.

(D) *Minimum current accrual rate.* (*1*) If the plan determines benefits based on final average compensation, the minimum current accrual rate for a plan year is 0.75 percent times final average compensation. If the plan determines benefits based on career average compensation, the minimum current accrual rate for a plan year is 1.1 percent times career average compensation.

(*2*) In the case of a current benefit structure that provides employees with a flat accrued benefit (expressed as a percentage of compensation) that employees accrue over their years of participation, the minimum current accrual rate for a plan year is the annual rate resulting for such employee under a formula that provides a flat accrued benefit at normal retirement age of either 30 percent of final average compensation or 45 percent of career average compensation, depending on the compensation base on which the plan benefits are determined, accrued on a level basis over all years of plan participation.

(E) *Compensation.* (*1*) A plan that determines benefits based on the highest average annual compensation averaged over a specified period not exceeding 5 consecutive years (or a participant's entire period of service for the employer if shorter than such specified period) shall be considered to base benefits on final average compensation and a plan that determines benefits based on average annual compensation averaged over a specified period exceeding 5 consecutive years (or a participant's entire period of service for the employer, if shorter than such specified period) shall be considered to base benefits on career average compensation.

(*2*) Compensation shall be compensation as defined under the plan, provided that such definition is reasonable and is nondiscriminatory under section 414(s). A definition of compensation that is significantly less inclusive than the maximum amount of compensation that may be taken into account under section 414(s) and the regulations thereunder is not reasonable. In addition, a definition of compensation is not reasonable if it provides that compensation is a uniform percentage of a basic definition of compensation under section 414(s) and the regulations thereunder (e.g., 95 percent of W-2 compensation). For purposes of determining final average compensation under this rule, compensation for years commencing prior to January 1, 1989, may be defined as compensation taken into account under the plan in such year.

(iii) *Nondecreasing benefit structure test*—(A) *In general.* A plan satisfies this test for a plan year only if, as of the close of such year, the hypothetical accrued benefits of at least the lesser of 50 active employees or 40 percent of the employer's active employees benefiting under one or more current benefit structures included in the plan are equal to or greater than the employees' actual accrued benefits under the plan. This test is satisfied only if the group of active employees with hypothetical accrued benefits equal to or greater than actual accrued benefits includes the three highly compensated active employees of the employer with the largest amounts of accrued benefits under the plan. If there are fewer than three highly compensated active employees with accrued benefits under the plan, all highly compensated active employees with accrued benefits under the plan must be among the employees with hypothetical accrued benefits equal to or greater than actual accrued benefits.

(B) *Deemed satisfaction of nondecreasing benefit structure test.* A plan that satisfies the nondecreasing benefit structure test in this paragraph (b)(2)(ii) for a plan year will be deemed to continue to satisfy such test with respect to its prior benefit structure on an ongoing basis without any requirement for retesting as long as both the current benefit formula and the rate of accrual relied on remain in effect and continue to provide benefit accruals to a group of employees that satisfies the requirements of section 401(a)(26).

(C) *Hypothetical accrued benefit.* An employee's hypothetical accrued benefit as of the close of a plan year is computed by using only the current benefit structure applicable to such employee for such plan year and by assuming that such current benefit structure has been in effect for all years through the close of such year. In making this determination of an employee's hypothetical accrued benefit, an employee's actual accrued benefit under the plan is disregarded. In addition, employees who do not have either greater than de minimis accrued benefits or greater that de minimis accrued benefit rates under a plan are treated as not having any hypothetical accrued benefit under the plan.

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

Example 1. Assume that an employer with 1,000 active employees has maintained a defined benefit plan for 20 years and that over 100 active employees currently benefit under the plan. During this entire period, the plan has had only one benefit structure—½ percent times years of service (not in excess of 30 years) times final average compensation. In this case, the hypothetical accrued benefit of each active employee benefiting under the plan equals such employee's actual accrued benefit. Thus, this defined benefit plan provides current benefits to active employees that are meaningful relative to the benefits accrued under the plan. If the employer were to amend the plan to improve the current benefit structure by increasing the rate from ½ to .6 percent, the plan would continue to provide benefits that are meaningful relative to the benefits accrued under the plan. This would be the case without regard to whether the increased rate applied to prior years of service under the plan.

Example 2. Assume the same facts as in *Example 1*, except that the employer amends the plan's formula for future years of service by increasing the rate from ½ to .6 percent, applying such higher rate to career average compensation (rather than final average compensation), and eliminating the 30 years of service limit. Whether this new current benefit structure provides benefits that are meaningful relative to the benefits accrued under the plan under the nondecreasing benefit structure test depends on whether there are at least 50 active employees with hypothetical accrued benefits (determined by applying the new current benefit structure using career average compensation to the current and all prior years) equal to or greater than actual accrued benefits under the plan.

(iv) *Minimum current benefit structure test*—(A) *In general*. A plan satisfies this test for a plan year only if, as of the close of such year, at least the lesser of 50 active employees or 40 percent of the employer's active employees benefiting under one or more current benefit structures under the plan have future service benefit rates that are equal to or greater than the plan's minimum benefit rate (as defined in paragraph (c)-(2) of this section).

(B) *Future service benefit rate*. The future service benefit rate for an active employee is the hypothetical, projected accrued benefit (expressed as a percentage of compensation) that would be accrued under the current benefit structure over the employee's future years of service, divided by such employee's future years of service under the plan. This determination is to be made on a basis consistent with the rules of paragraph (b)(2)(v)(B) of this section and by assuming that the employee commenced employment and plan participation at the beginning of the current plan year, assuming no change in the employee's annual compensation and annual hours of service and projecting the employee's age and service from the beginning of the current year to normal retirement age under the plan. This determination is to be made without projecting any increase in the annual limit on contributions and benefits under section 415. Also, in making this determination, the current year is to be taken into account as a future year of service. Finally, employees who do not have either greater than de minimis accrued benefits or greater than de minimis accrued benefit rates under a plan are treated as not having any future service benefit rate under the plan.

(C) *Examples*. The following examples illustrate the rules of this paragraph (b)(2)(iv):

Example 1. Assume that an employer maintains a defined benefit plan that currently benefits 100 active employees. During its 20 prior years of existence, the plan has had many different benefit structures. The plan's current benefit structure provides a benefit of 1 percent times years of service times career average compensation. The plan's minimum benefit rate for the plan is 85/100 percent times years of service times career average compensation. Accordingly, the benefits under the plan's current benefit structure are meaningful relative to the benefits accrued under the plan.

Example 2. Assume that an employer maintains a defined benefit plan that currently benefits 100 active employees. During its 20 prior years of existence, the plan has had many different benefit structures. The plan's current benefit structure provides a benefit of 35 percent times final average compensation and is accrued over employees' years of participation under the plan. The plan's minimum benefit rate for the plan is 1 1/10 percent times years of service times final average compensation. Based on the ages of the active employees currently benefiting under the plan, 60 of such employees have future service benefit rates of at least 1 1/10 percent times years of service times final average compensation. Thus, the benefits under the plan's current benefit structure are meaningful relative to the benefits accrued under the plan.

(v) *Benefit ratio test*—(A) *In general*. A plan satisfies this test for a plan year only if, as of the close of such year, the sum of the accrued benefits of all active employees under the plan is less than 60 percent of the sum of the projected accrued benefits of all active employees benefiting under the plan, and the plan satisfies the concentration test set forth in paragraph (b)(4) of this section.

(B) *Projected accrued benefit*. An employee's projected accrued benefit is determined by projecting the employee's accrued benefit to which the employee would be entitled at the plan's normal retirement age under the current benefit structure applicable to such employee under the plan, expressed in the form of an annuity for the life of the employee and assuming no change in the employee's annual compensation or in the annual hours of service. In determining an employee's projected accrued benefit under a current benefit structure, any change in such current benefit structure (e.g., a change in the accrual rate or in the definition of compensation) that does not currently apply to any individual who is or could be an employee under the current benefit structure is disregarded. This determination is to be made without projecting any increase in the annual limit on contributions and benefits under section 415. Also, in making this determination, the current year is to be taken into account. Thus, for example, in the case of an employee whose current age is equal to or greater than normal retirement age, the employee's projected accrued benefit includes the accrued benefit attributable to the current year of service. Finally, employees who do not have either greater than de minimis accrued benefits or greater than de minimis accrued benefit rates under a plan are treated as not having any projected accrued benefit under the plan.

(C) *Example*. The following example illustrates the rules of this paragraph (b)-(2)(v):

Example. Assume that an employer maintains a defined benefit plan that currently benefits 100 active employees. During its 20 prior years of existence, the plan has had many different benefit structures. In general, the benefit structures for prior years were richer than the current benefit structure, which provides a benefit of 1 percent times years of service times career average compensation. Also, for nearly all prior years, only about 10 active employees benefited under the plan for any year. In the current year, the plan benefits many more, generally younger employees. Because of the significant increase in the number of younger employees benefiting under the plan and in spite of the reduction in the plan's benefit structure, the sum of the accrued benefits of all active employees under the plan is less than 60 percent of the sum of the projected accrued benefits for all active employees under the plan. Thus, assuming that the plan also satisfies the concentration test set forth in paragraph (b)(4) of this section, this plan's current benefit structure is meaningful relative to the benefits under the plan.

(3) *Prior benefit structure requirement*—(i) *In general*. The group of active and former employees with meaningful benefits under a defined benefit plan satisfies section 401(a)(26) only if the plan satisfies at least one of tests set forth in paragraph (b)(3)(ii) and (b)(3)-(iii) of this section. These tests are applied by taking into account active and former employees with benefits under the plan.

(ii) *Minimum accrued benefit test*—(A) *In general*. A plan satisfies this test for a plan year only if, as of the close of such year, at least the lesser of 50 employees or 40 percent of the employer's employees benefiting under the plan have accrued benefit rates that are at least the plan's minimum benefit rate (determined in accordance with paragraph (c)(2) of this section).

(B) *Accrued benefit rate*. The accrued benefit rate for an employee for a plan year is the employee's accrued benefit under the plan (expressed as a percentage of compensation) as of the close of the plan year, divided by the years of service with the employer as of the close of such year. In making this determination, all of an employee's years of service taken into account under the plan are to be taken into account in determining the employee's accrued benefit rate. Alternatively, in making this determination, all of an employee's years of service with the employer may be taken into account (including years of service before and after the employee accrued benefits under the plan), other than years of service that both are not taken into account under the plan and may be disregarded under section 410(a)(1).

(C) *Example*. The following example illustrates the rules of this paragraph (b)-(3)(ii):

Example. Assume that an employer maintains a defined benefit plan that provides for no additional benefit accruals. Before becoming a frozen plan, the plan had many different benefit structures. Currently, 100 active and former employees have accrued benefits under the plan, and the plan is not top-heavy. The plan's minimum benefit rate is 1.1 percent times years of service times final average compensation. Based on the accrued benefits and years of service of the active and former employees with accrued benefits under the plan, 58 of the 100 employees have accrued benefit rates that are greater than the minimum benefit rate. Thus, the plan satisfies the minimum accrued benefit test of this paragraph (b)(3)(ii) and the plan's prior benefit structure satisfies this paragraph (b) for the plan year.

(iii) *Minimum employee coverage test*—(A) *General rule*. A plan satisfies this test for a plan year only if, as of the close of such year, at least 100 employees of the employer have accrued benefits or accrued benefit rates (or both) under the plan that are greater than de minimis and the plan satisfies the concentration test set forth in paragraph (b)-(4) of this section.

(B) *Example*. The minimum employee coverage test can be illustrated by the following example:

Assume that an employer maintains a defined benefit plan that benefits 500 active and former employees. The plan does not include a current benefit structure and thus the plan is a frozen plan. Also, the plan is not top-heavy. This plan has had many different benefit structures over its 25 years of existence. Assuming that at least 100 employees have either accrued benefits or accrued benefit rates that are greater than de minimis and the plan satisfies the concentration test of paragraph (b)(4) of this section, this plan satisfies the minimum employee coverage test of this paragraph (b)(3)(iii) and thus the plan's prior benefit structure satisfies this paragraph (b) for the plan year.

(4) *Concentration test*. (i) A plan satisfies this test for a plan year only if, as of the close of such year, the sum of the accrued benefits under the plan of the three employees who are or ever have been highly compensated employees (either as active employees, former employees or both) and who have the largest accrued benefits under the plan does not constitute more than 25 percent of the sum of the accrued benefits of all employees under the plan. If there are fewer than three employees with accrued benefits under the plan who are or ever have been highly compensated employees, this determination is to be made by reference to all employees with accrued benefits under the plan who are or ever have been highly compensated employees. This test is applied by taking into account all active and former employees with benefits under the plan.

(ii) *Example*. Assume that an employer maintains a frozen defined benefit plan under which 125 active and former employees have accrued benefits that are more than de minimis accrued benefits. However, because for its first 15 years of existence this plan benefited only three highly compensated employees and coverage under the plan was expanded under a significantly reduced benefit structure to 122 nonhighly compensated employees for only a year before the plan was frozen, the sum of the accrued benefits of the three highly compensated employees under the plan with the largest accrued benefits constitute over 25 percent of the total accrued benefits under the plan. This plan fails to satisfy the concentration test of this paragraph (b)(4).

(c) *Definitions for prior benefit structure tests*—(1) *Accrued benefit*—(i) *In general*. Solely for purposes of applying paragraph (b) of this section, an employee's accrued benefit under a defined benefit plan is the accrued benefit to which the employee is entitled commencing at the plan's normal retirement age, expressed as an annuity for such employee's life. Thus, the accrued benefit, for purposes of this paragraph (c)(1), is not adjusted to reflect benefit subsidies such as subsidized early retirement benefits or subsidized joint and survivor annuity provisions, whether or not the employee has satisfied the conditions for such benefit subsidy.

(ii) *Social security benefits and permitted disparity*. An employee's accrued benefit is to be determined based only on the employee's benefit under the plan being tested, without regard to benefits provided under social security or similar Federal or state law and without regard to the permitted disparity under section 401(l).

(iii) *Benefits under other plans*. An employee's accrued benefit is based only on the employee's benefit under the plan being tested. Thus, for example, if benefits under the plan being tested are reduced by benefits under another plan maintained by the employer maintaining the plan being tested (e.g., in a floor-offset arrangement) an employee's benefit under the plan being tested is determined after the reduction by benefits provided under such other plan. An employer may elect to disregard benefits under the plan being tested if such benefits were rolled over (rather than transferred) to such plan and such benefits are treated as voluntary employee contributions under such plan. A plan may not disregard benefits that were transferred to the plan being tested from any other plan, including a plan of an unrelated employer; or benefits that were originally accrued under another plan that was merged with the plan being tested.

(2) *Minimum benefit rate*—(i) *General rule*. The minimum benefit rate for a plan for a plan year is determined in the following manner. If the highly compensated benefit rate for such year is equal to or greater than 1½ percent, the minimum benefit rate is equal to 60 percent of the excess of the highly compensated benefit rate over ¾ percent. If the highly compensated benefit rate is less than 1½ percent, the minimum benefit rate is equal to 30 percent of the highly compensated benefit rate. If the minimum current accrual rate (determined under paragraph (b)(2)(ii) of this section) is less than the minimum benefit rate determined under the preceding two sentences, then the minimum benefit rate is such minimum current accrual rate.

(ii) *Highly compensated benefit rate*. (A) The highly compensated benefit rate for a plan year is the highest of the accrued benefit rates for the three active employees or former employees who are or ever were highly compensated employees of the employer (either as active employees, former employees, or both) with the largest accrued benefits under the plan as of the close of the plan year. For purposes of this rule, an employer may limit consideration of highly compensated former employees to those employees who had an hour of service with the employer during the plan year or any of the immediately preceding five plan years. In addition, the employer may disregard highly compensated former employees who became former employees prior to January 1, 1988. If more than three employees have the largest amounts of accrued benefits under the plan, all of such employees are taken into account in determining the highest accrued benefit rate. If there are fewer than three employees with accrued benefits under the plan who are or ever were highly compensated employees, this determination is to be made by reference to all employees with accrued benefits under the plan who are or ever were highly compensated employees. For purposes of applying this rule, employees who were highly compensated employees only for plan years ending before January 1, 1984, are not treated as highly compensated employees.

(B) *Example*. Assume that an employer maintains a defined benefit plan that benefits five active employees and five former employees who are or ever were highly compensated employees of the employer. To determine the plan's highly compensated benefit rate, the employer first must identify the 3 of these 10 employees who have the largest accrued benefits under the plan. Thus, if $90,000 is the largest accrued benefit for any employee under the plan and if 3 of the 10 employees each have a $90,000 accrued benefit, these 3 employees are taken into account in determining the plan's highly compensated benefit rate. If 4 of the 10 employees have $90,000 accrued benefits, all 4 are taken into account. Similarly, if 2 of the 10 employees have $90,000 accrued benefits and 2 of the 10 employees have $89,000 accrued benefits (the second largest amount under the plan), all 4 of these employees are taken into account in determining the plan's highly compensated benefit rate. Then, the employer must determine which of these employees who are taken into account has the highest accrued benefit rate, and such rate is the highly compensated benefit rate for the year.

(3) *Compensation*. An employee's compensation is compensation as defined by the plan for purposes of determining employees' benefits. Such definition must satisfy section 414(s) and the regulations thereunder. In applying the rules of paragraph (b) of this section, a plan must use a uniform definition of compensation and a uniform applicable period for determining compensation. Thus, for example, in applying the minimum current benefit structure test of paragraph (b)(2)(iii) of this section, a uniform definition of compensation must be used in determining the future service benefit rates and the minimum benefit rate. Similarly, in applying the minimum accrued benefit test of paragraph (b)(3)-(ii) of this section, a uniform definition of compensation must be used in determining the accrued benefit rates and the minimum benefit rate. Also, a plan may not take into account, for any plan year, compensation in excess of the amount that may be taken into account for such year under section 401(a)(17), and a plan may not project any increase in such amount.

(d) *Additional rules*. The Commissioner may, only in revenue rulings, notices or other documents of general applicability, prescribe such additional guidance as may be necessary or appropriate with respect to the application of this section.

§1.401(a)(26)-7 Definitions.

The following definitions are applicable for purposes of section 401(a)(26) and the regulations thereunder:

(a) *Collective bargaining agreement*. The term "collective bargaining agreement" refers to an agreement that the Secretary of Labor finds to be a collective bargaining agreement between employee representatives and the employer, which agreement satisfies §301.7701-17T. Employees described in section 413(b)(8) who are employees of the union or the plan and are treated as employees of an employer are not considered to be employees covered pursuant to a collective bargaining agreement for purposes of section 401(a)(26) unless such employees are actually covered pursuant to such an agreement.

(b) *Employee*—(1) *In general*. The term "employee" means an individual who performs services for the employer who is either a common-law employee of the employer or a self-employed individual treated as an employee pursuant to section 401(c)(1). The term "employee" includes a leased employee who is treated as an employee of the employer-recipient pursuant to the provisions of section 414(n)(2) or section 414(o)(2), other than individuals who are excluded by reason of section 414(n)(5). Individuals that an employer treats as leased employees under section 414(n), pursuant to the requirements of section 414(o), are considered to be leased employees for purposes of this paragraph (b).

(2) *Active and former employees*. An active employee is an individual currently performing services as an employee for the employer. An individual ceases to be an active employee and is treated as a former employee commencing with the day after the day on which the employee terminates from service for the employer. Thus, an employee who terminates from service for an employer during a plan year is both an active employee and a former employee for such plan year.

(3) *Highly compensated employee*. The term "highly compensated employee" means a highly compensated employee within the meaning of section 414(q).

(4) *Nonhighly compensated employee*. The term "nonhighly compensated employee" means an employee who is not a highly compensated employee.

(c) *Employer*. For purposes of section 401(a)(26), except as specifically provided otherwise in the regulations under section 401(a)(26), the term "employer" means the employer maintaining the plan and those employers required to be aggregated with such employer under sections 414(b), (c), (m), or (o). An individual who owns the entire interest of an unincorporated trade or business is treated as an employer. Also, a partnership is treated as the employer of each partner and each employee of the partnership.

(d) *Defined contribution plan*. The term "defined contribution plan" means a defined contribution plan within the meaning of section 414(i).

(e) *Defined benefit plan*. The term "defined benefit plan" means a defined benefit plan within the meaning of section 414(j).

(f) *Multiemployer plan*. A multiemployer plan is a multiemployer plan within the meaning of section 414(f).

(g) *Professional*. The term "professional" means any individual who, on any day of the plan year, performs professional services for the employer as a certified or other public accountant, actuary, architect, attorney, chiropodist, chiropractor, executive, investment banker, medical doctor, dentist, optometrist, osteopath, podiatrist, engineer, psychologist, stockbroker, veterinarian or in such other professional capacity determined by the Commissioner in a notice or other document of general applicability to constitute the performance of services as a professional.

§1.401(a)(26)-8 Effective dates and transition rules.

(a) *In general*. Except as provided in paragraphs (b), (c), and (d) of this section, section 401(a)(26) and the regulations thereunder shall apply to plan years beginning after December 31, 1988.

(b) *Transition rules*—(1) *Current benefit structures*. Notwithstanding paragraph (a) of this section, for plan years beginning after December 31, 1988, and before January 1, 1990, the only rights and features to be taken into account in identifying current benefit structures under §1.401(a)(26)-2(d)(3) are the bases and conditions applicable to the determination of an employee's contribution allocation under a defined contribution plan and the bases and conditions applicable to the determination of an employee's normal retirement benefit, any early retirement benefit that is reduced by less than 3 percent for each year of early commencement, the employee's qualified joint and survivor annuity benefit and any accrual, availability and eligibility conditions related to these normal retirement, early retirement or joint and survivor annuity benefits. Thus, for example, except to the extent included in the preceding sentence, optional forms of benefit, loans, self-directed investment options and ancillary benefits are to be disregarded for purposes of identifying a plan's current benefit structures for plan years beginning in 1989. However, the rules relating to other arrangements that, in accordance with §1.401(a)(26)-2(d)-(1), may cause a defined benefit plan to be treated as comprising separate current benefit structures are effective for all plan years that are subject to section 401(a)(26) under paragraph (a) of this section, including those that begin before January 1, 1990.

(2) *Prior benefit structures*. Notwithstanding paragraph (a) of this section, for plan years beginning after December 31,

1988, and before January 1, 1990, if a defined benefit plan reasonably complies with the rules in §1.401(a)(26)-6(b)(2) applicable in determining whether the plan has a current benefit structure that is meaningful relative to the benefits accrued under the plan and whether a plan's prior benefit structure satisfies section 401(a)(26), such plan will be treated as satisfying such standards. Whether compliance is reasonable is to be determined on the basis of all facts and circumstances; precise application and satisfaction of the rules in §1.401(a)-(26)-6(b)(2) is not required. In making this determination, special emphasis will be placed on whether a defined benefit plan that fails to satisfy the rules set forth in §1.401(a)(26)-6(b)(2) is an ongoing plan providing meaningful, additional benefits to employees or whether such plan is substantially inactive and whether the plan's design or operation is consistent with an attempt to avoid or has the effect of avoiding the requirements, objectives, or effective dates of section 401(a)(26).

(3) *Certain plan terminations*—(i) *In general*. Except as provided in paragraph (b)(3)(ii) of this section, if a plan terminates after section 401(a)(26) becomes effective with respect to the plan (as determined under paragraph (a) of this section), the plan will not be treated as a qualified plan upon termination unless it complies with section 401(a)(26) and the regulations thereunder (to the extent they are applicable) for all periods for which section 401(a)(26) is effective with respect to the plan.

(ii) *Exception*. Notwithstanding paragraphs (a) and (b)(3)(i) of this section, a plan will not fail to be treated as a qualified plan upon termination merely because such plan fails to satisfy the requirements of section 401(a)(26) and the regulations thereunder if all of the following applicable conditions are satisfied:

(A) In the case of a defined benefit plan, no highly compensated employee has an accrued benefit under the plan in addition to the lesser of either the benefit such employee had accrued as of the close of the last plan year beginning before January 1, 1989, or the benefit such employee would have accrued as of the close of such last plan year under the terms of the plan in effect and applicable with respect to such employee on December 13, 1988.

(B) In the case of a defined contribution plan, no highly compensated employee receives a contribution allocation for any plan year beginning after December 31, 1988. For this purpose, a contribution allocation with respect to an employee for a plan year beginning before January 1, 1989, may be treated as a contribution allocation for a plan year beginning after December 31, 1988 if the allocation for the prior year is in excess of the allocation that the employee would have received for such year under the terms of the plan in effect and applicable with respect to such employee on December 13, 1988. An allocation of forfeitures to highly compensated employees with respect to contributions made for plan years beginning before January 1, 1988, will not cause a defined contribution plan to fail to satisfy the requirements in this paragraph (b)(2)-(ii)(B).

(C) The plan is terminated with a termination date on or before May 31, 1989.

(c) *Waiver of excise tax on reversions*—(1) *In general*. Pursuant to section 1112(e)(3) of the Tax Reform Act of 1986 (TRA'86), if certain conditions are satisfied, a waiver of the excise tax under section 4980 applies with respect to any employer reversion that occurs by reason of the termination or merger of a plan before the first year to which section 401(a)(26) applies to such plan. In general, the applicable conditions are that the plan must have been in existence on August 16, 1986; the plan would have failed to satisfy the requirements of section 401(a)(26) if such section were in effect for the plan year including August 16, 1986, and such plan continued to fail such requirements at all times thereafter; the plan satisfies the applicable conditions in paragraph (b)(3)(ii)(A) or (B) of this section; and certain requirements regarding asset or liability transfers and mergers and spinoffs involving such plan after August 16, 1986, are satisfied.

(2) *Termination date*. An employer reversion with respect to a plan will be eligible for the section 4980 excise tax waiver only if such employer reversion occurs by reason of the termination of the plan with a termination date, prior to the first plan year for which section 401(a)(26) applies to such plan. Solely for purposes of this waiver, the employer reversion will be treated as satisfying this paragraph (c)(2) even though the plan's termination date is during the first plan year for which section 401(a)(26) applies to such plan if the plan's termination date is on or before May 31, 1989. If the termination date occurs in the first plan year for which section 401(a)(26) applied to the plan and the employer receives a reversion that is eligible for the waiver of the section 4980 tax, the plan is subject to the interest rate restriction set forth in section 1112(e)(3)(B) of TRA'86.

(3) *Failure to satisfy section 401(a)-(26)*. An employer reversion with respect to a plan will be eligible for the excise tax waiver only if such plan was in existence on August 16, 1986 and, if section 401(a)(26) had applied to the plan for the plan year including such date, the plan would have failed to satisfy section 401(a)(26) for such plan year and continuously thereafter until such plan's termination or merger. For purposes of this paragraph (c), a plan will be treated as though it would have failed to satisfy section 401(a)(26) before such section actually applied with respect to the plan only if the plan (as defined under section 414(l)) failed to benefit at least the lesser of 50 active employees or 40 percent of the employer's active employees. In general, this determination is to be made on the basis of only the applicable statutory provisions, without regard to the regulations under section 401(a)(26). Thus, for example, the current and prior benefit structure rules in the regulations under section 401(a)(26) are not applicable in determining whether a plan would have failed to satisfy section 401(a)(26) for plan years prior to the effective date of section 401(a)(26) with respect to such plan. Similarly, the failure to benefit at least the lesser of 50 former employees or 40 percent of the employer's former employees does not cause the plan to be treated as failing to satisfy section 401(a)(26) for plan years prior to the effective date of section 401(a)(26) with respect to the plan.

(d) *Special rule for collective bargaining agreements*. In the case of a plan maintained pursuant to one or more collective bargaining agreements (as defined in §1.401(a)(26)-7(a)) that were ratified before March 1, 1986, section 401(a)-(26) and the regulations thereunder shall not apply to plan years beginning before the earlier of —

(1) The later of —

(i) January 1, 1989, or

(ii) The date on which the last of such collective bargaining agreements terminates, or

(2) January 1, 1991. For purposes of this paragraph (b) of this section, any extension or renegotiation of any collective bargaining agreement that is ratified after February 28, 1986 shall be

disregarded in determining the date on which such collective bargaining agreement terminates.

Lawrence B. Gibbs,
Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on February 13, 1989, 8:45 a.m., and published in the issue of the Federal Register for February 14, 1989, 54 F.R. 6710)

Notice of Proposed Rulemaking

Arbitrage Restrictions on Tax-Exempt Bonds

FI-91-86

AGENCY: Internal Revenue Service, Treasury.

ACTION: Notice of proposed rulemaking by cross-reference to temporary regulations.

SUMMARY: In * * * [T.D. 8252, page 25, this Bulletin], the Internal Revenue Service is issuing temporary regulations relating to arbitrage restrictions on tax-exempt bonds. Changes to the applicable law were made by the Tax Reform Act of 1986 and the Technical and Miscellaneous Revenue Act of 1988. The text of those temporary regulations also serves as the comment document for this notice of proposed rulemaking.

DATES: The amendments to the regulations are proposed to be effective generally for private activity bonds issued after December 31, 1985, and for bonds other than private activity bonds issued after August 31, 1986. Written comments and requests for a public hearing must be delivered or mailed by July 14, 1989.

ADDRESS: Send comments and requests for a public hearing to: Internal Revenue Service, Attention: CC:CORP:T:R (FI-91-86), Room 4429, Washington, D.C. 20224.

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 1980 (44 U.S.C. 3504(h)). Comments on the collections of information should be sent to the Office of Management and Budget, Paperwork Reduction Project, Washington, D.C. 20503, with copies to the Internal Revenue Service, Attention: IRS Reports Clearance Officer TR:FR, Washington, D.C. 20224.

The collections of information in this regulation are in sections 1.148-0T, 1.148-1T, 1.148-3T, and 1.148-8T. This information is required by the Internal Revenue Service to properly credit the amount of arbitrage profits rebated to the United States by issuers of tax-exempt bonds pursuant to section 148(f) of the Internal Revenue Code of 1986. This information will be used to ensure that issuers of tax-exempt bonds are rebating arbitrage profits as required by section 148(f). The likely respondents are State and local governments.

The following estimates are an approximation of the average time expected to be necessary for a collection of information. They are based on such information as is available to the Internal Revenue Service. Individual respondents may require greater or less time, depending on their particular circumstances. The estimates below represent only the estimated time to physically prepare and maintain any writing requirement that may be imposed by sections 1.148-0T, 1.148-1T, 1.148-3T, and 1.148-8T. They do not represent an estimation of the time for making the decisions, judgments, and computations that may be necessary to satisfy the requirements of section 148(f) or to determine whether an election should be made. Estimated total annual reporting and recordkeeping burden not associated with Form 8038-T: 1,800 hours. The estimated annual burden per respondent varies from 60 minutes to 120 minutes, depending on individual circumstances, with an average of 90 minutes. Estimated number of respondents: 100. Estimated annual frequency of responses (for reporting requirements only): at most once every 5 years.

Submission to Small Business Administration

Pursuant to section 7805(f) of the Code, the rules proposed in this document will be submitted to the Administrator of the Small Business Administration for comment on their impact on small business.

Background

The temporary regulations (designated by a T following the section citations) in [T.D. 8252, page 25, this Bulletin] amend the Income Tax Regulations (26 CFR Part 1) to provide rules relating to arbitrage restrictions on tax-exempt bonds. The temporary regulations reflect the addition to section 148 and section 149(d) to the Internal Revenue Code by section 1301 of the Tax Reform Act of 1986 (100 Stat. 2602), amendments made by sections 1013, 4005(d), and 5035(b) of the Technical and Miscellaneous Revenue Act of 1988 (Pub. L. No. 100-647), and the applicable effective date provisions of sections 1311-1314 of the Tax Reform Act of 1986 (100 Stat. 2659). This document proposes to adopt the temporary regulations as final regulations. Accordingly, the text of the temporary regulations serves as the comment document for this notice of proposed rulemaking. The preamble to the temporary regulations explains the proposed and temporary rules.

For the text of the temporary regulations, see T.D. 8252 * * * [page 25, this Bulletin].

Regulatory Impact Analysis

These proposed rules are not major rules as defined in Executive Order 12291. Therefore, a Regulatory Impact Analysis is not required.

Comments and Requests for a Public Hearing

Before these proposed regulations are adopted, consideration will be given to any written comments that are submitted (preferably a signed original and seven copies) to the Internal Revenue Service. All comments will be available for public inspection and copying in their entirety. A public hearing will be scheduled and held upon written request by any person who submitted comments on the proposed rules. If a public hearing is held, notice of the time and place will be published in the Federal Register.

List of Subjects

26 CFR 1.61-1.281-4

Income taxes, Taxable income, Deductions, Exemptions.

26 CFR Part 602

Reporting and recordkeeping requirements.

Lawrence B. Gibbs,
Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on May 12, 1989, 8:45 a.m., and published in the issue of the Federal Register for May 15, 1989, 54 F.R. 20861)

Notice of Proposed Rulemaking

Taxpayer Assistance Orders

GL-75-89

AGENCY: Internal Revenue Service, Treasury

ACTION: Notice of proposed rulemaking by cross-reference to temporary regulations.

SUMMARY: In * * * [T.D. 8246, page 320, this Bulletin], the Internal Revenue Service is issuing temporary regulations relating to the issuance of taxpayer assistance orders. The text of the temporary regulations also serves as a comment document for this notice of proposed rulemaking.

DATE: Written comments and requests for a public hearing must be delivered or mailed by May 22, 1989. The regulations are proposed to be effective as of February 8, 1989.

ADDRESS: Send comments and requests for a public hearing to: Internal Revenue Service, Attn: CC:CORP:T:R (GL-75-89), Room 4429, Washington, D.C. 20224.

SUPPLEMENTARY INFORMATION:

Background

The temporary regulations in * * * [T.D. 8246, page 320, this Bulletin] amend the Procedure and Administration Regulations (26 CFR Part 301) under section 7811 of the Internal Revenue Code of 1986. The final regulations which are proposed to be based on the temporary regulations reflect the addition of section 7811 by section 6230 of the Technical and Miscellaneous Revenue Act of 1988. (Pub. L. 100-647). For the text of the temporary regulations see T.D. 8246 * * * [page 320, this Bulletin]. The preamble to the temporary regulations explains the regulations.

Special Analyses

The Commissioner of Internal Revenue has determined that this proposed rule is not a major rule as defined in Executive Order 12291 and that a regulatory impact analysis therefore is not required. It is hereby certified that these regulations will not have a significant economic impact on a substantial number of small entities. A regulatory flexibility analysis is therefore not required under the Regulatory Flexibility Act.

Comments and Requests for a Public Hearing

Before adopting these proposed regulations consideration will be given to any written comments that are submitted (preferably a signed original) to the Internal Revenue Service. All comments will be available for public inspection and copying. A public hearing will be held upon written request to the Internal Revenue Service by any person who also submits written comments. If a public hearing is held, notice of the time and place will be published in the Federal Register.

List of Subjects

26 CFR Part 301

Administrative practice and procedure, Bankruptcy, Courts, Crime, Disclosure of information, Employment taxes, Estate tax, Excise taxes, Filing requirements, Gift tax, Income taxes, Investigations, Law enforcement, Penalties, Pensions, Statistics, Taxes.

Lawrence B. Gibbs,
Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on March 21, 1989, 8:45 a.m., and published in the issue of the Federal Register for March 22, 1989, 54 F.R. 11744)

Notice of Proposed Rulemaking

Administrative Appeal of the Erroneous Filing of Notice of Federal Tax Lien

GL-161-89

AGENCY: Internal Revenue Service, Treasury

ACTION: Notice of proposed rulemaking by cross-reference to temporary regulations.

SUMMARY: In * * * [T.D. 8250, page 301, this Bulletin], the Internal Revenue Service is issuing temporary regulations relating to the administrative appeal of the erroneous filing of notice of federal tax lien. The text of the temporary regulations also serves as a comment document for this notice of proposed rulemaking.

DATE: Written comments and requests for a public hearing must be delivered or mailed by June 22, 1989.

ADDRESS: Send comments and requests for a public hearing to: Internal Revenue Service, Attn: CC:CORP:T:R (GL-161-89), Room 4429, Washington, D.C. 20224.

SUPPLEMENTARY INFORMATION:

Background

The temporary regulations in * * * [T.D. 8250, page 301, this Bulletin] amend the Procedure and Administration Regulations (26 CFR Part 301) pursuant to section 6326 of the Internal Revenue Code. The final regulations, which are proposed to be based on the temporary regulations, reflect the amendment of section 6326 by section 6238 of the Technical and Miscellaneous Revenue Act of 1988. (Pub. L. No. 100-647). For the text of the regulations see T.D. 8250 * * * [page 301, this Bulletin]. The preamble to the temporary regulations explains the regulations.

Special Analysis

The Commissioner of Internal Revenue has determined that this proposed rule is not a major rule as defined in Executive Order 12291 and that a regulatory impact analysis is not required. The rule would not significantly alter the reporting or recordkeeping duties of the taxpayer. A regulatory flexibility analysis therefore is not required under the Regulatory Flexibility Act.

Comments and Request for a Public Hearing

Before adopting these proposed regulations, consideration will be given to any written comments that are submitted (preferably a signed original) to the Internal Revenue Service. All comments will be available for public inspection and copying. A public hearing will be held upon written request to the Internal Revenue Service by any person who submits written comments. If a public hearing is to be held, notice of time and place will be published in the Federal Register.

List of Subjects

26 CFR Part 301

Administrative practice and procedure, Bankruptcy, Courts, Crime, Disclosure of information, Employment taxes, Estate tax, Excise taxes, Filing requirements, Gift tax, Income taxes, Investigations, Law enforcement, Penalties, Pensions, Statistics, Taxes.

Michael J. Murphy
Acting Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on May 5, 1989, 8:45 a.m., and published in the issue of the Federal Register for May 8, 1989, 54 F.R. 19578)

Notice of Proposed Rulemaking

Changes with Respect to Prizes and Awards and Employee Achievement Awards

IA-111-86

AGENCY: Internal Revenue Service.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed amendments to the regulations relating to the excludability of certain prizes and awards and to the deductibility of certain employee awards. Changes to the applicable tax law were made by the Tax Reform Act of 1986. These amendments, if adopted, will provide the public with the guidance needed to comply with this Act.

DATES: Written comments and requests for a public hearing must be delivered or mailed by March 10, 1989. The amendments are proposed to be effective after December 31, 1986.

ADDRESS: Send comments and requests for a public hearing to: Commissioner of Internal Revenue, Internal Revenue Service, 1111 Constitution Avenue, N.W., Washington, D.C. 20224; Attention: CC:CORP:T:R, IA-111-86.

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 1980 (44 U.S.C. 3504(h)). Comments on the collections of information should be sent to the Office of Information and Regulatory Affairs, Office of Management and Budget, Washington, D.C. 20503, attention: Desk Officer for the Internal Revenue Service. Copies of comments should also be sent to the Internal Revenue Service at the address previously specified.

The collections of information in this regulation are in 26 CFR §§1.74-1(c). This information is required by the Internal Revenue Service in order to verify that the proper amount of income is reported by taxpayers on their returns of tax. The likely respondents are individuals.

Estimated total annual reporting burden: 1,275 hours.

Estimated average annual burden per respondent: 15 minutes.

Estimated number of respondents: 5,100.

BACKGROUND

This document contains proposed amendments to the Income Tax Regulations (26 CFR Part 1) under sections 74, 102, and 274 of the Internal Revenue Code (Code). The amendments are proposed to conform the regulations to section 122 of the Tax Reform Act of 1986 (Pub. L. 99-514). [1986-3 (Vol. 1) C.B. 1, 26]. The proposed amendments, if adopted, will be issued under the authority contained in section 7805 of the Code (68A Stat. 917; 26 U.S.C. 7805).

GENERAL INFORMATION

Prior to the 1986 Code, section 74 stated that prizes and awards, other than certain types of fellowship grants and scholarships, were includible in gross income unless they were made primarily in recognition of religious, charitable, scientific, educational, artistic, literary, or civic achievement. To qualify for the exclusion, the recipient must have been selected without any action on his part and could not be required to render substantial services as a condition to receiving the prize or award.

Within the context of a business relationship, prizes and awards that would otherwise be includible in a recipient's gross income were excludable if they qualified as gifts under section 102. In general, section 274(b) disallowed an employer a business deduction for gifts to an employee to the extent that the total cost of all gifts of cash, tangible personal property, and other items to the same individual during the taxable year exceeded $25. A special exception to the $25 limitation was allowed for items of tangible personal property awarded to an employee for length of service, safety achievement, or productivity. The employer could deduct the cost of such an award up to $400. If the item was provided under a qualified award plan, the deductibility limitation was increased to $1600, provided the average cost of all plan awards made during the year did not exceed $400. A de minimis fringe benefit under section 132(e) was, and continues to be, excludable from gross income and is not subject to the requirements imposed upon prizes and awards under sections 74 and 274.

EXPLANATION OF PROVISIONS

These proposed amendments relate to the excludability of certain prizes and awards and to the deductibility of certain employee awards and reflect the substantial changes made by the Tax Reform Act of 1986 (the Act) to sections 74, 102 and 274 of the Internal Revenue Code (Code). Changes to the applicable sections of the Code and regulations, amended or newly incorporated by this document, are effective for awards made after December 31, 1986.

Under the Act, the section 74(b) exclusion for prizes or awards received in recognition of charitable achievement is available only if the payor transfers the prize or award to one or more entities described in paragraph (1) and/or (2) of section 170(c), pursuant to the direction of the recipient.

Section 1.74(c) of the proposed regulations requires that recipients of prizes and awards clearly designate, in writing, within 45 days of the date the item is granted that they wish to have the prize or award transferred to one or more qualifying donee organizations. The proposed regulations set forth requirements which, in certain instances, determine whether a qualifying designation has been made.

Section 1.74-1(d) of the proposed regulations clarifies that the exclusion under section 74(b) will not be available unless the prize or award is transferred by the payor to one or more qualified donee organizations before the recipient, or any person other than the grantor or a qualified donee organization, uses the item. In general, a transfer may be accomplished by any method that results in receipt of the prize or award by, or on behalf of, one or more qualified donee organizations.

Section 1.74-1(e) further clarifies the requirements of section 74(b) by defining certain terms. Definitions are included which determine what constitutes a "qualified donee organization," when a "disqualifying use" has taken place, and when an item is considered "granted."

Section 1.74-1(f) provides that neither the payor nor the recipient of the prize or award may claim a charitable contribution deduction for the value of any prize or award for which an exclusion is allowed under section 74(b).

All of the requirements of section 74(b) in existence prior to passage of the Act remain in effect and must be met in order for the award recipient to be eligible for the exclusion. Accordingly, rules and regulations governing these additional requirements, to the extent they are not inconsistent with the proposed regulations, will remain in effect.

New Code section 74(c) excludes certain employee achievement awards from gross income. The exclusion applies, subject to certain limitations, to the value of awards made by the employer for safety achievement or length of service achievement. The amount of the exclusion generally corresponds with the deduction given the employer under new section 274(j) for these "employee achievement awards." Thus, in general, the employee must include these awards in income to the extent that the fair market value of the award, or, if greater, the cost of the award to the employer, exceeds the amount deductible under section 274(j). The exclusion allows an employee to exclude the full fair market value of the award where the cost of the award is fully deductible by the employer.

Section 1.74-2(d) of the proposed regulations provides special rules for employee achievement awards applicable to sole-proprietors and tax-exempt employers.

Section 1.74-2(e) clarifies that an employee award, whether or not an employee achievement award, may be excludable from gross income as a de minimis fringe benefit under section 132(e).

Section 102(c) of the Code clarifies that, with the exception of employee achievement awards under section 74(c) and de minimis fringe benefits under section 132(e), an employee shall not exclude from gross income any amount transferred to the employee (or for the employee's benefit) by, or on behalf of, the employer in the form of a gift, bequest, devise, or inheritance. Therefore, while awards satisfying the requirements of section 74(c) and de minimis fringe benefits qualifying under section 132(e) will be excluded from gross income under those sections, no amounts (except in certain narrowly defined circumstances) transferred by, or on behalf of, an individual's employer will be excludable from gross income under section 102.

Section 1.102-1(f)(2) of the proposed regulations provides that for purposes of section 102(c), extraordinary transfers to the natural objects of one's bounty will not be considered transfers for the benefit of an employee if it can be shown that the transfer was not made in recognition of the transferee's employment. Thus, the rules set out in *Comm. v. Duberstein,* 363 U.S. 278 (1960), formerly applicable in the determination of whether all property transferred inter-vivos from an employer to an employee constitutes a gift, will only be applicable where the transferee employee would be the natural object of the employer's bounty.

From an employer's perspective, the Act substantially modifies an employer's ability to deduct the cost of certain employee awards. New section 274(j) defines deductible "employee achievement awards" to include only those awards made for length of service achievement or safety achievement. In addition, an employee achievement award must be an item of tangible personal property awarded as part of a meaningful presentation and made under conditions and circumstances that do not create a significant likelihood of the payment of disguised compensation.

Section 274(j) also establishes a limit on the amount that may be deducted by an employer. The annual deduction limitation per employee is $400 for employee achievement awards that are not awarded as part of a qualified award plan. The annual deduction limitation per employee is $1,600 for employee achievement awards that are awarded as part of a qualified award plan. In no event may an employer deduct more than $1,600 per employee for all employee achievement awards made during the year. An award is not a qualified plan award where the average cost of all employee achievement awards made by the employer pursuant to a plan exceeds $400 during the taxable year.

Section 1.274-8(b) of the proposed regulations clarifies that the $1,600 deduction limitation applies in the aggregate, so that the $1,600 limitation for qualified plan awards and the $400 limitation for employee achievement awards that are not qualified plan awards cannot be added together to allow deductions exceeding $1,600 for employee achievement awards made to an employee in a taxable year.

Section 1.274-8(c)(2) of the proposed regulations provides that tangible personal property does not include cash or any gift certificate other than a nonnegotiable gift certificate conferring only the right to receive tangible personal property. The proposed regulations also give examples of what will be considered to create a significant likelihood of the payment of disguised compensation. For example, the providing of employee achievement awards in a manner that discriminates in favor of highly paid employees will be considered to be payment of disguised compensation.

Section 1.274-8(c)(5) of the proposed regulations defines a "qualified plan award" as an employee achievement award presented pursuant to an established written award plan or program of the employer that does not discriminate as to eligibility or benefits.

Section 1.274-8(d)(1) of the proposed regulations states that the deduction limitations shall apply to a partnership as well as to each member of the partnership. Paragraph (d)(2) provides that the cost of length of service achievement awards (other than awards excludable under section 132(e)) may only be deducted by the employer if the employee has at least 5 years of service with the employer and has not received a length of service achievement award during that year or any of the 4 prior years. In addition, this paragraph clarifies that although a retirement award will be treated as having been provided for length of service achievement, it may also qualify for treatment as a de minimis fringe benefit under §132(e) of the Code. Paragraph (d)(3) provides guidance with respect to safety achievement awards. An employer may deduct the cost of safety achievement awards only when presented to no more than 10% of an employer's eligible employees. Eligible employees include any employee who has worked for the employer in a full time capacity for at least one year and who is not a manager, administrator, clerical employee, or other professional employee. Special rules clarify that in the case where more than 10% of an employer's eligible employees receive a safety achievement award, no award will be considered to be awarded for safety achievement if it cannot be determined that that award was presented before the 10% limitation was exceeded.

The Act specifically excludes awards qualifying as de minimis fringe benefits under section 132(e) from the requirements for length of service achievement and safety achievement. As a result, employers are not required to consider section 132(e) awards in determining whether employee achievement awards comply with the 5 year limitations for length of service achievement and the 10% eligible employee limitations for safety achievement.

SPECIAL ANALYSES

The Commissioner of Internal Revenue has determined that this proposed rule is not a major rule as defined in Executive Order 12291. Accordingly, a Regulatory Impact Analysis is not required. The Internal Revenue Service has concluded that although this document is a notice of proposed rulemaking that solicits public comment, the regulations proposed herein are interpretative and the notice and public procedure requirements of 5 U.S.C. 553 do not apply. Accordingly, no Regulatory Flexibility Analysis is required for this rule.

COMMENTS AND REQUESTS FOR A PUBLIC HEARING

Before adopting these proposed regulations, consideration will be given to any written comments that are submitted (preferably eight copies) to the Commissioner of Internal Revenue. All comments will be available for public inspection and copying. A public hearing will be held upon written request to the Commissioner by any person who has submitted written comments. If a public hearing is held, notice of time and place will be published in the FEDERAL REGISTER.

* * * * * *

PROPOSED AMENDMENTS TO THE REGULATIONS

The proposed amendments to 26 CFR Part 1 are as follows:

Part 1 [Amended]

§1.74-1 [Amended]

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

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

Par. 2. Section 1.74-1 is amended as follows:

(a) Paragraph (a)(1) is amended by

(1) Removing the phrase "subsection (b)" and adding the phrase "subsections (b) and (c)" in its place, and

(2) Removing the word "any" in the last sentence and adding the word "most" in its place.

(b) Paragraph (b) is amended by

(1) Removing the word "and" from the first sentence, and

(2) Removing "award." at the end of the first sentence and adding the language set forth below in its place.

(c) Paragraph (c) is removed and new paragraphs (c), (d), (e), (f), and (g) are added directly following paragraph (b) to read as set forth below.

§1.74-1 Prizes and awards

(b) *Exclusion from gross income*... award; and (4) the payor transfers the prize or award (and the prize or award is, in fact, transferred) to one or more governmental units or organizations described in paragraph (1) or (2) of section 170(c) pursuant to a designation by the recipient. Accordingly, awards such as the Nobel prize and the Pulitzer prize will qualify for the exclusion if the award is transferred by the payor to one or more qualifying organizations pursuant to a qualified designation by the recipient.

(c) *Designation by recipient*—(1) *In general*. To qualify for the exclusion under this section, the recipient must make a qualifying designation, in writing, within 45 days of the date the prize or award is granted (see paragraph (e)(3) of this section for a definition of "granted"). A qualifying designation is required to indicate only that a designation is being made. The document does not need to state on its face that the organization(s) are entities described in paragraph (1) and/or (2) of section 170(c) to result in a qualified designation. Furthermore, it is not necessary that the document do more than identify a class of entities from which the payor may select a recipient. However, designation of a specific nonqualified donee organization or designation of a class of recipients that may include nonqualified donee organizations is not a qualified designation. The following example illustrates the application of this section:

A distinguished opthamologist, S, is awarded the Nobel prize for medicine. S may designate that the prize money be given to a particular university that is described in section 170(c)(1), or to any university that is described in that section. However, S cannot designate that the award be given to a donee that is not described in section 170(c)(1), such as a foreign medical school. Selection of such a donee or inclusion of such a donee on a list of possible donees on S's designation would disqualify the designation:

(2) *Prizes and awards granted before 60 days after date of publication of final regulations*. In the case of prizes and awards granted before 60 days after date of publication of final regulations, a qualifying designation may be made at any time prior to 105 days after date of publication of final regulations.

(d) *Transferred by payor*. An exclusion will not be available under this section unless the designated items or amounts are transferred by the payor to one or more qualified donee organizations. The provisions of this paragraph shall not be satisfied unless the items or amounts are transferred by the payor to one or more qualifying donee organizations no later than the due date of the return (without regard to extensions) for the taxable year in which the items or amounts would otherwise be includible in the recipient's gross income. A transfer may be accomplished by any method that results in the receipt of the items or amounts by one or more qualified donee organizations from the payor and does not involve a disqualifying use of the items or amounts. Delivery of items or amounts by a person associated with a payor (*e.g.*, a contractual agent, licensee, or other representative of the payor) will satisfy the requirements of this section so long as the items or amounts are received by, or on behalf of, one or more qualified donee organizations. Possession of a prize or an award by any person before a designation is made will not result in the disallowance of an exclusion unless a disqualifying use of the items or amounts is made before the items or amounts are returned to the payor for transfer to one or more qualified donee organizations (see paragraph (e)(2) of this section for a definition of "disqualifying use"). Accordingly, transfer of an item or amount to a nonqualified donee organization will not result in an ineffective transfer under this section if the item or amount is timely returned to the payor by the nonqualified donee organization before a disqualifying use of the item or amount is made and the item or amount is then transferred to a qualifying organization.

(e) *Definitions*—(1) For purposes of this section, "qualified donee organizations" means entities defined in section 170(c)(1) or (2) of the Code.

(2) For purposes of this section, the term "disqualifying use" means, in the case of cash or other intangibles, spending, depositing, investing or otherwise using the prize or award so as to enure to the benefit of the recipient or any person other than the grantor or an entity described in section 170(c)(1) or (2). In the case of tangible items, the term "disqualifying use" means physical possession of the item for more than a brief period of time by any person other than the grantor or an entity described in section 170(c)(1) or (2). Thus, physical pos-

session by the recipient or a person associated with the recipient may constitute a disqualifying use if the item is kept for more than a brief period of time. For example, receipt of an unexpected tangible award at a ceremony that otherwise comports with the requirements of this section will not constitute a disqualifying use unless the recipient fails to return the item to the payor as soon as practicable after receipt.

(3) For purposes of this section, an item will be considered "granted" when it is subject to the recipient's dominion and control to such an extent that it otherwise would be includible in the recipient's gross income.

(f) *Charitable deduction not allowable.* Neither the payor nor the recipient will be allowed a charitable deduction for the value of any prize or award that is excluded under this section.

(g) *Qualified scholarships.* See section 117 and the regulations thereunder for provisions relating to qualified scholarships.

Par. 3. New section 1.74-2 is added to immediately follow section 1.74-1 as set forth below.

§1.74-2 Special exclusion for certain employee achievement awards.

(a) *General rule*—(1) Section 74(c) provides an exclusion from gross income for the value of an employee achievement award (as defined in section 274(j) received by an employee if the cost to the employer of the award does not exceed the amount allowable as a deduction to the employer for the cost of the award. Thus, where the cost to the employer of an employee achievement award is fully deductible after considering the limitation under section 274(j), the value representing the employer's cost of the award is excludable from the employee's gross income.

(2) Where the cost of an award to the employer is so disproportionate to the fair market value of the award that there is a significant likelihood that the award was given as disguised compensation, no portion of the award will qualify as an employee achievement award excludable under the provisions of this section (see also §1.274-8(c)(1) and (4)).

(b) *Excess deduction award.* Where the cost to the employer of an employee achievement award exceeds the amount allowable as a deduction to the employer, the recipient must include in gross income an amount which is the greater of (1) the excess of such cost over the amount that is allowable as a deduction (but not to exceed the fair market value of the award) or (2) the excess of the fair market value of the award over the amount allowable as a deduction to the employer.

(c) *Examples.* The operation of this section may be illustrated by the following examples:

Example (1). An employer makes a qualifying length of service award to an employee in the form of a television set. Assume that the deduction limitation under §274(j)(2) applicable to the award is $400. Assume also that the cost of the television set to the employer was $350, and that the fair market value of the television set is $475. The amount excludable is $475 (the full fair market value of the television set). This is true even though the fair market value exceeds both the cost of the television set to the employer and the $400 deduction allowable to the employer for non-qualified plan awards under section 274(j)(2)(A).

Example (2). Assume the same facts as in example (1) except that the fair market value of the television set is $900. Under these circumstances, the fair market value of the television set is so disproportionate to the cost of the item to the employer that the item will be considered payment of disguised compensation. As a result, no portion of the award will qualify as an employee achievement award. Since no portion of the award is excludable by the employee, the employer must report the full fair market value of the award as compensation on the employee's Form W-2.

Example (3). An employer makes a qualifying safety achievement award to an employee in the form of a pearl necklace. Assume that the deduction limitation under section 274(j) is $400. Assume also that the cost of the necklace to the employer is $425 and that the fair market value of the necklace is $475. The amount includible by the employee in gross income is the greater of (a) $25 (the difference between the cost of the item ($425) and the employer's deductible amount of $400) or (b) $75 (the amount by which the fair market value of the award ($475) exceeds the employer's deductible amount of $400). Accordingly, $75 is the amount includible in the employee's gross income. The remaining portion of the fair market value of the award (*i.e,* the $400 amount allowable as a deduction to the employer) is not included in the gross income of the employee. If the cost of the pearl necklace to the employer was $500 instead of $425, then $100 would be includible in the employee's gross income because the excess of the cost of the award over $400 (*i.e.,* $100) is greater than the excess of the fair market value of the award over $400 (*i.e.,* $75). The employer must report the $75, which is includible in the employee's gross income, as compensation on the employee's Form W-2.

Example (4). An employer invites its employees to attend a party it is sponsoring to benefit a charity. In order to encourage the employees to attend the party and to make contributions to the charity, the employer promises to match the employees' contributions and also provides expensive prizes to be awarded to contributing employees selected at random. Each employee receiving a prize must include the full fair market value of the prize in gross income because the prizes are not qualifying achievement awards under section 274(j) or de minimis fringe benefits under section 132(e). Since the prizes are not excludable the employer must report the full fair market value of the prize as compensation on the employee's Form W-2.

(d) *Special rules*— (1) The exclusion provided by this section shall not be available for any award made by a sole-proprietorship to the sole proprietor.

(2) In the case of an employer exempt from taxation under Subtitle A of the Code, any reference in this section to the amount allowable as a deduction to the employer shall be treated as a reference to the amount which would be allowable as a deduction to the employer if the employer were not exempt from taxation under Subtitle A of the Code.

(e) *Exclusion for certain de minimis fringe benefits.* Nothing contained in this section shall preclude the exclusion of the value of an employee award that is otherwise qualified for exclusion under section 132(e).

Par. 4 Section 1.102-1 is amended as follows:

(a) The last sentence of paragraph (a) is removed.

(b) A new paragraph (f) is added immediately following paragraph (e) to read as follows.

§1.102-1 Gifts and inheritances.

* * * * * *

(f) *Exclusions*—(1) *In general.* Section 102 does not apply to prizes and awards (including employee achievement awards) (see section 74); certain de minimis fringe benefits (see section 132); any amount transferred by or for an employer to, or for the benefit of, an employee (see section 102(c)); or to qualified scholarships (see section 117).

(2) *Employer/Employee transfers.* For purposes of section 102(c), extraordinary transfers to the natural objects of an employer's bounty will not be considered transfers to, or for the benefit of, an employee if the employee can show that the transfer was not made in recognition of the employee's employment. Accordingly, section 102(c) shall not apply to amounts transferred between related parties (*e.g.,* father and son) if the purpose of the transfer can be substantially attributed to the familial relationship of the parties and not to the circumstances of their employment.

§1.274-1 [Amended]

Par. 5. Section 1.274-1 is amended by removing everything after the word "business" in the last sentence of paragraph (d) and adding in its place "activity, see §1.274-6."; revising paragraph (e) and adding paragraph (f) to read as follows: * * * (e) treatment of personal portion of entertainment facility, see §1.274-7, and (f) employee achievement awards, see §1.274-8.

§1.274-3 [Amended]

Par. 6. Section 1.274-3 is amended as follows:

(a) The last sentence of paragraph (b)-(1) is amended by substituting "subsections (b) and (c) of section 74" for "section 74(b)".

(b) The language "recipient, or" at the end of paragraph (b)(2)(ii) is replaced by the language "recipient."

(c) Subdivisions (iii) and (iv) of paragraph (b)(2) are removed.

(d) The first, second, and fourth sentences of the flush material immediately following subdivision (iv) are removed and the last sentence is amended by substituting "sections 61, 74, 102, and 132" for "sections 61, 74, and 102".

(e) Paragraph (d) is removed and paragraphs (e), (f), and (g) are redesignated as paragraphs (d), (e), and (f).

Par. 7. Section 1.274-8 is redesignated as

§1.274-9 and a new §1.274-8 is added immediately following

§1.274-7 to read as set forth below.

§1.274-8 Disallowance of certain employee achievement award expenses.

(a) *In general.* No deduction is allowable under section 162 or 212 for any portion of the cost of an employee achievement award (as defined in section 274(j)(3)(A)) in excess of the deduction limitations of section 274(j)(2).

(b) *Deduction limitations.* The deduction for the cost of an employee achievement award made by an employer to an employee: (1) which is not a qualified plan award, when added to the cost to the employer for all other employee achievement awards made to such employee during the taxable year which are not qualified plan awards, shall not exceed $400, and (2) which is a qualified plan award, when added to the cost to the employer for all other employee achievement awards made to such employee during the taxable year (including employee achievement awards which are not qualified plan awards), shall not exceed $1,600. Thus, the $1,600 limitation is the maximum amount that may be deducted by an employer for all employee achievement awards granted to any one employee during the taxable year.

(c) *Definitions*—(1) *Employee achievement award.* The term "employee achievement award", for purposes of this section, means an item of tangible personal property that is transferred to an employee by reason of the employee's length of service or safety achievement. The item must be awarded as part of a meaningful presentation, and under conditions and circumstances that do not create a significant likelihood of the payment of disguised compensation. For purposes of section 274(j), an award made by a sole proprietorship to the sole proprietor is not an award made to an employee.

(2) *Tangible personal property.* For purposes of this section, the term "tangible personal property" does not include cash or a certificate (other than a nonnegotiable certificate conferring only the right to receive tangible personal property). If a certificate entitles an employee to receive a reduction of the balance due on his account with the issuer of the certificate, the certificate is a negotiable certificate and is not tangible personal property for purposes of this section. Other items that will not be considered to be items of tangible personal property include vacations, meals, lodging, tickets to theater and sporting events, and stocks, bonds, and other securities.

(3) *Meaningful presentation.* Whether an award is presented as part of a meaningful presentation is determined by a facts and circumstances test. While the presentation need not be elaborate, it must be a ceremonious observance emphasizing the recipient's achievement in the area of safety or length of service.

(4) *Disguised compensation.* An award will be considered disguised compensation if the conditions and circumstances surrounding the award create a significant likelihood that it is payment of compensation. Examples include the making of employee achievement awards at the time of annual salary adjustments or as a substitute for a prior program of awarding cash bonuses, the providing of employee achievement awards in a manner that discriminates in favor of highly paid employees, or, with respect to awards the cost of which would otherwise be fully deductible by the employer under the deduction limitations of section 274(j)(2), the making of an employee achievement award the cost of which to the employer is grossly disproportionate to the fair market value of the item.

(5) *Qualified plan awards*—(i) *In general.* Except as provided in paragraph (c)(5)(ii) of this section, the term "qualified plan award" means an employee achievement award that is presented pursuant to an established written plan or program that does not discriminate in terms of eligibility or benefits in favor of highly compensated employees. See section 414(q) of the Code for the definition of highly compensated employees. Whether an award plan is established shall be determined from all the facts and circumstances of the particular case, including the frequency and timing of any changes to the plan. Whether or not an award plan is discriminatory shall be determined from all the facts and circumstances of the particular case. An award plan may fail to qualify because it is discriminatory in its actual operation even though the written provisions of the award plan are nondiscriminatory.

(ii) *Items not treated as qualified plan awards.* No award presented by an employer during the taxable year will be considered a qualified plan award if the average cost of all employee achievement awards presented during the taxable year by the taxpayer under any plan described in paragraph (c)(5)(i) of this section exceeds $400. The average cost of employee achievement awards shall be computed by dividing (A) the sum of the costs to the employer for all employee achievement awards (without regard to the deductibility of those costs) by (B) the total number of employee achievement awards presented. For purposes of the preceding sentence, employee achievement awards of nominal value shall not be taken into account in the computation of average cost. An employee achievement award that costs the employer $50 or less shall be considered to be an employee achievement award of nominal value.

(d) *Special rules*—(1) *Partnerships.* Where employee achievement awards are made by a partnership, the deduction limitations of section 274(j)(2) shall apply to the partnership as well as to each member thereof.

(2) *Length of service awards.* An item shall not be treated as having been provided for length of service achievement if the item is presented for less than 5 years employment with the taxpayer or if the award recipient received a length of service achievement award (other than an award excludable under section 132(e)(1)) during that year or any of the prior 4 calendar years. An award presented upon the occasion of a recipient's retirement is a length of service award subject to the rules of this section. However, under appropriate circum-

stances, a traditional retirement award will be treated as a de minimis fringe. For example, assume that an employer provides a gold watch to each employee who completes 25 years of service with the employer. The value of the gold watch is excluded from gross income as a de minimis fringe. However, if the employer provides a gold watch to an employee who has not completed lengthy service with the employer or on an occasion other than retirement, the value of the watch is not excludable from gross income under section 132(e).

(3) *Safety achievement awards*—(i) *In general.* An item shall not be treated as having been provided for safety achievement if—

(A) During the taxable year, employee achievement awards (other than awards excludable under section 132(e)-(1)) for safety achievement have previously been awarded by the taxpayer to more than 10 percent of the eligible employees of the taxpayer, or

(B) Such item is awarded to a manager, administrator, clerical employee, or other professional employee.

(ii) *"Eligible employee" defined.* An eligible employee is one not described in paragraph (d)(3)(i)(B) of this section and who has worked in a full-time capacity for the taxpayer for a minimum of one year immediately preceding the date on which the safety achievement award is presented.

(iii) *Special rules.* Where safety achievement awards are presented to more than 10 percent of the taxpayer's eligible employees, only those awards presented to eligible employees before 10 percent of the taxpayer's eligible employees are exceeded shall be treated as having been provided for safety achievement. Where the only safety achievement awards presented by an employer consist of items that are presented at one time during the calendar year, then, if safety achievement awards are presented to more than 10 percent of the taxpayer's eligible employees, the taxpayer may deduct an amount equal to the product of the cost of the item (subject to the applicable deduction limitation) and 10 percent of the taxpayer's eligible employees. Except as provided in the preceding sentence, no award shall be treated as having been provided for safety achievement except to the extent that it can be reasonably demonstrated that that award was made before the 10 percent limitation was exceeded.

Lawrence B. Gibbs,
Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on January 6, 1989, 8:45 a.m., and published in the issue of the Federal Register for January 9, 1989, 54 F.R. 627)

Notice of Proposed Rulemaking

Minimum Tax—Tax Benefit Rule

IA-56-87

AGENCY: Internal Revenue Service, Treasury.

ACTION: Notice of proposed rulemaking by cross-reference to temporary regulations.

SUMMARY: In * * * [T.D. 8249, page 15, this Bulletin] the Internal Revenue Service is issuing temporary regulations relating to the application of the tax benefit rule to the minimum tax. The text of the temporary regulations also serves as the comment document for this notice of proposed rulemaking.

DATES: Except as otherwise provided, the amendments are proposed to be effective for items of tax preference that are subject to the minimum tax imposed by section 56 of the Code and arise in taxable years beginning after December 31, 1975, and before January 1, 1987. Written comments and requests for a public hearing must be delivered or mailed by

ADDRESS: Send comments and requests for a public hearing to: Internal Revenue Service, Attn: CC:CORP:R:T (IA-56-87), Room 4429, Washington, D. C. 20224.

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 1980 (44 U.S.C. 3504 (h)). Comments on the collections of information should be sent to the Office of Management and Budget, Paperwork Reduction Project, Washington, D.C. 20503, with copies to the Internal Revenue Service, Attn: IRS Reports Clearance Officer TR:FP, Washington, D.C. 20224.

The collections of information in this regulation are contained in paragraphs (c)(5)(iii)(B) and (e)(3) of §1.58-9T. This information is required by the Internal Revenue Service to administer section 58(h). Respondents are taxpayers who are subject to the minimum tax and who file amended returns under §1.58-9T(e)(3), or who make the election under §1.58-9T(c)(5)(iii)(B).

These estimates are an approximation of the average time expected to be necessary for a collection of information. They are based on such information as is available to the Internal Revenue Service. Individual respondents may require greater or less time, depending on their particular circumstances.

Estimated total annual reporting burden: 40 hours.

The estimated annual burden per respondent or recordkeeper varies from 10 minutes to 14 minutes, depending on individual circumstances, with an estimated average of 12 minutes.

Estimated number of respondents: 200.

Estimated annual frequency of responses: 1.

Background

The temporary regulations published in * * * [T.D. 8249, page 15, this Bulletin] amend the Income Tax Regulations (26 CFR Part 1) under section 58 of the Internal Revenue Code of 1954.

For the text of the temporary regulations, see T.D. 8249, published in * * * [page 15, this Bulletin]. The preamble to the temporary regulations explains the regulations.

Special Analyses

The Commissioner of Internal Revenue has determined that this proposed rule is not a major rule as defined in Executive Order 12291, and that a Regulatory Impact Analysis therefore is not required. Furthermore, it has been certified that this rule, if issued, will not have a significant economic impact on a substantial number of small entities because the taxpayers that are subject to these regulations tend to be large corporations. It would not significantly alter the reporting or recordkeeping duties of small entities. A regulatory flexibility analysis is therefore not required under the Regulatory Flexibility Act (5 U.S.C. chapter 6).

Comments and Requests for a Public Hearing

Before these proposed regulations are adopted, consideration will be given to any written comments that are submitted (preferably eight copies) to the Internal Revenue Service. All comments will be available for public inspection and copying. A public hearing will be held upon written request to the Internal Revenue Service by any person who also submits written comments. If a public hearing is held, notice of the time and place will be published in the Federal Register.

Michael J. Murphy,
Acting Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on May 4, 1989, 8:45 a.m., and published in the issue of the Federal Register for May 5, 1989, 54 F.R. 19409)

Notice of Proposed Rulemaking

Reduction of Tax Overpayments by Amount of Past-Due Legally Enforceable Debt Owed to Federal Agency

IA-41-88

AGENCY: Internal Revenue Service, Treasury.

ACTION: Notice of proposed rulemaking by cross-reference to temporary regulations.

SUMMARY: In * * * [T.D. 8239, page 302, this Bulletin], the Internal Revenue Service is issuing temporary regulations amending temporary regulations which were published in the Federal Register on September 30, 1985. [T.D. 8053, 1985-2 C.B. 333 and LR-291-84, 1985-2 C.B. 839], and were amended May 13, 1987 [T.D. 8139, 1987-2 C.B. 280 and LR-72-86, 1987-2 C.B. 1030], relating to the reduction of a taxpayer's overpayment (*i.e.*, tax refund) by the amount of any past-due legally enforceable debt owed to a Federal agency by the taxpayer and referred by that agency to the Internal Revenue Service for offset. The text of the temporary regulations also serves as the comment document for this notice of proposed rulemaking.

DATES: Written comments and requests for a public hearing must be delivered or mailed by March 7, 1989. The regulations are proposed to apply to refunds payable under section 6402 of the Internal Revenue Code of 1986 after December 31, 1985, and on or before January 10, 1994. However, if legislation is enacted extending the tax refund offset program beyond January 10 1994, the regulations are proposed to apply to refunds payable through the date to which such legislation extends the program.

ADDRESS: Send comments and requests for a public hearing to: Internal Revenue Service, Attention: CC:CORP:T:R (IA-41-88), Room 4429, Washington, D.C. 20224.

SUPPLEMENTARY INFORMATION

BACKGROUND

The temporary regulations (designated by a "T" following the section citation) in * * * [T.D. 8239, page 302, this Bulletin] amend temporary Procedure and Administration Regulations (26 CFR Part 301) under section 6402(d) and (e) of the Internal Revenue Code of 1954, and section 3720A of subchapter II of chapter 37 of Title 31, United States Code. This document proposes to adopt the amendments to those temporary regulations as amendments to the final regulations; accordingly, the text of the temporary regulations serves as the comment document for this notice of proposed rulemaking. In addition, the preamble to the temporary regulations provides a discussion of the proposed and temporary amendments. For the text of the temporary regulations, see T.D. 8239 * * * [page 302, this Bulletin].

SPECIAL ANALYSES

The Commissioner of Internal Revenue has determined that these proposed rules are not major rules as defined in Executive Order 12291 and, therefore, a regulatory impact analysis is not required. Although this document is a notice of proposed rulemaking that solicits public comment, the Internal Revenue Service has concluded that the regulations proposed herein are interpretative and that the notice and public procedure requirements of 5 U.S.C. 553 do not apply. Accordingly, these proposed regulations do not constitute regulations subject to the Regulatory Flexibility Act (5 U.S.C. chapter 6).

COMMENTS AND REQUESTS FOR A PUBLIC HEARING

Before these proposed regulations are adopted, consideration will be given to any written comments that are submitted (preferably nine copies) to the Commissioner of Internal Revenue. All comments will be available for public inspection and copying. A public hearing will be held upon written request to the Commissioner by any person who has submitted written comments. If a public hearing is held, notice of the time and place will be published in the FEDERAL REGISTER.

* * * * * *

Lawrence B. Gibbs,
Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on January 3, 1989, 2:39 p.m., and published in the issue of the Federal Register for January 6, 1989, 54 F.R. 428)

Notice of Proposed Rulemaking

Disclosure of Return Information to the Bureau of the Census

IA-42-88

AGENCY: Internal Revenue Service, Treasury.

ACTION: Notice of Proposed Rulemaking.

SUMMARY: This document contains proposed amendments to the regulations on Procedure and Administration to authorize the disclosure of three additional items of return information to the Bureau of the Census for use in certain statistical programs and to delete the authority to disclose those items of return information which the Bureau no longer needs. The proposed regulations will provide guidance to Internal Revenue Service personnel responsible for disclosing the information.

DATES: Written comments and requests for a public hearing must be delivered by January 13, 1989. The amendments to the regulations are proposed to be effective as of the date on which the Treasury decision adopting them is published in the FEDERAL REGISTER.

ADDRESS: Send comments and requests for a public hearing to: Commissioner of Internal Revenue, Attention CC:CORP:T:R (IA-42-88), Washington, D.C. 20224.

SUPPLEMENTARY INFORMATION:

BACKGROUND

This document contains proposed amendments to the regulations on Procedure and Administration (26 CFR Part 301) under section 6103(j)(1) of the

Internal Revenue Code of 1986. Under section 6103(j)(1), upon written request from the Secretary of Commerce, the Internal Revenue Service is to furnish such tax return information as may be prescribed by Treasury regulations to the Bureau of the Census for statutorily authorized statistical activities. Section 301.6103(j)(1)-1 of the regulations currently provides an itemized description of the return information authorized to be disclosed for this purpose.

Periodically, the disclosure regulations are amended to reflect the changing statistical needs of the Bureau of the Census for tax information, and these proposed regulations would update those regulations.

EXPLANATION OF PROVISIONS

The request by the Secretary of Commerce for amendment of the regulations indicates that the Bureau of the Census needs the following three new data items from returns of individual taxpayers for use in its statutorily authorized postcensal population and per capita income estimates programs: (1) the type of tax return filed (i.e., Form 1040, Form 1040A, etc.); (2) whether the taxpayer itemized deductions for federal income tax purposes; and (3) whether the taxpayer received Social Security benefits. The Bureau needs this information to help them determine whether a taxpayer is over 65 years of age.

These proposed regulations would amend §301.6103(j)(1)-1 of the present regulations to add the above items to the list of disclosable tax return information. In addition, the proposed regulations would delete from the list certain items of return information which the Bureau of Census no longer needs.

SPECIAL ANALYSES

The Commissioner of Internal Revenue has determined that this proposed rule is not a major rule as defined in Executive Order 12291 and that a regulatory impact analysis therefore is not required.

Although this document is a notice of proposed rulemaking that solicits public comments, the Internal Revenue Service has concluded that the regulations proposed herein are interpretative and that the notice and public procedure requirements of 5 U.S.C. 553 do not apply. Accordingly, these proposed regulations do not constitute regulations subject to the Regulatory Flexibility Act (5 U.S.C. Chapter 6).

COMMENTS AND REQUESTS FOR A PUBLIC HEARING

Before adopting these proposed regulations, consideration will be given to any written comments that are submitted (preferably a signed original and seven copies) to the Internal Revenue Service. All comments will be available for public inspection and copying in their entirety. A public hearing will be scheduled and held upon written request by any person who submits written comments on the proposed rules. Notice of the time and place for the hearing will be published in the FEDERAL REGISTER.

LIST OF SUBJECTS IN 26 CFR 301

Administrative practice and procedure, Bankruptcy, Courts, Crime, Employment Taxes, Estate Taxes, Excise Taxes, Gift, Income Taxes, Investigations, Law Enforcement, Penalties, Pensions, Statistics, Taxes, Disclosure of information, Filing requirements.

Accordingly, Title 26, Part 301 of the Code of Federal Regulations is proposed to be amended as follows:

Paragraph 1. The authority for Part 301 continues to read in part:

Authority: 26 U.S.C. 7805. * * * Section 301.6103(j)(1)-1 also issued under 26 U.S.C. 6103(j).

Par. 2. Section 301.6103(j)(1)-1 is amended by revising Paragraph (b)(1) to read as follows:

§301.6103(j)(1)-1 Disclosures of return information to officers and employees of the Department of Commerce for certain statistical purposes and related activities.

* * * * * *

(b) *Disclosure of return information to officers and employees of the Bureau of the Census*—(1) Officers or employees of the Service will disclose the following return information reflected on returns of an individual taxpayer to officers and employees of the Bureau of the Census for purposes of, but only to the extent necessary in, conducting and preparing, as authorized by chapter 5 of Title 13, United States Code, intercensal estimates of population and per capital income for all geographic areas included in the general revenue sharing program and demographic statistics programs, censuses and related program evaluation—

(i) Taxpayer identity information (as defined in section 6103(b)(6) of the Code), validity code with respect to the taxpayer identifying number (as described in section 6109), and taxpayer identifying number of spouse, if reported;

(ii) District office and service center codes;

(iii) Marital status;

(iv) Numbers and Classifications of reported exemptions;

(v) Adjusted gross income;

(vi) Wage and salary income;

(vii) Dividend income;

(viii) Interest income;

(ix) Gross rent and royalty income;

(x) Type of tax return filed;

(xi) Residence information from the revenue sharing question;

(xii) Code indicators for Form 1040; Schedules C, D, E, F, and SE;

(xiii) Julian date relative to filing;

(xiv) Whether deductions were itemized; and

(xv) Social Security benefits.

* * * * * *

Lawrence B. Gibbs,
Commissioner of Internal Revenue.

Approved November 2, 1988.

O. Donaldson Chapoton,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on December 13, 1988, 8:45 a.m., and published in the issue of the Federal Register for December 1, 1988, 53 F.R. 50243)

Notice of Proposed Rulemaking

Imposition of Backup Withholding Due to Notification of an Incorrect Taxpayer Identification Number and the Due Diligence Exception to the Imposition of a Penalty for a Missing or an Incorrect Taxpayer Identification Number

IA-104-88

AGENCY: Internal Revenue Service, Treasury.

ACTION: Notice of proposed rulemaking by cross-reference to temporary regulations.

SUMMARY: In * * * [T.D. 8248, page 280, this Bulletin], the Internal Revenue

Service is issuing temporary regulations that would amend and clarify the rules concerning the requirement for payors to backup withhold and the actions that payors must take to exercise due diligence with respect to a missing or an incorrect taxpayer identification number due to notification of an incorrect taxpayer identification number. The text of the temporary regulations also serves as the comment document for this notice of proposed rulemaking.

DATES: The regulations are proposed to be effective for reportable payments made after December 31, 1983, and to information returns filed after December 31, 1984. However, the requirements of §35a.34061 are proposed to be effective on and after January 1, 1989. Written comments and requests for a public hearing must be delivered or mailed by June 12, 1989.

ADDRESS: Send comments and requests for a public hearing to: Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Attn: CC:CORP:TR (IA-104-88), Washington, D.C. 20044.

SUPPLEMENTARY INFORMATION:

Background

The temporary regulations published in * * * [T.D. 8248, page 280, this Bulletin] amend the rules set forth in §35a.3406-1 and §§35a.9999-1 and 35a.9999-3 in order to conform those rules to the changes made by Notice 88-77, 1988-2 C.B. 392, and Notice 88-89, 1988-2 C.B. 413. Further, the temporary regulations would provide a new due diligence standard for payors of certain accounts with post-1987 awaiting-TIN certifications, for payors of beneficiaries under life-insurance contracts, and for payors of certain payees who are exempt from the payment of the tax on self-employment income under Code section 1401 or the Federal Insurance Contributions Act tax on employers or employees under Code section 3111 or 3101, respectively. For the text of the new temporary regulations, see T.D. 8248 * * * [page 280, this Bulletin]. The preamble to the temporary regulations explains the regulations.

Special Analyses

These proposed rules are not major rules as defined in Executive Order 12291. Therefore, a Regulatory Impact Analysis is not required. Although this document is a notice of proposed rulemaking that solicits public comments, the notice and public procedure requirements of 5 U.S.C. §553 do not apply because the regulations proposed herein are interpretative. Therefore, an initial Regulatory Flexibility Analysis is not required by the Regulatory Flexibility Act (5 U.S.C. Chapter 6).

Comments and Requests for a Public Hearing

Before adopting these proposed regulations, consideration will be given to any written comments that are submitted (preferably a signed copy and seven copies) to the Internal Revenue Service. All comments will be available for pubic inspection and copying in their entirety. A public hearing will be scheduled and held upon written request by any person who submits written comments on the proposed rules. Also, the Internal Revenue Service intends to publish a notice of proposed rulemaking in the near future that will provide comprehensive rules on backup withholding. Generally, the pertinent provisions of all the temporary regulations with respect to backup withholding will be incorporated in the notice of proposed rulemaking. The Internal Revenue Service intends to schedule one hearing to receive comments under these proposed rules and under the comprehensive proposed rules that will be published shortly. Notice of the time and place of the hearing will be published in the Federal Register. However, the notice and hearing will not cover any of the rules set forth in INTL-52-86. See 53 FR 5991 and 54 FR 11236.

Lawrence B. Gibbs,
Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on April 10, 1989, 8:45 A.M., and published in the issue of the Federal Register for April 11, 1989, 54 F.R. 14364)

Notice of Proposed Rulemaking

Abatement of Penalty or Addition to Tax Attributable to Erroneous Advice

IA-24-89

AGENCY: Internal Revenue Service, Treasury.

ACTION: Notice of proposed rulemaking by cross-reference to temporary regulations.

SUMMARY: In * * * [T.D. 8254, page 304, this Bulletin], the Internal Revenue Service is issuing temporary regulations relating to the abatement of a portion of any penalty or addition to tax attributable to erroneous written advice furnished to a taxpayer by the Service. The text of the temporary regulations also serves as the comment document for this notice of proposed rulemaking.

DATES: The regulations are proposed to be effective with respect to advice requested on or after January 1, 1989. Written comments and requests for a public hearing must be delivered or mailed by July 17, 1989.

ADDRESS: Send comments and requests for a public hearing to: Internal Revenue Service, ATTN: CC:CORP:T:R (IA-24-89), Room 4429, Washington, D.C. 20224.

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 1980 (44 U.S.C. 3504(h)). Comments on the collection of information should be sent to the Office of Management and Budget, Paperwork Reduction Project, Washington, D.C. 20503, with copies to the Internal Revenue Service, Attn: IRS Reports Clearance Officer TR:FP, Washington, D.C. 20224.

The collection of information requirement in this regulation is contained in section 26 CFR 301.6404-3T. This information is required by the Internal Revenue Service in order to determine whether a taxpayer is entitled to an abatement of a penalty or addition to tax under section 6404(f). The likely respondents are individual taxpayers, businesses or other for-profit organizations, and small businesses or organizations.

The time estimates for the reporting and recordkeeping requirements contained in this regulation are included in the burden of Form 843.

Background

The temporary regulations published in * * * [T.D. 8254, page 304, this Bulletin] amend the Procedure and Administration Regulations under section 6404 of the Internal Revenue Code of 1986 by adding §301.6404-3T to Title 26 of the Code of Federal Regulations (CFR). For the text of the new temporary regulations, see T.D. 8254, published * * * [page 304, this Bulletin]. The preamble to the temporary regulations explains the regulations.

Regulatory Impact Analysis

These proposed rules are not major rules as defined in Executive Order 12291. Therefore, a Regulatory Impact Analysis is not required.

Submission to Small Business Administration

Pursuant to section 7805(f) of the Code, the rules proposed in this document will be submitted to the Administrator of the Small Business Administration for comment on their impact on small business.

Comments and Requests for a Public Hearing

Before these temporary regulations are adopted, consideration will be given to any written comments that are submitted (preferably a signed original) to the Internal Revenue Service. All comments will be made available for public inspection and copying. A public hearing will be held upon written request to the Internal Revenue Service by any person who also submits written comments. If a public hearing is held, notice of the time and place will be published in the Federal Register.

Michael J. Murphy,
Acting Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on May 15, 1989, 8:45 a.m., and published in the issue of the Federal Register for May 16, 1989, 54 F.R. 21073)

Notice of Proposed Rulemaking

Limitation of Foreign Tax Credit for Foreign Oil and Gas Taxes

INTL-152-86

AGENCY: Internal Revenue Service, Treasury.

ACTION: Notice of proposed rulemaking by cross-reference to temporary regulations.

SUMMARY: This document contains proposed Income Tax Regulations relating to the amendments made to the Internal Revenue Code by the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA). The amendments require that foreign oil and gas extraction income and losses from all foreign countries be aggregated before computing the limit on creditability of foreign taxes. The amendments also repeal the separate application of the foreign tax credit limitation to taxes on foreign oil related income. In * * * [T.D. 8240, page 238, this Bulletin], the Internal Revenue Service is issuing temporary regulations relating to these matters. The text of those temporary regulations also serves as the comment document for this proposed rulemaking.

DATES: Written comments and request for a public hearing must be delivered or mailed by April 24, 1989. The amendments are proposed to be effective, generally, for taxable years beginning after December 31, 1982.

ADDRESS: Send comments and request for a public hearing to: Commissioner of Internal Revenue, (Attention: CC:COPP: T:R, INTL-152-86), Washington, D.C. 20224.

SUPPLEMENTARY INFORMATION:

BACKGROUND

The temporary regulations published in * * * [T.D. 8240, page 238, this Bulletin] add new §§1.907(a)-0T, 1.907(c)-1T, 1.907(a)-0AT through 1.907(f)-1AT. The final regulations that are proposed to be based on the temporary regulations would amend 26 CFR Part 1 to conform the regulations to changes made to section 907 by section 211 (96 Stat. 448) of TEFRA. For the text of the temporary regulations, see T.D. 8240 published in * * * [page 238, this Bulletin].

SPECIAL ANALYSIS

It has been determined that these proposed rules are not major rules as defined in Executive Order 12291. Therefore, a Regulatory Impact Analysis is not required. Although this document is a notice of proposed rulemaking that solicits public comments, the notice and public procedure requirements of 5 U.S.C. §553 do not apply because it has been determined that these proposed regulations are interpretative. Therefore, an initial Regulatory Flexibility Analysis is not required by the Regulatory Flexibility Act (5 U.S.C. Chapter 6).

COMMENTS AND REQUESTS FOR A PUBLIC HEARING

Before adopting these proposed regulations, consideration will be given to any written comments that are submitted (preferably a signed original and seven copies) to the Commissioner of Internal Revenue. All comments will be available for public inspection and copying. A public hearing will be held upon written requests by any person who has submitted written comments on the proposed rules. Notice of the time and place for the hearing will be published in the FEDERAL REGISTER.

* * * * * *

Proposed amendments to the regulations

The temporary regulations T.D. 8240, published in * * * [page 238, this Bulletin], are hereby also proposed as final regulations under section 907 of the Internal Revenue Code of 1986.

Lawrence B. Gibbs,
Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on January 19, 1989, 8:45 a.m., and published in he issue of the Federal Register for January 23, 1989, 54 F.R. 3083)

Notice of Proposed Rulemaking

Subsidies Under Section 901(i)

INTL-942-86

AGENCY: Internal Revenue Service, Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document provides proposed Income Tax Regulations relating to denial of foreign tax credits for subsidies provided by foreign governments through the use of taxing systems. These regulations are proposed to implement the Tax Reform Act of 1986.

DATES: Written comments and requests for a public hearing must be delivered or mailed before January 17, 1989. These rules would apply to amounts paid or accrued in taxable years beginning after December 31, 1986.

ADDRESS: Send comments and requests for a public hearing to Commissioner of Internal Revenue, Attention: CC:CORP: T:R (INTL-942-86) , Washington, DC 20224.

SUPPLEMENTAL INFORMATION:

BACKGROUND

This document contains proposed Income Tax Regulations (26 CFR Part 1) under section 901(i) of the Internal Revenue Code of 1986, as added by section 1204 of the Tax Reform Act of 1986 (100 Stat. 2085, 2532, Pub. L. 99-514).

The regulations are proposed to be issued under the authority contained in section 7805(a).

DISCUSSION

Section 901(i) was added to the Code to deny foreign tax credits where the amount paid or accrued (and designated as a "tax" by the foreign government) is used to provide a subsidy. The proposed regulations would clarify the circumstances under which the foreign tax credit is denied for such amounts.

Under the proposed regulations, the amount of the tax would be treated as a subsidy and not as an amount of tax paid or accrued if the amount is used, directly or indirectly, by the foreign country imposing the tax to provide a subsidy to the taxpayer, to a related person (within the meaning of section 482), to any party to the transaction, or to any party to a related transaction. The subsidy may be provided by any means but must be determined, directly or indirectly, by reference to the amount of the tax, or to the base used to compute the amount of the tax.

The proposed regulations state that the method of providing a subsidy may include, but is not limited to, a rebate, a refund, a credit, a deduction, a payment, a discharge of an obligation, or any other method. The term "subsidy" is defined to include any benefit conferred, directly or indirectly, by a foreign country. Examples are provided that describe specific circumstances which give rise to a subsidy as contemplated by the regulations.

Under the proposed regulations, the use of an official exchange rate under certain circumstances would not be a subsidy determined, directly or indirectly, by reference to the amount of the tax, or to the base used to compute the amount of tax. Rev. Rul. 84-143, 1984-2 C.B. 127, held that the use of the official exchange rate of the Mexican Exchange Control Decree, effective December 20, 1982, is not a subsidy under prior law. The official exchange rate rule in the proposed regulations adopts the holding of Rev. Rul. 84-143. The fact pattern of Rev. Rul. 84-143 is addressed in example (3).

COMMENTS AND REQUESTS FOR A PUBLIC HEARING

Before adopting these proposed regulations as final, consideration will be given to any written comments that are submitted (preferably nine copies) to the Commissioner of Internal Revenue. All comments will be available for public inspection and copying. A public hearing will be held upon written request to the Commissioner by any person who has submitted written comments. If a public hearing is held, notice of the time and place will be published in the FEDERAL REGISTER.

SPECIAL ANALYSES

It has been determined that this proposed rule is not a major rule as defined in Executive Order 12291 and that a Regulatory Impact Analysis is therefore not required. Although this document is a notice of proposed rulemaking that solicits public comment, it has been determined that the proposed regulations are interpretative and that the notice and public procedure requirements of 5 U.S.C. 553 do not apply. Accordingly, these proposed regulations do not constitute regulations subject to the Regulatory Flexibility Act (5 U.S.C. Chapter 6) and a Regulatory Flexibility Analysis has not been prepared.

* * * * * *

Proposed amendments to the regulations

Accordingly, the proposed amendments to 26 CFR Part 1 are as follows:

INCOME TAX REGULATIONS (26 CFR Part 1)

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

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

Par. 2. Section 1.901-2(e)(3) is revised to read as follows:

§1.901-2 Income, war profits, or excess profits tax paid or accrued.

* * * * * *

(e) *Amount of income tax that is creditable.*

* * * * * *

(3) Subsidies—(i) *General Rule.* An amount of foreign income tax is not an amount of income tax paid or accrued by a taxpayer to a foreign country to the extent that—

(A) The amount is used, directly or indirectly, by the foreign country imposing the tax to provide a subsidy by any means (including, but not limited to, a rebate, refund, credit, deduction, payment, discharge of an obligation, or other method) to the taxpayer, to a related person (within the meaning of section 482), to any party to the transaction, or to any party to a related transaction; and

(B) The subsidy is determined, directly or indirectly, by reference to the amount of the tax, or by reference to the base used to compute the amount of the tax.

(ii) *Subsidy.* The term "subsidy" includes any benefit conferred, directly or indirectly, by a foreign country to one of the parties enumerated in paragraph (e)(3)(i)(A) of this section. Substance and not form shall govern in determining whether a subsidy exists. The fact that the U.S. taxpayer may derive no benefit from the subsidy is irrelevant in determining whether a subsidy exists.

(iii) *Official exchange rate.* A subsidy described in paragraph (e)(3)(i)(B) of this section does not include the actual use of an official foreign government exchange rate converting foreign currency into dollars where a free exchange rate also exists if—

(A) The economic benefit represented by the use of the official exchange rate is not targeted to or tied to transactions that give rise to a claim for a foreign tax credit;

(B) The economic benefit of the official exchange rate applies to a broad range of international transactions, in all cases based on the total payment to be made without regard to whether the payment is a return of principal, gross income, or net income, and without regard to whether it is subject to tax; and

(C) Any reduction in the overall cost of the transaction is merely coincidental to the broad structure and operation of the official exchange rate.

In regard to foreign taxes paid or accrued in taxable years beginning before January 1, 1987, to which the Mexican Exchange Control Decree, effective as of December 20, 1982, applies, see Rev. Rul. 84-143, 1984-2 C.B. 127.

(iv) *Examples.* The provisions of this paragraph (e)(3) may be illustrated by the following examples:

Example (1). (i) Country X imposes a 30 percent tax on nonresident lenders with respect to interest which the nonresident lenders receive from borrowers who are residents of Country X, and it is established that this tax is a tax in lieu of an income tax within the meaning of §1.903-1(a). Country X remits to resident borrowers an incentive payment for engaging in foreign loans, which payment is an amount equal to 20 percent of the interest paid to nonresident lenders.

(ii) Because the incentive payment is based on the interest paid, it is determined by reference to the base used to compute the tax in lieu of an income tax that is imposed on the nonresident lender. The incentive payment is considered a subsidy under this paragraph (e)(3) since it is provided to a party (the borrower) to the transaction and is based on the amount of tax in lieu of an income tax that is imposed on the lender with respect to the transaction. Therefore, two-thirds (20 percent/30 percent) of the amount withheld by the resident borrower from interest payments to the nonresident lender is not a tax in lieu of an income tax.

Example (2). (i) A U.S. bank lends money to a development bank in Country X. The development bank relends the money to companies resident in Country X. A withholding tax is imposed by Country X on the U.S. bank with respect to the interest that the development bank pays to the U.S. bank. On the date that the tax is withheld, fifty percent of the tax is credited by Country X to an account of the development bank. Country X requires the development bank to transfer the amount credited to the borrowing companies.

(ii) The amount successively credited to the account of the development bank and then to the account of the borrowing companies is determined by reference to the amount of the tax and the tax base. Since the amount credited to the borrowing companies is a subsidy provided to a party (the borrowing companies) to a related transaction and is based on the amount of tax and the tax base, it is not a creditable tax (without regard to whether the U.S. bank derived any benefit from the subsidy).

Example (3). (i) A U.S. bank lends dollars to a Country X borrower. Country X imposes a withholding tax on the lender with respect to the interest. The tax is to be paid in Country X currency, although the interest is payable in dollars. Country X has a dual exchange rate system, comprised of a controlled official exchange rate and a free exchange rate. Priority transactions such as exports of merchandise, imports of merchandise, and payments of principal and interest on foreign currency loans payable abroad to foreign lenders are governed by the official exchange rate which yields more dollars per unit of Country X currency than the free exchange rate. The Country X borrower remits the net amount of dollar interest due to the U.S. bank (interest due less withholding tax), pays the tax withheld in Country X currency to the Country X government, and provides to the U.S. bank a receipt for payment of the Country X taxes.

(ii) The use of the official exchange rate by the U.S. bank to determine foreign taxes with respect to interest is not a subsidy described in paragraph (e)(3)(i)(B) of this section. The official exchange rate is not targeted to or tied to transactions that give rise to a claim for a foreign tax credit. The use of the official exchange rate applies to the interest paid and to the principal paid. Any benefit derived by the U.S. bank through the use of the official exchange rate is merely coincidental to the broad structure and operation of the official exchange rate.

(v) *Effective Date.* This paragraph (e)(3) shall apply to foreign taxes paid or accrued in taxable years beginning after December 31, 1986. For rules for taxable years beginning before January 1, 1987, see 26 C.F.R. §1.901-2(e)(3) (Revised as of April 1, 1987).

Lawrence B. Gibbs,
Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on November 14, 1988, 8:45 a.m., and published in the issue of the Federal Register for November 15, 1988, 53 F.R. 45942)

Notice of Proposed Rulemaking

Requirements Relating to Certain Exchanges Involving a Foreign Corporation

INTL-988-86

AGENCY: Internal Revenue Service, Treasury.

ACTION: Notice of proposed rulemaking by cross-reference to temporary regulations.

SUMMARY: This document provides proposed Income Tax Regulations concerning requirements relating to certain exchanges involving a foreign corporation. In * * * [T.D. 8243, page 108, this Bulletin], the Internal Revenue Service is issuing temporary regulations relating to these matters. The portions of the text of those temporary regulations that amend Part 7 of 26 CFR also serve as the comment document for this proposed rulemaking. When the regulations are made final, Part 7 will be amended by removing the temporary regulations and Part 1 will be amended by adding the final regulations to that part.

DATES: Written comments and requests for a public hearing must be delivered or mailed before May 5, 1989.

ADDRESS: Send comments and requests for a public hearing to: Commissioner of Internal Revenue, Attention: CC:CORP: T:R (INTL-988-86), Washington, D.C. 20224.

SUPPLEMENTARY INFORMATION:

BACKGROUND

The temporary regulations published in * * * [T.D. 8243, page 108, this Bulletin], amend, in part, §§7.367(b)-2(d) and (f), 7.367(b)-7(c)(1) and 7.367(b)-9(b) of 26 CFR Parts 1 and 7. The final regulations that are proposed to be based on the temporary regulations would amend 26 CFR Parts 1 and 7. For the text of the temporary regulations, see paragraphs 2 through 4 of Treasury decision [T.D. 8243] published in * * * [page 108, this Bulletin].

Temporary regulations under §§7.367-(b)-2, 7.367(b)-7 and 7.367(b)-9 with cross-reference notice were originally published on December 20, 1977 (42 FR 65152, 65204) [1977-2 C.B. 112]. This document, therefore, also serves to amend that notice of proposed rulemaking.

SPECIAL ANALYSES

It has been determined that these proposed rules are not major rules as defined in Executive Order 12291, and a Regulatory Impact Analysis is therefore not required. Although this document is a notice of proposed rulemaking which solicits public comment, it has been concluded that the regulations proposed herein are interpretative and that the notice and public procedure requirements of 5 U.S.C. 553 do not apply. Accordingly, these proposed regulations do not constitute regulations subject to the Regulatory Flexibility Act (5 U.S.C. chapter 6).

COMMENTS AND REQUESTS FOR A PUBLIC HEARING

Before adopting these proposed regulations as final, consideration will be given to any written comments that are submitted (preferably eight copies) to the Commissioner of Internal Revenue. All comments will be available for public inspection and copying. A public hearing will be held upon written request to the Commissioner by any person who has submitted written comments. If a public hearing is held, notice of the time and place will be published in the FEDERAL REGISTER.

LIST OF SUBJECTS IN 26 CFR §§1.301-1 through 1.385-6

Income taxes, Corporations, Corporate distributions, Corporate adjustments, Reorganizations.

LIST OF SUBJECTS IN 26 CFR Part 7

Income taxes, Tax Reform Act of 1976.

Proposal of regulations

Paragraphs 2 through 4 of the temporary regulations T.D. 8243 published in * * * [page 108, this Bulletin] are hereby also proposed as final regulations under section 367(b) of the Internal Revenue Code.

Lawrence B. Gibbs,
Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on March 3, 1989, 11:08 a.m., and published in the issue of the Federal Register for March 6, 1989, 54 F.R. 9236)

Notice of Proposed Rulemaking

Extension of Time to File for Taxpayers Outside the United States and Puerto Rico

INTL-461-87

AGENCY: Internal Revenue Service, Treasury.

ACTION: Notice of proposed rulemaking by cross-reference to temporary regulations.

SUMMARY: This document provides proposed Income Tax Regulations relating to the extension of time to file federal income tax returns for United States citizens and U.S. residents who are outside of the United States and Puerto Rico. In * * * [T.D. 8241, page 297, this Bulletin] the Internal Revenue Service is issuing temporary regulations relating to these matters. The text of those temporary regulations also serves as the comment document for this notice of proposed rulemaking.

DATES: Written comments and requests for a public hearing must be delivered or mailed before April 24, 1989. These rules are proposed to apply to federal income tax returns due on or after April 15, 1988.

ADDRESS: Send comments and requests for a public hearing to Commissioner of Internal Revenue, Attention: CC:LR:T (INTL-461-87), Washington, D.C. 20224.

SUPPLEMENTARY INFORMATION:

PAPERWORK REDUCTION ACT

The temporary regulations contain no new reporting or recordkeeping requirements but merely move existing requirements to the new temporary regulations section and, thus, are not subject to the Paperwork Reduction Act (44 U.S.C. 3501), as amended.

BACKGROUND

The temporary regulations published in the Rules and Regulations portion of * * * T.D. 8241 contain amendments to the Income Tax Regulations (26 CFR Part 1) under section 6081 of the Internal Revenue Code. For the text of the temporary regulations, see T.D. 8241 published in * * * [page 297, this Bulletin].

EXECUTIVE ORDER 12991 AND REGULATORY FLEXIBILITY ACT

The Commissioner of Internal Revenue has determined that these proposed rules are not major rules as defined in Executive Order 12991 and that a Regulatory Impact Analysis is therefore not required. Although this document is a notice of a proposed rulemaking which solicits public comment, the Internal Revenue Service has concluded that the regulations proposed herein are interpretative and that the notice and public procedure requirements of 5 U.S.C. 553 do not apply. Accordingly, these proposed regulations do not constitute regulations subject to the Regulatory Flexibility Act (5 U.S.C. chapter 6).

COMMENTS AND REQUESTS FOR A PUBLIC HEARING

Before adopting these proposed regulations, consideration will be given to any written comments that are submitted (preferably eight copies) to the Commissioner of Internal Revenue. All comments will be available for public inspection and copying. A public hearing will be held upon written request to the Commissioner by any person who has submitted written comments. If a public hearing is held, notice of the time and place will be published in the FEDERAL REGISTER.

LIST OF SUBJECTS IN 26 CFR §§1.6001-1 through 1.6109-2

Income taxes, Administration and procedure, Filing requirements.

Proposed Amendments to the regulations

The temporary regulations, T.D. 8241, published in * * * [page 297, this Bulletin] are hereby also proposed as final regulations under section 6081 of the Internal Revenue Code of 1954.

Lawrence B. Gibbs,
Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on February 22, 1989, 8:45 a.m., and published in the issue of the Federal Register for February 23, 1989, 54 F.R. 7783)

Notice of Proposed Rulemaking

Allocation and Apportionment of Deduction for State Income Taxes

INTL-41-88

AGENCY: Internal Revenue Service, Treasury.

ACTION: Notice of proposed rulemaking by cross-reference to temporary regulations.

SUMMARY: In * * * [T.D. 8236, page 228, this Bulletin] the Internal Revenue Service is issuing temporary Income Tax Regulations relating to the allocation and apportionment of deductions for state income taxes in computing taxable income from sources inside and outside the United States. The text of those temporary regulations also serves as the text for this Notice of Proposed Rulemaking.

DATES: Written comments and requests for a public hearing must be delivered or mailed by February 10, 1989. This regulation is proposed to be effective on the date that final regulations are published in the FEDERAL REGISTER.

ADDRESS: Send comments and requests for a public hearing to: Commissioner of Internal Revenue, Attention: CC:CORP:TR (INTL-41-88), Washington, DC 20224.

SUPPLEMENTARY INFORMATION:

BACKGROUND

The temporary Income Tax Regulations in * * * [T.D. 8236, page 228, this Bulletin] supplement the Income Tax Regulations (26 CFR Part 1) under sections 861(b), 862(b), and 863(a) of the Internal Revenue Code. These temporary Income Tax Regulations add paragraph (e)(6) and examples (25) through (29) of paragraph (g) of §1.861-8T. Paragraph (e)(6)(i) of §1.861-8T as promulgated herein restates the previously promulgated general principle that state, local and foreign income, war profits and excess profits taxes are definitely related and allocable to the gross income with respect to which such taxes are imposed. Paragraph (e)(ii) of §1.861-8T refers to five examples of the application of the principle in paragraph (e)(6)(i) and provides that methods other than those illustrated in the examples may be more appropriate in facts that differ from those in the examples. Paragraph (e)(6)(iii) of §1.861-8T provides taxpayers with the option to apply the provisions of paragraph (e)(ii) of §1.861-8T and examples (25) through (29) of paragraph (g) of §1.861-8T to deductions for state tax incurred in taxable years beginning before January 1, 1988, which is the effective date of the temporary Income Tax Regulations. Paragraph (g) of §1.861-8T restates and supplements the language preceding the examples in §1.861-8(g), and adds examples (25) through (29) to provide five specific examples of the allocation and apportionment of the deduction for state income taxes.

SPECIAL ANALYSES

It has been determined that this proposed rule is not a major legislative regulation subject to Executive Order 12291. Accordingly, a Regulatory Impact Analysis is not required. Although this document is a notice of proposed rulemaking which solicits public comment, it has been concluded that the proposed regulations are interpretative and that the notice and public comment procedural requirements of 5 U.S.C. §553 do not apply. Accordingly, these proposed regulations do not constitute regulations subject to the Regulatory Flexibility Act (5 U.S.C. Chapter 6).

COMMENTS AND REQUESTS FOR A PUBLIC HEARING

Before adopting as final regulations these proposed regulations, consideration will be given to any written comments that are submitted (preferably eight copies) to the Commissioner of Internal Revenue. All comments will be available for public inspection and copying. A public hearing will be held upon written request to the Commissioner by any person who has submitted written comments. If a public hearing is to be held, notice of the time and place will be published in the FEDERAL REGISTER.

LIST OF SUBJECTS IN 26 CFR §§1.861-1 THROUGH 1.997-1

Income taxes, Aliens, Exports, DISC, Foreign investment in United States, Foreign tax credit, FSC, Sources of income, United States investments abroad.

Proposal of regulations.

The temporary Income Tax Regulations, * * * [T.D. 8236, page 228, this Bulletin] * * * are hereby also proposed as final regulations under sections 861(b), 862(b), and 863(a) of the Internal Revenue Code.

Lawrence B. Gibbs,
Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on December 7, 1988, 3:39p.m., and published in the issue of the Federal Register for December 12, 1988, 53 F.R. 49893)

Notice of Proposed Rulemaking

Election, Revocation, Termination, and Tax Effect of Subchapter S Status

PS-260-82

AGENCY: Internal Revenue Service, Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations relating to the election, revocation, termination, and corporate effect of electing subchapter S treatment as a result of the changes to the tax law made by the Subchapter S Revision Act of 1982, as amended by the Tax Reform Act of 1984, the Tax Reform Act of 1986, and the Technical and Miscellaneous Revenue Act of 1988. The regulations would provide guidance to persons seeking to elect, revoke, or terminate subchapter S status.

DATES: Written comments and requests for a public hearing must be mailed or delivered by February 27, 1989. The regulations are proposed to be effective for taxable years beginning after December 31, 1982, except for §1.1362-3(d) which is proposed to be effective for taxable years beginning after December 31, 1981, and except for that portion of §1.1362-1(c) relating to taxable years of 2½ months or less which is proposed to be effective for elections made after October 19, 1982. The portion of §1.1362-3(d)(5)(ii) relating to options or commodities dealers is proposed to be effective and shall apply to positions established after July 18, 1984, in taxable years ending after such date.

ADDRESS: Send comments and requests for a public hearing to: Internal Revenue Service, Attn: CC:CORP:T:R (PS-260-82), Room 4429, Washington, D.C. 20224.

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 1980 (44 U.S.C. 3504(h)). Comments on the collections of information should be sent to the Office of Information and Regulatory Affairs, Attention: Desk Officer for the Internal Revenue Service, Office of Management and Budget, Washington, D.C. 20503, with copies to the Internal Revenue Service at the address previously specified.

The collections of information in this regulation are §§1.1362-1, 1.1362-2, 1.1362-3, 1.1362-4, 1.1362-5 and 1.1362-6. This information is required by the Internal Revenue Service to effectuate the statutory provisions of section 1362. This information will be used to determine the eligibility of corporations and their shareholders to receive the special benefits of the Code under section 1362. The likely respondents are individuals or households, farms, business or other for-profit institutions, and small businesses or organizations.

Estimated total annual reporting and recordkeeping burden: 80,000 hours.

Estimated number of respondents: 80,000.

Estimated average annual burden per respondent: 1 hour.

Estimated annual frequency of responses: On occasion.

These estimates are an approximation of the average time expected to be necessary for a collection of information. They are based on such information as is available to the Internal Revenue Service. Individual respondents may require greater or less time, depending on their particular circumstances.

Background

This document contains proposed amendments to the Income Tax Regulations (26 CFR Part 1) with respect to the election, termination, and corporate effect of subchapter S status. These amendments are necessary to implement sections 1362 and 1363 of the Internal Revenue Code of 1986 as added by section 2 of the Subchapter S Revision Act of 1982 (98 Stat. 1669), as amended by sections 102 and 721 of the Tax Reform Act of 1984 (98 Stat. 623 and 966), sections 511, 632, and 701 of the Tax Reform Act of 1986 (100 Stat. 2244, 2275, and 2320), and sections 1006(f)-(6)-(7) and 1007(g)(9) of the Technical and Miscellaneous Revenue Act Revenue Act of 1988 (Pub. L. No. 100-647).

Explanation of provisions

Section 1362 provides that a corporation may file its subchapter S election at any time before the 16th day of the third month of its taxable year, at any time before the 16th day of the third month following the first day of the taxable year if the taxable year is 2½ months or less, or at any time during the preceding taxable year. Proposed §1.1362-1 provides rules with respect to the time and manner of making a subchapter S election. The proposed regulations define the term "month" to mean the period commencing with the beginning of the first day of the taxable year and ending with the close of the day preceding the numerically corresponding day of the succeeding taxable month.

Proposed §1.1362-2 contains the rules relating to the requirement that shareholders must consent to the subchapter S election. Provisions for an extension of time to file the required consents are provided in the proposed regulations.

Proposed §1.1362.3 provides rules with respect to the termination of a corporation's subchapter S election. An election may be revoked provided that shareholders holding more than 50 percent of the issued and outstanding shares of stock, including non-voting stock, consent to the revocation. A revocation made on or before the 15th day of the third month of the taxable year shall be effective on the first day of the taxable year unless the revocation states a prospective date. A revocation made after the 15th day of the third month of the taxable year shall be effective for the following taxable year unless the revocation states some other prospective date. The proposed regulations provide that a revocation, once made, may be rescinded prior to its effective date.

A corporation's election is terminated by its ceasing to be a small business corporation as described in proposed §1.1362-3(c). A corporation's election also is terminated whenever the corporation has subchapter C earnings and profits at the close of each of three consecutive taxable years, and has gross receipts for each of the three taxable years more than 25 percent of which are passive investment income as provided in §1.1362-3(d).

Passive investment income generally includes gross receipts derived from royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities. This definition was not amended by the Subchapter S Revision Act of 1982 ("The 1982 Act"). However, the passive investment income limitation now only applies to S corporations with C corporation earnings and profits. The legislative history of this provision indicates that the purpose for retaining the rule is "to prevent the conversion of a regular corporation's operating company into a holding company whose income is not subject to a corporate level tax, without the imposition of any shareholder tax on accumulated corporate earnings as would occur if the corporation was liquidated." H.R. Rept. No. 826, 97th Cong., 2d Sess. 5 (1982). Consistent with this purpose, the proposed regulations provide that royalties do not include royalties that would not be personal holding company income under section 543(a) if the corporation remained a C corporation. Thus, proposed §1.1362-3(d)(5)(iii) provides that copyright royalties that are excluded from personal holding company income under section 543(a)(4), mineral, oil, or gas royalties excluded from personal holding company income under section 543(a)(3), and active computer software royalties (as defined in section 543(d), but determined without regard to section 543(d)(5)) are not treated as royalties for purposes of the passive investment income limitation. The Service invites public comment on the appropriate scope of the passive investment income limitation, including the use of these personal holding company rules to distinguish passive investment income from other types of income. In particular, the Service invites public comment on alternative definitions of passive investment income (*e.g.*, a definition that would distinguish between passive investment income and income earned in the active conduct of a trade or business.)

Proposed §1.1362-4 provides rules relating to the treatment of an "S termination year." Generally, section 1362(e) requires the pro rata allocation of items of income, loss, deduction, and credit for the taxable year to each of the short S and C years. Exceptions from the pro rata allocation method apply where (1) the corporation elects to have items assigned to each short year under its normal tax accounting method, (2) an election is made under section 338 with respect to the corporation to treat the purchase of its stock as an asset purchase, or (3) there is a sale or exchange of 50 percent or more of the stock of the S corporation during the S termination year. In such cases where the pro rata rules do not apply, the corporation must allocate items of income, gain, loss, deduction, and credit to the short S and short C years on the basis of normal tax accounting rules.

Section 1362(f) provides that the Secretary may waive certain inadvertent terminations of subchapter S elections. Proposed §1.1362-5 contains rules relating to the determination of inadvertence as well as the procedures for requesting a waiver of the terminating event.

Proposed §1.1363-1 sets forth rules relating to the general effect on the corporation that elects to receive subchapter S treatment.

Special Analyses

The Commissioner of Internal Revenue has determined that this proposed regulation is not a major regulation subject to review under Executive Order 12291. Accordingly, a Regulatory Impact Analysis is not required.

The Commissioner of Internal Revenue has concluded that the notice and public procedure requirements of 5 U.S.C. 553 do not apply. Accordingly, this proposed regulation is a regulation not subject to the Regulatory Flexibility Act (5 U.S.C. chapter 6).

Comments and Requests for a Public Hearing

Before adopting these proposed regulations, consideration will be given to any written comments that are submitted to the Internal Revenue Service. All comments will be available for public inspection and copying. A public hearing will be held upon written request to the Commissioner by any person who also submits written comments. If a public hearing is held, notice of time and place will be published in the Federal Register.

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Proposed Amendments to the Regulations

The proposed amendments to 26 CFR, Chapter 1, Part 1 are as follows:

PART I—INCOME TAX; TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1986

Paragraph 1. The authority for Part 1 is amended by adding the following citation:

Authority: 26 U.S.C. 7805. * * * Sections 1.1362-0 through 1.1362-6, and 1.1363-1 are also issued under 26 U.S.C. 1377.

Par. 2. There are added immediately after §1.1361-0A the following new §§1.1362-0, 1.1362-1, 1.1362-2, 1.1362-3, 1.1362-4, 1.1362-5, 1.1362-6, and 1.1363-1:

§1.1362-0 Election, revocation, and termination of S corporation.

In order to facilitate use of §§1.1362-1 through 1.1362-6, this section lists the paragraphs, subparagraphs, and subdivisions contained in those sections.

§1.1362-1 Election to be an S corporation.

(a) In general.

(b) Manner of making election.

(c) Time of making election.

(1) In general.

(2) Elections made during the first 2½ months treated as made for the following taxable year.

(3) Definition of "month" and the beginning of the taxable year.

(4) Cross reference.

(d) Years for which election is effective.

(e) Examples.

§1.1362-2 Shareholders' consent.

(a) In general.

(b) Persons required to consent.

(1) In general.

(2) Special rules.

(c) Extension of time for filing consents.

§1.1362-3 Termination of election.

(a) In general.

(b) Revocation.

(1) In general.

(2) When effective.

(3) Revocations specifying a prospective revocation date.

(4) Effect on taxable year of corporation.

(5) Rescission of a revocation.

(6) Creation of an S termination year.

(7) Examples.

(c) Corporation ceasing to be a small business corporation.

(1) In general.

(2) When effective.

(3) Effect on taxable year of the corporation.

(4) Creation of an S termination year.

(5) Examples.

(d) Excess passive investment income.

(1) In general.

(2) When effective.

(3) Subchapter C earnings and profits.

(4) Gross receipts.

(i) In general.

(ii) Sales of capital assets, stock and securities.

(A) Sales of capital assets.

(B) Sales of stock or securities.

(iii) Other exclusions from gross receipts.

(iv) Examples.

(5) Passive investment income.

(i) In general.

(ii) Special rule for options or commodities dealer.

(A) Exclusion of certain capital gains.

(B) Definitions.

(*1*) Options dealer.

(*2*) Commodities dealer.

(*3*) Section 1256 contract.

(C) Effective date.

(iii) Royalties.

(A) In general.

(B) Copyright royalties.

(C) Mineral, oil, or gas royalties.

(D) Active business computer software royalties

(iv) Rents.

(v) Dividends.

(vi) Interest.

(vii) Annuities.

(viii) Gross receipts from the sale of stock or securities.

(ix) Treatment of certain lending or finance companies.

(6) Example.

§1.1362-4 Treatment of S termination year.

(a) In general.

(b) Pro rata allocation.

(c) Income, loss, deduction, and credit items assigned to each short taxable year under normal tax accounting rules.

(1) In general.

(2) Election.

(3) Pro rata allocation not to apply to certain items if purchase of stock treated as an asset purchase under section 338.

(i) In general.

(ii) Special rule.

(4) Pro rata allocation not to apply if 50 percent change in ownership during S termination year.

(i) In general.

(ii) Newly owned stock.

(iii) Stock acquired other than by sale or exchange.

(A) In general.

(B) Qualified transferor.

(iv) Special rule.

(v) Examples.

(5) Special rule for S corporation that is a partner in a partnership.

(d) Tax for the C short year.

(1) In general.

(2) Minimum tax.

(3) Example.

(e) Other special rules.

(1) Short year treated as taxable year.

(2) Year for carryover purposes.

(3) Due date for S year return.

(4) Year in which income from S short year is includible.

§1.1362-5 Inadvertent terminations.

(a) In general.

(b) Inadvertent termination.

(c) Corporation's request for determination of an inadvertent termination.

(d) Correction of terminating event.

(e) Consent to Commissioner's requirement.

(f) Adjustments.

(g) Status of corporation.

§1.1362-6 Election after termination.

(a) In general.

(b) Successor corporation.

(c) Special rule for certain terminations.

§1.1362-1 Election to be an S corporation.

(a) *In general.* Except as provided in §1.1362-6, for taxable years beginning after December 31, 1982 (and for taxable years beginning before January 1, 1983, with respect to which an election was made after October 19, 1982), a small business corporation (other than a qualified casualty insurance electing small business corporation described in section 6(c)(2) of the Subchapter S Revision Act of 1982, or a qualified oil corporation described in section 6 (c)(3) of that Act) may elect to be an S corporation under section 1362. For elections made under section 1372(a) (as in effect before the enactment of the Subchapter S Revision Act of 1982) see section 1379.

(b) *Manner of making election.* To make the election to be an S corporation, a small business corporation shall file Form 2553, containing all the information required by that form. The election form shall be signed by any person who is authorized to sign the return required to be filed under section 6037 and shall be filed with the service center designated in the instructions applicable to Form 2553. The election is not valid unless each shareholder who is required by §1.1362-2(b) to consent to the election of the corporation makes the consent in the manner provided in §1.1362-2(a).

(c) *Time of making election*—(1) *In general.* The election described in paragraph (a) of this section may be made by a small business corporation at any time during the taxable year that immediately precedes the taxable year for which the election is to be effective, or during the taxable year for which the election is to be effective provided that such election is made before the 16th day of the third month of such year.

If a corporation makes an election for a taxable year that meets all the requirements provided in this section, but the election is made at any time during the period beginning after the 15th day of the third month of such taxable year and ending before the 16th day of the third month of the following taxable year, the election is treated as being made for that following taxable year provided that the corporation meets all the requirements provided in section 1361(b) at the time the election is made. For taxable years of $2\frac{1}{2}$ months or less, an election made after October 19, 1982, and before the 16th day of the third month after the first day of the taxable year shall be treated as made during such year.

(2) *Elections made during the first $2\frac{1}{2}$ months treated as made for the following taxable year.* If a corporation makes the election described in paragraph (a) of this section during the taxable year for which the election is to be effective and such election is made before the 16th day of the third month of such year but—

(i) The corporation is not a small business corporation at any time during the portion of such taxable year which occurs before the date the election is made, or

(ii) Any person who held stock in the corporation at any time during the portion of such taxable year which occurs before the time the election is made, and who does not hold stock at the time the election is made, does not consent to the election,

the election is treated as made for the following taxable year provided that the corporation meets the requirements of section 1361(b) at the time the election is made.

(3) *Definition of "month" and beginning of the taxable year.* For purposes of this paragraph (c), the term "month" means a period commencing on the same numerical day of any calendar month as the day of the calendar month on which the taxable year began and ending with the close of the day preceding the numerically corresponding day of the succeeding calendar month or, if there is no such corresponding day, with the close of the last day of such succeeding calendar month. In addition, for purposes of this paragraph (c), the taxable year of a new corporation begins on the date that the corporation has shareholders, acquires assets, or begins doing business, whichever is the first to occur.

(4) *Cross-reference.* For rules relating to when an election is treated as made, see section 7502 and the regulations thereunder. For rules relating to the time for the making of the election where the last day prescribed for making the election falls on Saturday, Sunday, or a legal holiday, see section 7503 and the regulations thereunder.

(d) *Years for which election is effective.* An election under section 1362 is effective for the entire taxable year of the corporation for which it is made and for all succeeding taxable years of the corporation, unless it is terminated with respect to any taxable year. Thus, the election has a continuing effect and need not be renewed annually, although annual returns of information must be filed under section 6037.

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

Example (1). A calendar year small business corporation begins its first taxable year on January 7, 1988. To be an S corporation beginning with its first taxable year, the corporation must make the election set forth in this section during the period that begins January 7, 1988, and ends before March 22, 1988. An election made earlier than January 7, 1988, will not be valid.

Example (2). Assume the same facts as in example (1), except that the corporation begins its first taxable year on November 8, 1988. To be an S corporation beginning with its first taxable year, the corporation must make the election set forth in this section during the period that begins November 8, 1988, and ends before January 23, 1989.

Example (3). On January 1, 1988, the first day of its taxable year, a subchapter C corporation had 15 shareholders. On January 30, 1988, two of the C corporation's shareholders, A and B, both individuals, sold their shares in the corporation to P, Q, and R, all individuals. On March 1, 1988, the corporation filed its election to be an S corporation for the 1988 taxable year. The election will be effective (assuming the other requirements of section 1361(b) are met) provided that all of the shareholders as of March 1, 1988, as well as former shareholders A and B, consent to the election.

Example (4). On January 1, 1988, two individuals and a partnership own all of the stock of a calendar year subchapter C corporation. On January 31, 1988, the partnership dissolved and distributed its shares in the corporation to its five partners, all individuals. On February 28, 1988, the seven shareholders of the corporation consented to the corporation's election of subchapter S status. The corporation files a properly completed Form 2553 on March 2, 1988. The corporation is not eligible to be a subchapter S corporation for the 1988 taxable year because during the period of the taxable year prior to the election it had an ineligible shareholder. The election is treated as made for the corporation's 1989 taxable year.

Example (5). On January 1, 1988, three individuals own all of the stock of a calendar year subchapter C corporation. On April 15, 1988, the corporation, in accordance with paragraph (b) of this section, files a properly completed Form 2553. The corporation anticipates that the election will be effective beginning January 1, 1989, the first day of the succeeding taxable year. On October 1, 1988, the three shareholders collectively sell 75% of their shares in the corporation to another individual. On January 1, 1989, the corporation has as shareholders the three original individuals as well as the new shareholder. Because the election was valid and binding when made, it is not necessary for the new shareholder to consent to the election. The corporation's subchapter S status will begin on January 1, 1989.

§1.1362-2 Shareholders' consent.

(a) *In general.* The consent of a shareholder to an election by a small business corporation must be made either on Form 2553 or on a separate statement signed by the shareholder in which the shareholder consents to the election of the corporation. The separate statement must set forth the name, address, and taxpayer identification number of the corporation, the name, address, and taxpayer identification number of the shareholder, the number of shares of stock owned by the shareholder, the date (or dates) on which the stock was acquired and the date on which the shareholder's taxable year ends. When a shareholder's consent is made on a separate statement, that statement must be attached to the election of the corporation. The shareholder's consent is binding and may not be withdrawn after a valid election is made by the corporation. Except as provided in paragraph (c) of this section, the election of the corporation is not valid if any consent required by paragraph (b) of this section is not filed in accordance with the rules contained in this paragraph (a).

(b) *Persons required to consent*—(1) *In general.* Each person who is a shareholder (including any person who is treated as a shareholder under section 1361(c)(2)(B)) at the time the election is made must consent to the election of the corporation. If the election is made before the 16th day of the third month of the taxable year and is intended to be effective for that year, each person who was a shareholder (including any person who was treated as a shareholder under section 1361(c)(2)(B)) at any time during the portion of that year which occurs before the time the election is made, and who is not a shareholder at the time the election is made, must also consent to the election. If the election is made to be effective for the following taxable year, no consent need be filed by any shareholder who is not a shareholder on the date of the election. For purposes of this paragraph (b), any person who is considered to be a shareholder for state law purposes solely by virtue of his or her status as an incorporator is not treated as a shareholder.

(2) *Special rules.* When stock of the corporation is owned by husband and

wife as community property (or the income from which is community property), or is owned by tenants in common, joint tenants, or tenants by the entirety, each person having a community interest in such stock and each tenant in common, joint tenant and tenant by the entirety must consent to the election. The consent of a minor must be made by the minor or by the legal representative of the minor (or by a natural or an adoptive parent of the minor if no legal representative has been appointed). The consent of an estate must be made by an executor or administrator thereof. In the case of a trust described in section 1361(c)(2)(A) (including a trust treated under section 1361(d)(1)(A) as a trust described in section 1361(c)(2)(A)(i)), only the person treated as the shareholder for purposes of section 1361(b)(1) must consent to the election.

(c) *Extension of time for filing consents.* An election that is timely filed for any taxable year, and that would be valid except for the failure of any shareholder to file a timely consent, is not invalid for such reason if—

(1) It is shown to the satisfaction of the district director or director of the service center with which the corporation files its income tax return that there was reasonable cause for the failure to file such consent and that the interests of the Government will not be jeopardized by treating such election as valid,

(2) Such shareholder files a proper consent to the election within such extended period of time as may be granted by the Internal Revenue Service, and—

(3) New consents are filed within such extended period of time as may be granted by the Internal Revenue Service by each person who was required to consent to the corporation's election pursuant to paragraph (b) of this section.

§1.1362-3 Termination of election.

(a) *In general.* An election in effect under section 1362(a) may be terminated for any year in any one of three ways described in section 1362(d)(1) through (3) and paragraphs (b) through (d) of this section.

(b) *Revocation*—(1) *In general.* An election made under section 1362(a) may be revoked by the corporation for any taxable year of the corporation, including the first taxable year for which the election is effective. A revocation may be made only with the consent of shareholders who, at the time the revocation is made, hold more than one-half of the number of issued and outstanding shares of stock (including non-voting stock) of the corporation. Such revocation shall be made by the corporation by filing a statement that the corporation revokes the election made under section 1362(a), which statement shall state the section 1362(a), which statement shall state the number of shares of stock (including non-voting stock) that are issued and outstanding at the time the revocation is made. For revocations which specify a prospective revocation date (as defined in paragraph (b)(3) of this section), the statement shall indicate the date on which the revocation is intended to be effective. The statement shall be signed by any person authorized to sign the return required to be filed under section 6037 and shall be filed with the service center with which the election was properly filed. In addition, there shall be attached to the statement of revocation a statement of consent, stating the name, address, and taxpayer identification number of each shareholder who consents to the revocation, and the number of issued and outstanding shares of stock (including non-voting stock) held by each shareholder (whether consenting or not) at the time of the revocation. The statement shall be signed by each shareholder who consents to the revocation. For purposes of this paragraph (b), a revocation is made once it is filed in accordance with section 7502 and the regulations thereunder with the service center with which the election was properly filed.

(2) *When effective.* Except as provided in paragraph (b)(3) of this section, a revocation made during the taxable year and before the 16th day of the third month of such taxable year shall be effective on the first day of such taxable year, and a revocation made after the 15th day of the third month of the taxable year shall be effective for the following year. Except as provided in paragraph (b)(3) of this section, if a corporation makes an election to be an S corporation which is to be effective beginning with the next taxable year (see §1.1362-1) and revokes such election prior to the first day of such next taxable year, such corporation will be deemed to have revoked its election on the first day of such next taxable year.

(3) *Revocations specifying a prospective revocation date.* In the case of a corporation that specifies a date for revocation which is on or after the day on which the revocation is made, such revocation shall become effective on and after the date so specified. The preceding sentence shall apply only if the prospective revocation date is expressed in terms of a stated day, month, and year rather than in terms of particular event.

(4) *Effect on taxable year of corporation.* In the case of a corporation that revokes its election to be an S corporation effective on the 1st day of the first taxable year for which such election was effective, any statement on the Form 2553 regarding a change in the taxable year of the corporation filed by such corporation with respect to such election will have no effect on such corporation's taxable year.

(5) *Rescission of a revocation.* A revocation under paragraph (b)(2) or (3) of this section may be rescinded by a corporation at any time before the revocation becomes effective. A rescission may be made only with the consent of each person who consented to the revocation and by each person who became a shareholder of the corporation within the period beginning on the first day after the date the revocation was made and ending on the date on which the rescission is made. Such rescission shall be made by the corporation by filing a statement that the corporation rescinds the revocation made under section 1362(d)(1). The statement shall contain the name, address, and taxpayer identification number of the corporation and shall be signed by any person authorized to sign the return required to be filed under section 6037. The statement shall be filed with the service center with which the revocation was properly filed. In addition, there shall be attached to the statement of rescission a statement of consent stating the name, address, and taxpayer identification number of each shareholder who consents to the rescission. The statement shall be signed by each shareholder who consents to the rescission. For purpose of this paragraph (b)(5), a rescission is made once it is filed in accordance with section 7502 and the regulations thereunder with the service center with which the revocation was properly filed.

(6) *Creation of an S termination year.* A corporation that specifies a prospective date for revocation that is other than the first day of the taxable year will create an S termination year and will be subject to the rules in section 1362(e) and §1.1362-4.

(7) *Examples.* The principles of this paragraph (b) may be illustrated by the following examples:

Example (1). A calendar year S corporation has issued and outstanding 40,000 shares of class A voting common stock and 20,000 shares of class B non-voting common stock. The corporation wishes to revoke its election of subchapter S status. Shareholders owning 11,000 shades of class A stock sign revocation consents and 29,000 do not. Shareholders owning 20,000 shares of class B stock sign revocation consents. The corporation has obtained the required shareholder consent to revoke its subchapter S election because shareholders owning more thar one-half of the total number of issued and outstanding shares of stock of the corporation consented to the revocation.

Example (2). In June 1988, a calendar year S corporation determines that it will revoke its subchapter S election effective August 1, 1988. To do so it must file its revocation statement with consents attached on or before August 1, 1988, indicating that the revocation is intended to be effective August 1, 1988.

Example (3). Corporation M, a subchapter C corporation that uses a June 30 taxable year, elects to be an S corporation for its taxable year beginning on July 1, 1988, by filing a properly completed Form 2553 on July 15, 1988. On the Form 2553, M states that it will change its taxable year to a calendar year. On September 15, 1988, M properly revokes its S election effective July 1, 1988. Because M revoked its election to be an S corporation effective on the first day for which its election to be an S corporation was effective, the statement on the Form 2553 regarding the change in M's taxable year will have no effect on M's taxable year. Therefore, M will retain a June 30 taxable year for its taxable year beginning July 1, 1988.

(c) *Corporation ceasing to be a small business corporation*—(1) *In general.* An election under section 1362(a) shall be terminated if at any time on or after the first day of the first taxable year for which the election is effective, the corporation ceases to be a small business corporation as defined in section 1361(b). Thus, for example, the election is terminated if a 36th person, a nonresident alien, an ineligible trust, a partnership, or a corporation becomes a shareholder. In the event of a termination under this paragraph (c)(1), the corporation shall immediately notify the service center with which the election under section 1362(a) was filed. Such notification shall set forth the cause of the termination and the date thereof. In addition, if the termination was caused by the transfer of stock to a 36th shareholder, to a nonresident alien, or to an ineligible trust, partnership, or corporation, the notification shall specify the number of shares transferred to such person, the name of such person (or in the case of a trust, the names of the trustee and beneficiary), and the name of the shareholder who transferred such stock to such person. If the termination was caused by the issuance of a second class of stock, the notification shall indicate the number of shares of such new class issued and shall describe the differentiating characteristics of the new class of stock.

(2) *When effective.* If an election terminates because of a specific event that causes the corporation to fail to meet the definition of a small business corporation, such termination is effective as of the date on which such event occurred. If a corporation makes an election to be an S corporation which is to be effective beginning with the next taxable year (see §1.1362-1), and fails to meet the definition of a small business corporation on the first day of such taxable year, its election will be treated as having terminated on such first day. For purposes of the preceding sentence, if a corporation meets the definition of a small business corporation on the first day of its taxable year for which the election is effective, there is no termination of its election as a result of the failure to meet such definition at any time during the period beginning after its election and before the first day of such year.

(3) *Effect on taxable year of the corporation.* In the case of a corporation that fails to meet the definition of a small business corporation on the first day of the first taxable year for which its election to be an S corporation was effective, any statement on the Form 2553 filed by such corporation with respect to such election regarding a change in such corporation's taxable year will have no effect on the taxable year of the corporation.

(4) *Creation of an S termination year.* A corporation that ceases to be a small business corporation on a date other than the first day of the taxable year will create an S termination year and will be subject to the rules in section 1362(e) and §1.1362-4.

(5) *Examples.* The principles of this paragraph (c) may be illustrated by the following examples:

Example (1). On January 1, 1988, the first day of its taxable year, a subchapter C corporation had three individuals as shareholders. On April 15, 1988, the corporation, in accordance with §1.1362-1A, filed a properly completed Form 2553. The corporation anticipated that the election would become effective January 1, 1989, the first day of the succeeding taxable year. On October 1, 1988, one of the shareholders sold 40 percent of his shares in the corporation to a partnership. On January 1, 1989, the corporation had as its shareholders, the original three individuals as well as the partnership. The corporation fails to meet the definition of a small business corporation on January 1, 1989, and its election will be treated as having terminated on that date. Because the corporation ceases to be a small business corporation on the first day of the taxable year an S termination year is not created.

Example (2). On July 15, 1988, Corporation M, a subchapter C corporation that uses a June 30 taxable year, files a properly completed Form 2553 to be an S corporation for its taxable year beginning on July 1, 1989. On the Form 2553, M states that it will use a calendar year as its taxable year. On June 15, 1989, one of the shareholders of M sells his entire interest in the corporation to a partnership. M fails to meet the definition of a small business corporation on July 1, 1989, and its election will be treated as having terminated on that date. Because M failed to meet the definition of a small business corporation on the first day of the first taxable year for which its election to be an S corporation was effective, the statement on the Form 2553 regarding the change in M's taxable year will have no effect on M's taxable year. Therefore, M will retain a June 30 taxable year for its taxable year beginning on July 1, 1989.

(d) *Excess passive investment income*—(1) *In general.* A corporation's election under section 1362(a) shall terminate if such corporation has subchapter C earnings and profits at the close of each of three consecutive taxable years and has gross receipts more than 25 percent of which for each of such taxable years are derived from passive investment income (as defined in paragraph (d)(5) of this section). For purposes of this paragraph (d), only taxable years beginning after December 31, 1981, for which the corporation was an S corporation (an electing small business corporation for taxable years beginning before January 1, 1983) will be taken into account in the determination of the consecutive three year period. For the tax imposed on the excess passive investment income of an S corporation with subchapter C earnings and profits, see section 1375 and the regulations thereunder.

(2) *When effective.* A termination under this paragraph (d) shall be effective on and after the first day of the first taxable year beginning after the third consecutive year in which the S corporation with subchapter C earning and profits had passive investment income in excess of 25 percent of gross receipts.

(3) *Subchapter C earnings and profits.* For purposes of this paragraph (d), the "subchapter C earnings and profits" of any corporation are its earnings and profits (within the meaning of section 312 and the regulations thereunder) for any period during which it was not an S corporation (or an electing small business corporation under prior law). The subchapter C earnings and profits of an S corporation shall be modified as required by section 1371(c).

(4) *Gross receipts*—(i) *In general.* The term "gross receipts" as used in section 1362(d)(3) is not synonymous with "gross income". The term "gross receipts" means the total amount received or accrued under the method of

accounting used by the corporation in computing its taxable income. Thus, the total amount of receipts is not reduced by returns and allowances, cost of goods sold, or deductions. For example, gross receipts will include the total amount received or accrued during the corporation's taxable year from the sale or exchange (including a sale or exchange to which section 337, as it existed prior to its amendment by the Tax Reform Act of 1986, applies) of any kind of property (except capital assets, stock, and securities), from investments, and for services rendered by the corporation.

(ii) *Sales of capital assets, stock and securities*—(A) *Sales of capital assets.* Gross receipts from the sales or exchanges of capital assets (as defined in section 1221 and the regulations thereunder), other than stock and securities, shall be taken into account only to the extent of the capital gain net income therefrom. For purposes of this paragraph (d), the term "capital gain net income" has the same meaning given such term in section 1222 and the regulations thereunder.

(B) *Sales of stock or securities.* In applying section 1362(d)(3), gross receipts from the sales or exchanges of stock or securities shall be taken into account only to the extent of gains therefrom. Thus, the gross receipts from the sale of a particular share of stock will be the excess (if any) of the amount realized over the adjusted basis of such share. Losses on sales or exchanges of stock or securities do not offset gains on the sales or exchanges of other stock or securities for purposes of computing gross receipts from such sales or exchanges. Gross receipts from the sale or exchange of stock and securities include gains received from such sales or exchanges by a corporation even though such corporation is a regular dealer in stocks and securities. However, gross receipts from the sale or exchanges of stock or securities does not include certain amounts which are treated under section 331 (relating to corporate liquidations) as payments in exchange for stock owned by the S corporation, if, on the date of the first distribution with respect to such liquidation, the S corporation owned more than 50 percent of each class of stock (whether voting or nonvoting) of the liquidating corporation. Shares of stock of the liquidating corporation held by a shareholder of the S corporation shall not be attributed to the S corporation. For purposes of this paragraph (d)(4)(ii), the term "stock or securities" includes shares or certificates of stock, stock rights or warrants, or an interest in any corporation (including any joint stock company, insurance company, association, or other organization classified as a corporation by the Code), an interest in any partnership, certificates of interest or participation in any profit-sharing agreement, or in any oil, gas, or other mineral property, or lease, collateral trust certificates, voting trust certificates, bonds, debentures, certificates of indebtedness, notes, car trust certificates, bills of exchange, or obligations issued by or on behalf of a State, Territory, or political subdivision thereof.

(iii) *Other exclusions from gross receipts.* For purposes of section 1362(d)(3), gross receipts does not include (A) amounts received in nontaxable sales or exchanges (other than those to which former section 337 applies), except to the extent that gain is recognized by the corporation on the sale or exchange, (B) amounts received as a loan, as a repayment of a loan, as a contribution to capital, or on the issuance by the corporation of its own stock, or (C) certain amounts which are treated under section 331 (relating to corporate liquidations) as payments in exchange for stock (see paragraph (d)(4)(ii)(B) of this section).

(iv) *Examples.* The meaning of the term "gross receipts" as used in section 1362(d)(3) may be further illustrated by the following examples:

Example (1). A corporation that uses an accrual method of accounting sells: (1) a depreciable asset, held for more than 6 months, which is used in the corporation's business, (2) a capital asset (other than stock and securities) for a gain, (3) a capital asset (other than stock and securities) for a loss, and (4) securities, and receives payment for each asset partly in money and partly in the form of a note payable at a future time. The corporation elects not to report the sales on the installment method. The amount of money and the face amount of the note received for the business asset would be considered gross receipts in the taxable year of sale and would not be reduced by the adjusted basis of the property, costs of sale or any other amount. With respect to the sale of the capital asset, gross receipts would include the cash down payment and face amount of any notes, but only to the extent of the corporation's capital gain net income. In the case of the sale of the securities, gross receipts would include the cash down payment and face amount of the notes, but only to the extent of gain on the sale. In determining gross receipts from sales of securities, losses would not be netted against gains.

Example (2). A corporation has a long-term contract as defined in paragraph (b) of §1.451-3 with respect to which it reports income according to the percentage-of-completion method as described in paragraph (c)(1) of §1.451-3. The portion of the gross contract price which corresponds to the percentage of the entire contract which has been completed during the taxable year shall be included in gross receipts for such year.

Example (3). For its 1983 taxable year, a corporation which regularly sells personal property on the installment plan elects to report its taxable income from the sale of such property (other than property qualifying as a capital asset or stock or securities) on the installment method in accordance with section 453A. The installment payment actually received in a given taxable year of the corporation shall be included in gross receipts for such year.

(5) *Passive investment income*—(i) *In general.* Except as provided in this paragraph (d)(5), the term "passive investment income" means gross receipts (as defined in paragraph (d)(4) of this section) derived from royalties, rents, dividends, interest, annuities, and gains from the sales or exchanges of stock or securities.

(ii) *Special rule for options or commodities dealers.* (A) *Exclusion of certain capital gains.* In the case of any options dealer or commodities dealer, passive investment income shall be determined by not taking into account any gain or loss (in the normal course of the taxpayer's activity of dealing in or trading section 1256 contracts) from any section 1256 contract or property related to such a contract.

(B) *Definitions.* For purposes of this paragraph (d)(5)(ii)—

(*1*) *Options dealer.* The term "options dealer" has the meaning given to such term by section 1256(g)(8).

(*2*) *Commodities dealer.* The term "commodities dealer" means a person who is actively engaged in trading section 1256 contracts and is registered with a domestic board of trade which is designated as a contract market by the Commodities Future Trading Commission.

(*3*) *Section 1256 contract.* The term "section 1256 contract" has the meaning given to such term by section 1256(b).

(C) *Effective date.* This paragraph (d)(5)(ii) shall apply to positions established after July 18, 1984, in taxable years ending after such date.

(iii) *Royalties*—(A) *In general.* Except as provided in this paragraph (d)(5)(iii), the term "royalties" as used in section 1363 (d)(3)(D) means all royalties, including mineral, oil, and gas royalties, and amounts received for the privilege of using patents, copyrights, secret processes end formulas, good will, trademarks, tradebrands, franchises, and other like property. For purposes of this paragraph (d)(5)(iii), the gross amount of royalties shall not be reduced by any part of the cost of the rights under which they are received or by any amount allowable as a deduction in computing taxable income.

(B) *Copyright royalties.* The term "royalties" does not include copyright royalties if the income from such royalties would not be treated as personal holding company income under section 543(a)(4) if the corporation were a C corporation. For the definition of "copyright royalties," see paragraph (b)(12)-(iv) of §1.543-1.

(C) *Mineral, oil, or gas royalties.* The term "royalties" does not include mineral, oil, or gas royalties if the income from such royalties would not be treated as personal holding company income under section 543(a)(3) if the corporation were a C corporation. Moreover, the term "royalties" does not include amounts received upon disposal of timber, coal, or domestic iron ore with a retained economic interest with respect to which the special rules of section 631(b) and (c) apply. For the definition of "mineral, oil, or gas royalties," see paragraph (b)(11)(ii) and (iii) of §1.543-1.

(D) *Active business computer software royalties.* The term "royalties" does not include active computer software royalties as that term is defined in section 543(d) (without regard to paragraph (d)(5)).

(iv) *Rents.* The term "rents" as used in section 1362(d)(3)(D) means amounts received for the use of, or right to use, property (whether real or personal) of the corporation. The term "rents" does not include payments received for the use or occupancy of property if the corporation also performs significant services in return for such payments. Examples of payments not treated as rents for purposes of section 1362(d)(3)(D) include payments for the use or occupancy of rooms or other quarters in hotels, boarding houses, or apartment houses furnishing hotel services, or in tourist homes, motor courts, or motels. Generally, services are considered rendered to the occupant if they are primarily for his convenience and are other than those usually or customarily rendered in connection with the rental of rooms or other space for occupancy only. Maid service supplied by a hotel is an example of such services; in contrast, the furnishing of heat and light, the cleaning of public entrances, exits, stairways and lobbies, the collection of trash, and similar activities are not considered as services rendered to the occupant. Payments for the use or occupancy of entire private residences or living quarters in duplex or multiple housing units, of offices in an office building, etc., generally constitute "rents" under section 1362(d)(3)(D). Payments for the parking of automobiles ordinarily do not constitute rents. Payments for the warehousing of goods or for the use of personal property constitute rents unless significant services are rendered in connection with such payments.

(v) *Dividends.* The term "dividends" as used in section 1362(d)(3)(D) includes dividends as defined in section 316, amounts required to be included in gross income under section 551 (relating to foreign personal holding company income taxed to U.S. shareholders), and consent dividends as provided in section 565.

(vi) *Interest.* The term "interest" as used in section 1362(d)(3)(D) means any amounts received for the use of money (including tax-exempt interest and amounts treated as interest under section 483, 1272, 1274, or 7872). However, amounts received as interest on obligations acquired in the ordinary course of the corporation's trade or business from the sale of property described in section 1221(1) shall not constitute passive investment income.

(vii) *Annuities.* The term "annuities" as used in section 1362(d)(3)(D) means the entire amount received as an annuity under an annuity, endowment, or life insurance contract, regardless of whether only part of such amount would be includible in gross income under section 72.

(viii) *Gross receipts from the sale of stock or securities.* Gross receipts from sales or exchanges of stock or securities (to the extent of gains therefrom) as described in paragraph (d)(4)(ii)(B) of this section constitute passive investment income.

(ix) *Treatment of certain lending or finance companies.* An S corporation that is a lending or finance company as defined in section 542(c)(6) and the regulations thereunder shall not include in its passive investment income for the year gross receipts which are derived from the active and regular conduct of a lending or finance business, as defined in section 542(d)(1) and the regulations thereunder. The preceding sentence does not apply to gross receipts that are not directly derived from the active and regular conduct of a lending or finance business. Thus, the corporation's passive investment income will include amounts that are not directly related to the activities described in section 542(d)(1). Thus, for example, interest from the investment of idle funds in short-term securities, interest on judgments obtained on a defaulted loan and rent derived from property acquired by reason of a borrower's default on a loan do not constitute gross receipts derived directly from the conduct of the corporation's lending or finance business and therefore would not be excluded by section 1362(d)(3)(D)(iii). However, subject to the exception provided in section 542(d)-(1)(B), gross receipts from the sale or transfer of (A) notes acquired in the business of making loans and (B) accounts receivable, notes, or installment obligations acquired in the business of purchasing or discounting accounts receivable, notes, or installment obligations constitute gross receipts derived directly from the conduct of the corporation's lending or finance business and thus would be excluded from inclusion in such corporation's passive investment income.

(6) *Example.* The principles of this paragraph (d) may be illustrated by the following example:

Example. X, an S corporation with subchapter C earnings and profits, in the first taxable year for which its election was effective had gross income from business operations of $75,000 of which $5,000 was received from royalty payments with respect to a patent. In addition, X received $3,000 gross rental receipts, $1,000 gross interest receipts from inventory sales on open account, and $500 in gross dividend income. X recognized a gain of $2,500 on a sale of stock in P corporation and recognized a loss of $1,000 on a sale of stock in Q corporation. X also sold two parcels of land it had purchased and held for investment. The parcels sold for $10,000 each and carried a basis of $5,000 for parcel 1 and $11,000 for parcel 2. Finally, X sold a business asset for $3,000. X originally purchased the asset for $3,000 and had an adjusted basis of $2,805. The corporation's total gross receipts will be calculated as follows:

$75,000	Gross Receipts From Operations
3,000	Gross Rental Receipts
1,000	Gross Interest Receipts
500	Gross Dividend Receipts
2,500	Gain on Sale of P Stock (Loss on Q stock is not taken into account)
4,000	Net Gain on Sale of Parcels 1 and 2
3,000	Gross Receipt on Sale of Business Asset
$89,000	Total Gross Receipts

Passive investment income is determined as follows:

$ 5,000	Gross Patent Royalty Receipts
3,000	Gross Rental Receipts
500	Gross Dividend Receipts
2,500	Gain on Sale of P Stock (loss on Q stock is not taken into account)
$11,000	Total Passive Investment Income Gross Receipts

X's passive investment income percentage for its first year as an S corporation is 12.36 percent. This does not exceed 25 percent of X's gross receipts and consequently will not begin the running of the 3 year period for purposes of terminating the election under section 1362(d)(3).

§1.1362-4 Treatment of S termination year.

(a) *In general.* Terminations under §1.1362-3 that take effect during the taxable year on a date other than the first day of the taxable year will result in the creation of an S termination year. The portion of the S termination year ending on the close of the last day prior to the effective date of the termination shall be treated as a short taxable year for which the corporation is an S corporation and is hereinafter referred to as an S short year. The portion of the S termination year beginning on the first day the termination is effective shall be treated as a short taxable year for which the corporation is a C corporation and is hereinafter referred to as a C short year. Generally, the accounting books and records of a corporation do not have to be closed as of the termination date; rather, the corporation will allocate income or loss for the entire year on a pro rata basis. The pro rata allocation rules set forth in section 1362(e)(2) and paragraph (b) of this section will not apply (1) if the election under 1362(e)(3) and paragraph (c)(2) of this section is made by the corporation to have items assigned to each short taxable year under the corporation's normal tax accounting rules, (2) to any item resulting from an election made by an acquiring corporation to treat the purchase of the corporation's stock as an asset purchase under section 338, or (3) if there is a sale or exchange of 50 percent or more of the stock (as defined in paragraph (c)(4) of this section) of the corporation during an S termination year. Where the pro rata allocation rules do not apply, the corporation will allocate items of income, loss, deduction, and credit under normal tax accounting rules as set forth in paragraph (c) of this section.

(b) *Pro rata allocation.* Except as provided in paragraph (c) of this section, the items of income, gain, loss, deduction, and credit for an S termination year shall be allocated between the S short year and the C short year in the following manner:

(1) Determine, for the entire S termination year, the amount of each of the separately stated items of income, loss, deduction, or credit described in section 1366(a)(1)(A), and the amount of nonseparately computed income or loss described in section 1366(a)(2).

(2) Assign an equal ratable portion of each amount determined under paragraph (b)(1) to each day of the S termination year. For example, if a corporation has an S termination year in 1987 that consists of an S short year from January 1 through June 30 and a C short year from July 1 through December 31, it will make a pro rata allocation of 181/365 of its separately and nonseparately computed amounts to the S short year and will allocate 184/365 of such amounts to the C short year.

(c) *Income, loss, deduction, and credit items assigned to each short taxable year under normal accounting* rules—(1) *In general.* If paragraph (c)(2) or (4) of this section applies, or to the extent that paragraph (c)(3) of this section applies, then the rules of section 1363 (e)(2) and paragraph (b) of this section shall not apply, and the determination of the corporation's income, loss, deduction, and credit for its S short year and C short year shall be allocated under this paragraph (c). To the extent that this paragraph (c) applies, items of income, loss, deduction, and credit shall be assigned to each short taxable year on the basis of the corporation's method of accounting, as determined under section 446 and §1.446-1.

(2) *Election.* A corporation may elect under section 1362(e)(3) and this paragraph (c)(2) to allocate its S termination year income on the basis of its normal tax accounting method rather than under section 1362(e)(2). An election under this paragraph to have the rules of section 1362(e)(2) not apply can be made only with the consent of all persons who are or were shareholders in the corporation at any time during the S short year and all persons who are or were shareholders in the corporation at any time during the first day of the C short year. To make such election, a corporation shall file a statement that it elects under section 1362(e)(3) to have the rules provided in section 1362(e)(2) not apply. Such statement shall set forth the cause of the termination and the date thereof and shall be signed by any person authorized to sign the return required to be filed under section 6037. The statement shall be filed with the return for the short taxable year described in section 1362(e)(1)(B). In addition, there shall be attached to the statement of election a statement of consent, signed by each person who is or was a shareholder in the corporation at any time during the S short year and each person who is or was a shareholder of the corporation at any time during the first day of the C short year. The separate statement must set forth the name, address, and taxpayer identification number of the corporation, and the name, address, and taxpayer identification number of each person required to consent.

(3) *Pro rata allocation not to apply to certain items if purchase of stock treated as an asset purchase under section 338*—(i) *In general.* Section 1362(e)(2) and §1.1362-4(b) will not apply with respect to any item resulting from the application of section 338. In such case, the principles of section 1362(c)(3) and this paragraph (c) shall be applicable with respect to such items without election by the shareholders.

(ii) *Special rule.* Paragraph (c)(3)(i) of this section shall not apply to any item resulting from the application of section 338 if—

(A) Any portion of the qualified stock purchase under section 338 is pursuant to a binding contract entered into on or after October 19, 1982, and before July 18, 1984, and

(B) The purchasing corporation establishes by clear and convincing evidence that such contract was negotiated in contemplation that, with respect to the deemed sale under section 338, section 1362(e)(2) would apply.

(4) *Pro rata rule not to apply if 50 percent change in ownership during S termination year*—(i) *In general.* Section 1362(e)(2) and §1.1362-4(b) will not apply to an S termination year if at any time during such year, as a result of sales or exchanges of stock in the corporation during that year, 50 percent or more of the issued and outstanding shares of stock of the corporation (whether an S or C corporation) is newly owned stock within the meaning of paragraph (c)(4)(ii) of this section. In such case, the principles of section 1362(e)(3) and paragraph (c) of this section shall be applicable without any election by the shareholders.

(ii) *Newly owned stock.* For purposes of paragraph (c)(4)(i) of this section, the stock of a corporation owned by any person immediately after the close of any sale or exchange of stock shall be treated as newly owned stock to the extent that—

(A) The percentage of the corporation's issued and outstanding shares of stock (whether as an S or C corporation) owned by such person immediately after such sale or exchange, exceeds

(B) The percentage of the corporation's issued and outstanding shares of stock owned by such person on the last day of the taxable year immediately preceding the S termination year.

However, stock will not be treated as newly owned stock to the extent that such stock is treated as newly owned stock with respect to another person immediately after the close of any previous sale or exchange of stock.

(iii) *Stock acquired other than by sale or exchange*— (A) *In general.* For purposes of paragraph (c)(4)(ii) of this section, if a person acquired stock in the corporation after the last day of the taxable year immediately preceding the S termination year and such stock was acquired by such person from a qualified transferor other than by a sale or exchange, then such stock shall be treated as held on the last day of the taxable year immediately preceding the S termination year by the person that so acquired the stock from a qualified transferor.

(B) *Qualified transferor.* For purposes of paragraph (c)(4)(iii)(A) of this section, the term ''qualified transferor'' means a person—

(*1*) Who (or whose estate) held stock in the S corporation on the last day of the taxable year immediately preceding the S termination year, or

(*2*) Who acquired the stock in an acquisition which meets the requirements of paragraph (c)(4)(iii)(A) of this section.

(iv) *Special rule.* Paragraph (c)(4)(i) of this section shall not apply to an S termination year if—

(A) On or before July 18, 1984, 50 percent or more of the newly owned stock (as defined in paragraph (c)(4)(ii) of this section) was sold or exchanged in 1 or more transactions, and

(B) The person (or persons) acquiring such stock establishes by clear and convincing evidence that such acquisitions were negotiated in contemplation that section 1362(e)(2) would apply to the S termination year in which such sales or exchanges occurred.

(v) *Examples.* The provisions of this paragraph (c)(4) may be illustrated by the following examples:

Example (1). A, an individual, owns all 100 outstanding shares of stock of Corporation M, a calendar year S corporation. On January 31, 1988, A sells 60 shares of M stock to B, an individual. On June 1, 1988, A sells 5 shares of M stock to P, a partnership. M ceases to be a small business corporation on June 1, 1988, and pursuant to section 1362(d)(2) its S corporation election terminates effective on that date. All of the M stock acquired by B and P is newly owned stock because neither B nor P held such stock on December 31, 1987 Thus, 65 percent of the issued and outstanding shares of stock is treated as newly owned stock. Because more than 50 percent of the issued and outstanding shares of M stock is treated as newly owned stock, M must assign the items of income, loss, deduction, or credit for the S termination year to the two short taxable years on the basis of M's method of accounting.

Example (2). Assume the same facts as in example (1), except that A sells the 60 shares of M stock to B on July 1, 1988. Since 65 percent of the issued and outstanding shares of M stock is treated as newly owned stock, M must assign the items of income, loss, deduction, or credit for the S termination year to the two short taxable year on the basis of M's method of accounting.

Example (3). C and D are shareholders in Corporation N, a calendar year S corporation. Each owns 50 percent of the issued and outstanding shares of N on December 31, 1987. On March 1, 1988, C makes a gift of his entire shareholder interest to T, a trust not permitted as a shareholder under section 1361(c)(2). N ceases to be a small business corporation on March 1, 1988, and pursuant to section 1362(d)(2) its S corporation election terminates effective on that date. As a result of the gift, T owns 50 percent of N's issued and outstanding stock. However, because T acquired the stock by gift from C, a qualified transferor, the stock is treated as owned by T on December 31, 1987 Hence, the stock acquired by T is not treated as newly owned stock.

(5) *special rule for S corporation that is a partner in a partnership.* For purposes of section 706(c), if—

(i) A corporation's election under section 1362(a) is terminated under paragraph (b) or (c) of §1.1362-3;

(ii) Paragraph (c)(2) or (4) of this section applies to such corporation;

(iii) Such corporation is a partner in a partnership during any portion of the S short year; and

(iv) Any taxable year of such partnership ends with or within the C short year;

then such termination shall be treated as a sale or exchange of such corporation's entire interest in such partnership. A sale or exchange pursuant to the preceding sentence shall be deemed to occur on the last day of the S short year. For rules on determining each shareholder's share of the corporation's items of income, loss, deduction, or credit that are attributable to a partnership, see sections 1366 and 1377 and the regulations thereunder.

(d) *Tax for the C short year*—(1) *In general.* The tax liability for the C short year shall be a portion of the amount of tax that is determined on the annualized taxable income for the C short year. For purposes of this paragraph (d)(1), the annualized taxable income for the C short year is determined by multiplying the taxable income for such short year by the number of days in the S termination year and by dividing the result by the number of days in the C short year. The tax on the annualized taxable income is then computed according to the corporate rate brackets; this result is adjusted to determine the C short year tax liability. The adjustment is made by multiplying the tax on the annualized taxable income by the number of days in the C short year and dividing the result by the number of days in the S termination year.

(2) *Minimum tax.* For purposes of computing the corporation's liability for the corporate minimum tax with respect to the C short year, section 443(d) shall apply.

(3) *Example.* A corporation determines, under either paragraph (2) or (3) of section 1362(e), that it has taxable income of $4,000 for the C short year December 12, 1989 through December 31, 1989. The taxable income on an annual basis is $73,000 [($4,000 × 365)/20], tax on the annualized taxable income is $13,250 ($7,500 + $5,750), and the tax liability for the C short year is $726 [($13,250 × 20)/365].

(e) *Other special rules*—(1) *Short year treated as taxable year.* Except as otherwise provided in paragraph (e)(2) of this section, the short S and C years will be treated as two separate years for purposes of all provisions of the Code.

(2) *Year for carryover purposes.* The short S and C years will be treated as one year for purposes of determining the number of taxable years to which any item may be carried back or forward by the corporation.

(3) *Due date for S year return.* The due date for filing the return for the S short year shall be the same as the due date for filing the return for the C short year, including extensions thereof.

(4) *Year in which income from short S year is includible.* A shareholder shall include in taxable income for the year with or within which the S termination year ends the shareholder's pro rata share of the items described in section 1366(a) for the S short year.

§1.1362-5 Inadvertent terminations.

(a) *In general.* A corporation will be treated as continuing to be an S corporation during the period specified by the Commissioner if—

(1) A valid election under section 1362(a) is terminated under §1.1362-3(c) or (d),

(2) The Commissioner determines that the termination was inadvertent,

(3) Steps were taken by the corporation to return to small business corpo-

ration status within a reasonable period after discovery of the terminating event, and

(4) The corporation and shareholders agree to adjustments required by the Commissioner for such period.

Any reference in this section to steps taken by the corporation to return to small business corporation status shall include steps taken by the corporation so that it no longer violates the passive investment income limitations under §1.1362-3(d). For purposes of this section, consideration will be given only to terminating events occurring in taxable years beginning after December 31, 1982.

(b) *Inadvertent termination.* For purposes of this paragraph (b), the determination of whether a termination was inadvertent will be made by the Commissioner. The corporation has the burden of establishing that under the relevant facts and circumstances the Commissioner should determine that the termination was inadvertent. The fact that the terminating event was not reasonably within the control of the corporation and was not part of a plan to terminate the election, or the fact that the event took place without the knowledge of the corporation notwithstanding its due diligence in the course of its business to safeguard itself against such an event, tends to establish that the termination was inadvertent. For example, if a corporation, in good faith and using due diligence, determined that it had no subchapter C earnings and profits, but it was later determined on audit that its election terminated by reason of violating the passive investment income test for three consecutive years because the corporation in fact had accumulated earnings and profits, it may be appropriate for the Commissioner to find that the terminating event was inadvertent.

(c) *Corporation's request for determination of an inadvertent termination.* A corporation that believes its election was terminated inadvertently shall request a determination of inadvertent termination from the Commissioner. The request shall be made in the form of a ruling request and shall contain the information required by regulations and revenue procedures pertaining thereto. The request shall set forth all relevant facts pertaining to the event including, but not limited to, the facts described in paragraph (b) of this section, the date of the corporation's election under section 1362(a), a detailed explanation of the event causing termination, when and how such event was discovered, and the steps taken to return the corporation to small business corporation status. Send requests for a determination of inadvertent termination to: Internal Revenue Service, Associate Chief Counsel (Technical), Attention: CC:PS, 1111 Constitution Ave., N.W., Washington, D.C. 20224.

(d) *Correction of terminating event.* In order to satisfy paragraph (a) of this section, a corporation the election of which terminates by reason of a disqualifying event must, within a reasonable period of time after discovery of such event, take steps to correct the event so that the corporation is once more a small business corporation. For example, if the terminating event is one that causes the corporation to have more than one class of stock, the corporation must take steps to eliminate the second class of stock. If the election is terminated because the corporation had an ineligible shareholder, the corporation must take steps to terminate such shareholder's interest. If the cause of termination is excessive passive investment income, the corporation must reduce such excess income or eliminate its subchapter C earnings and profits. For purposes of this paragraph (d), a corporation will have discovered the terminating event when it has actual knowledge of such event, or at such time as a reasonable person would have had knowledge of such event. Before a waiver can become effective, the steps taken must be completed so that the corporation is once more a small business corporation.

(e) *Consent to Commissioner's requirement.* Before any waiver is granted, the corporation and the shareholders must consent to any adjustment required by the Commissioner for the specified period. The adjustments required must be consistent with the treatment of the corporation as an S corporation during the specified period. The period specified by the Commissioner may be retroactive either for all years or for the period in which the corporation again became eligible for treatment under subchapter S. All persons who were shareholders of the corporation at any time during the period specified by the Commissioner must consent to the Commissioner's adjustments. Shareholder and corporate consents shall be in the form of a statement setting forth the Commissioner's requirements, the period for which a waiver of the terminating event is given, and must be signed by the shareholder (in the case of a shareholder consent) or the person authorized to sign the return required by section 6037 (in the case of corporate consent). A shareholder's consent statement shall set forth the name, address, and taxpayer identification numbers of the corporation and shareholder, the number of shares of stock owned by the shareholder during the period, and the dates during the period on which such stock was owned. The corporate consent statement shall set forth the name, address, and taxpayer identification numbers of the corporation and each shareholder. The consent of the shareholders and of the corporation must be attached to the return for the period in which the adjustments are to be made.

(f) *Adjustments.* In the case of a transfer of stock to an ineligible shareholder which is treated as an inadvertent termination under section 1362(f), the Commissioner may require such an adjustment as will cause the ineligible shareholder to be treated as a shareholder of an S corporation during the period such shareholder actually held stock in the corporation. Moreover, the Commissioner may require such protective adjustments as will prevent any loss of revenue which may otherwise result because of a transfer of stock to an ineligible shareholder (*e.g.*, a transfer to a nonresident alien). The agreement to make the required adjustments may be reflected in a closing agreement entered into pursuant to the authority contained in section 7121.

(g) *Status of corporation.* The status of the corporation after the terminating event and before the determination of inadvertence shall be determined by the period of waiver specified by the Commissioner. A waiver may be granted retroactive for all years for which the terminating event was effective, in which case the corporation will be treated as if its election had not terminated. A waiver may be granted retroactive only for the period in which the corporation again became eligible for subchapter S treatment, in which case the corporation will be treated as a C corporation during the period for which the corporation was not eligible for subchapter S treatment.

§1.1362-6 Election after termination.

(a) *In general.* If a corporation has made a valid election and such election has been terminated, unless the Commissioner consents to a new election, such corporation (or any successor corporation) is not eligible to make a new election for any taxable year prior to its fifth taxable year which begins after the first taxable year for which such termination is effective. The burden will be on the corporation to establish that under the relevant facts the Commissioner should consent to a new election. The fact that more than 50 percent of the stock in the corporation is owned by persons who did not own any stock in the corporation on the date of the termination will tend to establish that consent should be granted. In the absence of such fact, consent will ordinarily be denied unless it can be shown that the event causing termination was not reasonably within the control of the corporation or shareholders having a substantial interest in the corporation, and was not part of a plan on the part of the corporation or of such shareholders to terminate the election.

(b) *Successor corporation.* The term "successor corporation" as used in section 1362(g) means any corporation—

(1) 50 percent or more of the stock of which is owned, directly or indirectly, by the same persons who, on the date of the termination, owned 50 percent or more of the stock of the small business corporation with respect to which the election was terminated, and

(2) (i) Which acquires a substantial portion of the assets of such small business corporation, or

(ii) A substantial portion of the assets of which were assets of such small business corporation.

(c) *Special rule for certain terminations.* The five year waiting period described in paragraph (a) of this section shall not apply to a corporation if the termination occurred because the corporation—

(1) Revoked its election effective on the first day of the first taxable year for which its election to be an S corporation was effective (see §1.1362-3(b)(2)), or

(2) Failed to meet the definition of a small business corporation on the first day of the first taxable year for which its election to be an S corporation was effective (see §1.1362-3(c)(2)).

Thus, for terminations described in this paragraph (c), a corporation is not required to wait five years for reelection and is not required to secure the consent of the Commissioner for such reelection.

§1.1363-1 Effect of election on corporation.

(a) *Exemption of corporation from income tax*—(1) *In general.* Except as provided in this paragraph (a), the effect on a small business corporation of a valid election under section 1362(a) is to exempt the corporation from the taxes imposed by chapter 1 of the Code with respect to taxable years of the corporation for which the election is in effect.

(2) *Taxable years beginning after December 31, 1986.* For taxable years beginning after December 31, 1986, an S corporation shall not be exempt from the tax imposed by section 47 (relating to the tax on the early disposition of section 38 property) or section 1375 (relating to the tax imposed when passive investment income of corporation having subchapter C earnings and profits exceeds 25 percent of gross receipts). An S corporation shall also not be exempt from the tax imposed by section 1374 (as amended by the Tax Reform Act of 1986 or as in effect prior to its amendment by the Act). See also section 1363(d) (relating to the recapture of LIFO benefits) for the rules regarding the payment by an S corporation of LIFO recapture amounts.

(3) *Taxable years beginning after December 31, 1982, and before January 1, 1987.* For taxable years beginning after December 31, 1982, and before January 1, 1987, an S corporation shall not be exempt from the tax imposed by section 47 and section 1375. An S corporation shall also not be exempt from the tax imposed by section 56 (relating to corporate minimum tax) and section 1374 (relating to tax imposed on certain capital gains), as those sections were in effect prior to their amendment by the Tax Reform Act of 1986.

(b) *Computation of corporate taxable income*—(1) *In general.* The taxable income of an S corporation shall be computed in the same manner as the taxable income of a individual except that section 248 shall apply and except as otherwise provided in this paragraph (b). An S corporation is required to state separately in its return the items of income (including tax-exempt income), loss, deduction, or credit the separate treatment of which could affect the tax liability of any shareholder.

(2) *Deductions not allowed.* An S corporation is not allowed the following deductions:

(i) The deductions for personal exemptions provided in section 151.

(ii) The deduction provided in section 164(a) for taxes, described in section 901, paid or accrued to foreign countries and to possessions of the United States.

(iii) The deduction for charitable contributions provided in section 170.

(iv) The net operating loss deduction provided in section 172.

(v) The additional itemized deductions for individuals provided in part VII of subchapter B, as follows: Expenses for production of income (section 212); medical, dental, etc., expenses (section 213); alimony, etc. payments (section 215); amounts representing taxes, interest and business depreciation of a cooperative housing corporation (section 216); moving expenses (section 217); retirement savings (section 219); and deduction for two-earner married couples (section 221) and adoption expenses (section 222), as sections 221 and 222 were in effect prior to their repeal by the Tax Reform Act of 1986.

(vi) The deduction for depletion with respect to oil and gas wells provided in section 611.

(3) *Corporate preference items.* Section 291 of the Code shall apply to the computation of the taxable income of an S corporation if the S corporation (or any predecessor) was a C corporation for any of the 3 immediately preceding taxable years.

(c) *Elections of the S corporation*—(1) *General rule.* Any elections (other than those described in paragraph (c)(2) of this section) affecting the computation of items derived from an S corporation shall be made by the corporation. For example, elections of methods of accounting, of computing depreciation, of treating soil and water conservation expenditures, and the option to deduct as expenses intangible drilling and development costs, shall be made by the corporation and not by the shareholders separately. All corporate elections are applicable to all shareholders.

(2) *Exceptions*—(i) Each shareholder shall add his pro rata share of expenses described in section 617 paid or accrued by the S corporation to any such expenses paid or accrued by him and shall treat the total amount according to his method of treating such expenses, notwithstanding the treatment of the expenses by the corporation.

(ii) Each shareholder shall add his pro rata share of taxes described in section 901 paid or accrued by the S corporation to foreign countries or possessions of the United States (according to its method of treating such taxes) to any such taxes paid or accrued by him (according to his method of treating such taxes), and may elect to use the total amount either as a credit against tax or as a deduction from income.

(iii) For shareholder taxable years beginning before January 1, 1987, each shareholder shall:

(A) Add his pro rata share of investment interest, paid or accrued by the S corporation, to any such interest paid by him,

(B) Add his pro rata share of investment income and expenses (exclusive of interest) incurred by the S corporation to those incurred by him, and

(C) Subject the total amounts to the rules provided in section 163(d).

Lawrence B. Gibbs,
Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on December 23, 1988, 8:45 a.m., and published in the issue of the Federal Register for December 27, 1988, 53 F.R. 52190 as corrected by 54 F.R. 5939.)

Notice of Proposed Rulemaking

Golden Parachute Payments

PS-217-84

AGENCY: Internal Revenue Service, Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations relating to golden parachute payments. Changes to the applicable tax law were made by the Tax Reform Act of 1984, the Tax Reform Act of 1986, and the Technical and Miscellaneous Revenue Act of 1988. The regulations will provide guidance to taxpayers who must comply with section 280G of the Internal Revenue Code of 1986.

DATES: Written comments and requests for a public hearing must be delivered or mailed by July 5, 1989. Generally, these regulations are proposed to be effective for payments made under agreements entered into or renewed after June 14, 1984. These regulations also are proposed to be effective for certain payments under agreements entered into on or before June 14, 1984, and amended or supplemented in significant relevant respect after that date.

ADDRESS: Send comments and requests for a public hearing to: Internal Revenue Service, Attention: CC:CORP:T:R (PS-217-84), Room 4429, Washington, D.C. 20024.

SUPPLEMENTARY INFORMATION:

Background

This document contains proposed amendments to the Income Tax Regulations (26 CFR Part 1) under section 280G of the Internal Revenue Code. These amendments are proposed to conform the Income Tax Regulations to section 67 of the Tax Reform Act of 1984 (Pub. L. No. 98-369; 98 Stat. 585) [1984-3 C.B. (Vol. 1) 1, 93], which added sections 280G and 4999 to the Code and amended Code sections 275(a)(6) and 3121(v)(2)(A), and to section 1804(j) of the Tax Reform Act of 1986 (Pub. L. No. 99-514; 100 Stat. 2807) [1986-3 C.B. (Vol. 1) 1, 724] and section 1018(d)(6)-(8) of the Technical and Miscellaneous Revenue Act of 1988 (Pub. L. No. 100-647; 102 Stat. 3581), which amended Code section 280G. These provisions relate to golden parachute payments. Specifically, section 280G denies a deduction for any "excess parachute payment," section 4999 imposes a 20-percent excise tax on the recipient of any excess parachute payment, section 275(a)(6) denies a deduction for the section 4999 excise tax, and section 3121(v)(2)(A) relates to FICA.

Overview of Statutory Provisions

In applying the golden parachute provisions, the first step is to identify payments that constitute "parachute payments." Section 280G(b)(2)(A) defines a "parachute payment" as any payment that meets all of the following four conditions: (a) the payment is in the nature of compensation; (b) the payment is to, or for the benefit of, a disqualified individual; (c) the payment is contingent on a change in the ownership of a corporation, the effective control of a corporation, or the ownership of a substantial portion of the assets of a corporation ("change in ownership or control"); and (d) the payment has (together with other payments described above in (a), (b), and (c) with respect to the same individual) an aggregate present value of at least 3 times the individual's base amount.

For this purpose, an individual's base amount is, in general, the individual's average annualized includible compensation for the most recent 5 taxable years ending before the change in ownership or control.

Section 280G(b)(2)(B) provides that the term "parachute payment" also includes any payment in the nature of compensation to, or for the benefit of, a disqualified individual if the payment is pursuant to an agreement that violates any generally enforced securities laws or regulations ("securities violation parachute payment").

Once payments are identified as "parachute payments", the next step is to determine any "excess" portion of the payments. Section 280G(b)(1) defines the term "excess parachute payment" as an amount equal to the excess of any parachute payment over the portion of the disqualified individual's base amount that is allocated to such payment. For this purpose, the portion of the base amount allocated to a parachute payment is the amount that bears the same ratio to the base amount as the present value of the parachute payment bears to the aggregate present value of all such payments to the same disqualified individual.

Generally, excess parachute payments may be reduced by certain amounts of reasonable compensation. Section 280G(b)(4)(B) provides that except in the case of securities violation parachute payments, the amount of an excess parachute payment is reduced by any portion of the payment that the taxpayer establishes by clear and convincing evidence is reasonable compensation for personal services actually rendered by the disqualified individual before the date of change in ownership or control. Such reasonable compensation is first offset against the portion of the base amount allocated to the payment.

Exempt Payments

Section 280G specifically exempts several types of payments from the definition of the term "parachute payment."

Deductions for payments exempt from the definition of "parachute payment" are not disallowed by section 280G, and such exempt payments are not subject to the 20-percent excise tax of section 4999. In addition, such exempt payments are not taken into account in applying the three-times-base-amount test of section 280G(b)(2)(A)(ii).

Section 280G(b)(5) provides an exemption for payments with respect to certain corporations. Pursuant to that section, the term "parachute payment" does not include any payment made to a disqualified individual with respect to a corporation which, immediately before the change in ownership or control, was a small business corporation (as defined in section 1361(b) but without regard to paragraph (1)(C) thereof). In addition, the term "parachute payment" does not include any payment made with respect to a corporation if, immediately before the change in ownership or control, no stock in the corporation was readily tradable on an established securities market (or otherwise) and certain shareholder approval requirements are met with respect to the payment. For this purpose, stock that is described in section 1504-(a)(4) is not treated as being readily tradable on an established securities market if the payment does not adversely affect the shareholder's redemption and liquidation rights. The proposed regulations provide guidance on applying the exemptions contained in section 280G(b)(5).

Section 280G(b)(6) exempts certain payments under a qualified plan. Pursuant to that section, the term "parachute payment" does not include any payment to or from: (a) a plan described in section 401(a) which includes a trust exempt from tax under section 501(a); (b) an annuity plan described in section 403(a); or (c) a simplified employee pension as defined in section 408(k).

Finally, section 280G(b)(4)(A) exempts certain payments of reasonable compensation. Pursuant to that section, except in the case of securities violation parachute payments, the term "parachute payment" does not include the portion of any payment which the taxpayer establishes by clear and convincing evidence is reasonable compensation for personal services to be rendered on or after the date of the change in ownership or control. The proposed regulations provide guidance for determining amounts of reasonable compensation.

Disqualified Individuals

To be a parachute payment, a payment must be made to (or for the benefit of) a "disqualified individual." Section 280G(c) defines the term "disqualified individual" to include any individual who (a) is an employee or independent contractor who performs personal services for a corporation, and (b) is an officer, shareholder, or highly-compensated individual. The proposed regulations provide guidance on who will be treated as an "officer," a "shareholder," and a "highly-compensated individual" for this purpose.

Section 280G(c) provides that a "highly-compensated individual" with respect to a corporation only includes an individual who is (or would be if the individual were an employee) a member of the group consisting of the highest paid 1 percent of the employees of the corporation or, if less, the 250 highest paid employees of the corporation. The proposed regulations provide rules for applying this definition. In addition, the proposed regulations provide that no individual whose annual compensation is less than $75,000 will be treated as a highly compensated individual. The proposed regulations also provide an exception to the definition of "highly-compensated individual" to prevent fees earned by independent service providers (such as independent brokers, attorneys, and investment bankers) from becoming subject to section 280G when they perform services in connection with a change in ownership or control.

With respect to who will be treated as a "shareholder" for purposes of section 280G(c), the proposed regulations provide a *de minimis* rule. Pursuant to this rule, only an individual who owns stock of a corporation having a value that exceeds the lesser of $1 million, or 1 percent of the total value of the outstanding shares of all classes of the corporation's stock, is treated as a disqualified individual with respect to the corporation by reason of stock ownership. For purposes of determining the amount of the stock owned by an individual, the constructive ownership rules of section 318-(a) shall apply.

The proposed regulations also limit the number of employees who will be treated as disqualified individuals with respect to a corporation by reason of being "officers" of the corporation. The proposed regulations provide that no more than 50 employees (or, if less, the greater of 3 employees or 10 percent of the employees of the corporation) will be treated as disqualified individuals with respect to a corporation by reason of being an officer of the corporation. In the case of an affiliated group treated as one corporation, the previous sentence will be applied to each member of such group.

Contingent on Change

To be a parachute payment, a payment must be contingent on a change in ownership or control. The proposed regulations provide rules on when a payment will be treated as so "contingent."

In general, a payment will be treated as contingent on a change in ownership or control if the payment would not in fact have been made had no change in ownership or control occurred. A payment generally will be treated as one which would not in fact have been made in the absence of a change in ownership or control unless it is substantially certain, at the time of the change, that the payment would have been made whether or not the change occurred. In addition, a payment generally is treated as contingent on a change in ownership of control if (a) the payment is contingent on an event that is closely associated with such a change, (b) a change in ownership or control actually occurs, and (c) the event is materially related to the change in ownership or control. Some types of events that are considered closely associated with a change in ownership or control are the onset of a tender offer, the termination of the disqualified individual's employment, and a significant reduction in the disqualified individual's job responsibilities.

Moreover, a payment will be treated as contingent on a change in ownership or control if the change accelerates the time at which the payment is made. However, if it is substantially certain at the time of the change that the payment would have been made whether or not the change occurred, but the payment is treated as contingent on the change solely because the change accelerates the time at which the payment is made, only a portion of the payment will be treated as contingent on the change. In such case, the portion of the payment that will be treated as contingent on the change is the amount by which the amount of the accelerated payment exceeds the present value of the payment absent the acceleration. In addition, if a payment is accelerated by a change in ownership or control and the payment is substantially certain, at the time of the change, to have been made without regard to such change provided that the disqualified individual had continued to perform services for the corporation for a specified period of time, only a portion of the payment is treated as contingent on the change. The proposed regulations provide rules for determining the portion of the payment so treated. The proposed regulations provide that payments made pursuant to an agreement that is entered into after a change in ownership or control will not be treated as contingent on the change. However, for this purpose, an agreement that is executed after a change in ownership or control pursuant to a legally enforceable agreement that was entered into before the change will be considered to have been entered into before the change.

Presumption That Payment is Contingent on Change

Section 280G(b)(2)(C) provides a presumption that certain payments are contingent on a change in ownership or control. Specifically, this provision provides that any payment pursuant to an agreement (or an amendment of a previous agreement) that is entered into within one year before a change in ownership or control is presumed to be contingent on such change unless the contrary is established by clear and convincing evidence.

The proposed regulations provide that an amendment of a previous agreement triggers this presumption only if the previous agreement is amended "in any significant respect." The proposed regulations also provide that when the presumption is triggered by an amendment, only the portion of a payment that exceeds the amount of such payment that would have been made in the absence of the amendment is presumed, by reason of the amendment, to be contingent on the change in ownership or control.

In addition, the proposed regulations provide that if an agreement is entered into within one year before the date of a change in ownership or control, clear and convincing evidence that the agreement is (a) a nondiscriminatory employee plan or program; (b) a contract that replaces a prior contract entered into by the same parties more than one year before the change in ownership or control (if the new contract meets certain requirements); or (c) a contract between a corporation and a disqualified individual who did not perform services for the corporation prior to the individual's taxable year in which the change in ownership or control occurs (if the contract meets certain requirements); generally will rebut the presumption that payments under the agreement are contingent on the change.

Change in Ownership or Control

The proposed regulations also provide guidance on when a change in ownership or control will be considered to occur. The regulations provide that a change in the ownership of a corporation occurs when any one person, or more than one person acting as a group, acquires ownership of stock of the corporation that, together with stock held by such person or group, has more than 50 percent of the total fair market value or voting power of all of the corporation's outstanding stock. Section 318(a) will apply in determining stock ownership for this purpose.

The proposed regulations provide that a change in the ownership of a substantial portion of the assets of a corporation occurs when any one person, or more than one person acting as a group, acquires (or has acquired during the 12 months ending on the date of the most recent acquisition by such person or persons) assets from the corporation that have a total fair market value equal to or more than one third of the total fair market value of all of the assets of the corporation immediately prior to such acquisition or acquisitions. However, the proposed regulations provide that a transfer of assets by a corporation will not be treated as a change in ownership if the assets are transferred to certain shareholders of the corporation or to an entity at least 50 percent of the total value or voting power of which is owned by the corporation.

Under the proposed regulations, a change in the effective control of a corporation is presumed to occur when either of the following events occurs: (a) any one person, or more than one person acting as a group acquires (or has acquired during the 12 month period ending on the date of the most recent acquisition) ownership of stock of the corporation possessing 20 percent or more of the total voting power of the stock of the corporation; or (b) a majority of the members of the corporation's board of directors is replaced during any 12-month period by directors whose appointment or election is not endorsed by a majority of the members of the corporation's board of directors prior to the appointment or election.

Under the proposed regulations, a taxpayer may rebut the presumption described in the preceding paragraph by establishing that such acquisition or acquisitions of the corporation's stock, or such replacement of the majority of the members of the corporation's board of directors, does not transfer the power to control (directly or indirectly) the management and policies of the corporation from any one person or group to another person or group.

Securities Violation Parachute Payments

The proposed regulation implement section 280G(b)(2)(B) by providing that the term "parachute payment" also includes any payment in the nature of compensation to (or for the benefit of) a disqualified individual if such payment is made (a) pursuant to an agreement that violates any generally enforced federal or state securities law or regulation, and (b) in connection with a potential or actual change in ownership or control. However, a violation will not be taken into account for this purpose if it is merely technical in character or is not materially prejudicial to shareholders or potential shareholders. Generally, a securities violation will be presumed not to exist unless the existence of the violation has been determined or admitted in a civil or criminal action (or an administrative action by a regulatory body charged with enforcing the particular securities law or regulation) which has been resolved by adjudication or consent.

Reasonable Compensation

As previously mentioned, section 280G(b)(4)(A) provides that except in the case of securities violation parachute payments, the amount of a payment treated as a parachute payment shall not include the portion of such payment which the taxpayer establishes by clear and convincing evidence is reasonable compensation for personal services to be rendered on or after the date of the change in ownership or control.

Section 280G(b)(4)(B) provides that except in the case of securities violation parachute payments, the amount of a payment treated as an excess parachute payment is reduced by any portion of the payment that the taxpayer establishes by clear and convincing evidence is reasonable compensation for personal services actually rendered by the disqualified individual before the date of the change in ownership or control. Such reasonable compensation is first offset against the portion of the base amount allocated to the payment.

The proposed regulations provide criteria for determining whether payments are reasonable compensation. In general, whether payments are reasonable compensation is determined on the basis of all the facts and circumstances in the particular case. Factors relevant to such a determination include the nature of the services rendered or to be rendered, the individual's historic compensation for performing such services, and the compensation of individuals performing comparable services in situations where the compensation is not contingent on the change. The proposed regulations also provide that payments made under certain nondiscriminatory employee plans or programs will generally be considered to be clear and convincing evidence that the payments are reasonable compensation.

Generally, clear and convincing evidence of reasonable compensation for personal services to be rendered on or after the change in ownership or control will not exist if the individual does not, in fact, perform the services. However, the proposed regulations provide that damages paid for the breach of an employment contract may be reasonable compensation for such services if certain factors are shown. One of these factors is that the damages must be reduced by mitigation. For this purpose, damages will be treated as being mitigated if the damages are reduced (or any payment of such damages is returned) to the extent of the disqualified individual's earned income during the remainder of the contract term. The proposed regulations do not provide a rule concerning the method of establishing mitigation of damages in other situations, such as where the disqualified individual does not accept alternative employment during the remainder of the contract term or where the individual and the corporation considered mitigation in determining the amount of a lump-sum settlement agreement, because the Service is concerned about the administrability of such a rule. Accordingly, the Service solicits comment on how a rule which would allow damages to be treated as mitigated in such cases could be administered.

Finally, the proposed regulations provide that for purposes of section 280G, severance payments will not be considered as reasonable compensation.

Issues on Which Comments are Requested

In addition to the issue concerning mitigation of damages, the Service solicits comment on the following issues:

(a) How the present value of a payment to be made in the future should be determined if such value depends on some uncertain future event or condition (and what adjustments, if any, are to be made if the amount of the actual payment differs from the amount used in determining present value). See Q/A-31, Q/A-32, and Q/A-33 of the proposed regulations.

(b) How the special rules of section 280G should interact with special income deferral rules such as those contained in section 83. See Q/A-12 and Q/A-13 of the proposed regulations.

(c) Whether the rules for identifying the disqualified individuals of a corporation (including the rules relating to the time period that should be utilized to determine who the disqualified individuals are and how the compensation for such a time period should be determined) could be simplified. See Q/A-20 and Q/A-21 of the proposed regulations.

(d) How severance payments should be treated. See Q/A-44 of the proposed regulations.

(e) Whether any of the rules contained in the proposed regulations should be given only prospective effect.

Special Analyses

The Commissioner of Internal Revenue has determined that this proposed rule is not a major rule as defined in Executive Order 12291 and that a Regulatory Impact Analysis is therefore not required.

Although this document is a notice of proposed rulemaking which solicits public comments, the Internal Revenue Service has concluded that the regulations proposed herein are interpretative and that the notice and public procedure requirements of 5 U.S.C. 553 do not apply. Accordingly, these proposed regulations do not constitute regulations subject to the Regulatory Flexibility Act (5 U.S.C. Chapter 6).

Comments and Requests for a Public Hearing

Before these proposed regulations are adopted consideration will be given to any written comments that are submitted to the Commissioner of Internal Revenue. All comments will be available for public inspection and copying. A public hearing will be held upon written request to the Commissioner by any person who has submitted written comments. If a public hearing is held, notice of the time and place will be published in the FEDERAL REGISTER.

List of Subjects

26 CFR §§1.61-1 — 1.281-4

Income taxes, Taxable income, Deductions, Exemptions.

Proposed amendments to the regulations

The proposed amendments to 26 CFR Part 1 are as follows:

PART 1—INCOME TAX; TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1986

Paragraph 1. The authority for Part 1 is amended by adding the following citation:

Authority: 26 U.S.C. 7805. * * * Section 1.280G-1 also issued under 26 U.S.C. 280G(b) and (e).

Par. 2. A new §1.280G-1 is added after §1.280F-6T to read as follows:

§1.280G-1 Golden parachute payments.

The following questions and answers relate to the treatment of golden parachute payments under section 280G of the Internal Revenue Code of 1986, as added by section 67 of the Tax Reform Act of 1984 (Pub. L. No. 98-369; 98 Stat. 585) and amended by section 1804-(j) of the Tax Reform Act of 1986 (Pub. L. No. 99-514; 100 Stat. 2807) and section 1018(d)(6)-(8) of the Technical and Miscellaneous Revenue Act of 1988 (Pub. L. No. 100-647; 102 Stat. 3581).

The following is a table of contents for this section:

Overview

Q-1: What is the effect of Code section 280G?

A-1: Section 280G disallows a deduction for any "excess parachute payment" paid or accrued. For rules relating to the imposition of a nondeductible 20-percent excise tax on the recipient of any excess parachute payment, see Code sections 4999, 275(a)(6), and 3121(v)(2)(A).

Q-2: What is a "parachute payment" for purposes of section 280G?

A-2: (a) The term "parachute payment" means any payment (other than a payment with respect to certain corporations exempted under Q/A-6 of this section, a payment under a qualified plan exempted under Q/A-8 of this section, or a payment of reasonable compensation exempted under Q/A-9 of this section) that—

(1) Is in the nature of compensation;

(2) Is made or is to be made to (or for the benefit of) a "disqualified individual;"

(3) Is contingent on a change—

(i) In the ownership of a corporation,

(ii) In the effective control of a corporation, or

(iii) In the ownership of a substantial portion of the assets of a corporation; and

(4) Has (together with other payments described in paragraph (a)(1), (2), and (3) of this A-2 with respect to the same disqualified individual) an aggregate present value of at least 3 times the individual's "base amount."

Hereinafter, a change referred to in paragraph (a)(3) of this A-2 is referred to as a "change in ownership or control." For a discussion of the application of paragraph (a)(1), see Q/A-11 through Q/A-14; paragraph (a)(2), Q/A-15 through Q/A-21; paragraph (a)(3), Q/A-22 through Q/A-29; and paragraph (a)(4), Q/A-30 through Q/A-36.

(b) The term "parachute payment" also includes any payment in the nature of compensation to (or for the benefit of) a disqualified individual that is pursuant to an agreement that violates a generally enforced securities law or regulation. This type of parachute payment is referred to in this section as a "securities violation parachute payment." See Q/A-37 for the definition and treatment of securities violation parachute payments.

Q-3: What is an "excess parachute payment" for purposes of section 280G?

A-3: The term "excess parachute payment" means an amount equal to the excess of any parachute payment over the portion of the "base amount" allocated to such payment. Subject to certain exceptions and limitations, an excess parachute payment is reduced by any portion of the payment which the taxpayer establishes by clear and convincing evidence is reasonable compensation for personal services actually rendered by the disqualified individual before the date of the change in ownership or control. For a discussion of the computation of excess parachute payments and their reduction by reasonable compensation, see Q/A-38 through Q/A-44. For a discussion of the nonreduction of a securities violation parachute payment by reasonable compensation, see Q/A-37.

Q-4: What is the effective date of section 280G and this section?

A-4: In general, section 280G and this section apply to payments under agreements entered into or renewed after June 14, 1984. Section 280G and this section also apply to certain payments under agreements entered into on or before June 14, 1984, and amended or supplemented in significant relevant respect after that date. For a discussion of the application of the effective date, see Q/A-47 through Q/A-52.

Exempt Payments

Q-5: Are some types of payments exempt from the definition of the term "parachute payment"?

A-5: Yes. The following four types of payments are exempt from the definition of "parachute payment": (a) payments with respect to a small business corporation (described in Q/A-6 of this section); (b) certain payments with respect to a corporation no stock in which is readily tradable on an established securities market (or otherwise) (described in Q/A-6 of this section); (c) payments to or from a qualified plan (described in Q/A-8 of this section); and (d) certain payments of reasonable compensation (described in Q/A-9 of this section). Deductions for payments exempt from the definition of "parachute payment" are not disallowed by section 280G, and such exempt payments are not subject to the 20-percent excise tax of section 4999. In addition, such exempt payments are not taken into account in applying the three-times-base-amount test of Q/A-30 of this section.

Q-6: Which payments with respect to a corporation referred to in paragraph (a) or (b) of A-5 of this section are exempt from the definition of "parachute payment"?

A-6: (a) The term "parachute payment" does not include—

(1) Any payment to a disqualified individual with respect to a corporation

which (immediately before the change in ownership or control) was a small business corporation (as defined in section 1361(b) but without regard to paragraph (1)(C) thereof), or

(2) Any payment to a disqualified individual with respect to a corporation (other than a small business corporation described in paragraph (a)(1) of this A-6) if—

(i) Immediately before the change in ownership or control, no stock in such corporation was readily tradable on an established securities market or otherwise, and

(ii) The shareholder approval require ments described in Q/A-7 of this section are met with respect to such payment.

(b) For purposes of paragraph (a)(1) of this A-6, the members of an affiliated group are not treated as one corporation.

(c) The requirements of paragraph (a)-(2)(i) of this A-6 are not met if a substantial portion of the assets of any entity consists (directly or indirectly) of stock in such corporation and any ownership interest in such entity is readily tradable on an established securities market or otherwise. For this purpose, such stock constitutes a substantial portion of the assets of an entity if the total fair market value of the stock is equal to or more than one third of the total fair market value of all of the assets of the entity. If a corporation is a member of an affiliated group (which group is treated as one corporation under A-46 of this section), the requirements of paragraph (a)(2)(i) of this A-6 are not met if any stock in any member of such group is readily tradable on an established securities market or otherwise.

(d) For purposes of paragraph (a)(2)(i) of this A-6, the term "stock" does not include stock described in section 1504-(a)(4) if the payment does not adversely affect the redemption and liquidation rights of any shareholder owning such stock.

(e) For purposes of paragraph (a)(2)(i) of this A-6, stock shall be treated as readily tradable if it is regularly quoted by brokers or dealers making a market in such stock.

(f) For purposes of paragraph (a)(2)(i) of this A-6, the term "established securities market" means an established securities market as defined in §1.897-1-(m).

(g) The following examples illustrate the application of this exemption:

Example (1). A small business corporation (within the meaning of paragraph (a)(1) of this section) operates two businesses. The corporation sells the assets of one of its businesses, and these assets represent a substantial portion of the assets of the corporation. Because of the sale, the corporation terminates its employment relationship with persons employed in the business the assets of which are sold. Several of these employees are highly-compensated individuals to whom the owners of the corporation make severance payments in excess of 3 times each employee's base amount. Since the corporation is a small business corporation immediately before the change in ownership or control, the payments are not parachute payments.

Example (2). Assume the same facts as in example (1), except that the corporation is not a small business corporation within the meaning of paragraph (a)(1) of this section. If no stock in the corporation is readily tradable on an established securities market (or otherwise) immediately before the change in ownership or control and the shareholder approval requirements described in Q/A-7 of this section are met, the payments are not parachute payments.

Example (3). Seventy percent of the stock of Corporation S is owned by Corporation P, stock in which is readily tradable on an established securities market. The Corporation S stock represents a substantial portion of the assets of Corporation P. Corporation P sells all of its stock in Corporation S to Corporation X. Because of the sale, Corporation S makes severance payments to several of its highly-compensated individuals in excess of 3 times each individual's base amount. Since stock in Corporation P is readily tradable on an established securities market, the payments are not exempt from the definition of "parachute payments" under this A-6.

Q-7: How are the shareholder approval requirements referred to in paragraph (a)(2)(ii) of A-6 of this section met?

A-7: (a) The shareholder approval requirements referred to in paragraph (a)(2)(ii) of A-6 of this section are met with respect to any payment if—

(1) Such payment was approved by a separate vote of the persons who owned, immediately before the change in ownership or control, more than 75 percent of the voting power of all outstanding stock of the corporation, and

(2) There was adequate disclosure, to all persons entitled to vote under paragraph (a)(1) of this A-7, of all material facts concerning all material payments which (but for Q/A-6 of this section) would be parachute payments with respect to a disqualified individual.

The vote described in paragraph (a)(1) of this A-7 must determine the right of the disqualified individual to receive the payment, or, in the case of a payment made before the vote, the right of the disqualified individual to retain the payment.

(b) Approval of a payment by any shareholder that is not an individual ("entity shareholder") generally must be made by the person authorized by the entity shareholder to approve the payment. However, if a substantial portion of the assets of an entity shareholder consists (directly or indirectly) of stock in the corporation undergoing the change in ownership or control, approval of the payment by that entity shareholder must be made by a separate vote of the persons who hold, immediately before the change in ownership or control, more than 75 percent of the voting power of the entity shareholder. The preceding sentence does not apply if the value of the stock of the corporation owned, directly or indirectly, by or for the entity shareholder does not exceed 1 percent of the total value of the outstanding stock of the corporation. Where approval of a payment by an entity shareholder must be made by a separate vote of the owners of the entity shareholder, the normal voting rights of the entity shareholder determine which owners shall vote.

(c) In determining the persons who comprise the "more than 75 percent" group referred to in paragraph (a)(1) of this A-7, stock is not counted as outstanding stock if the stock is actually owned or constructively owned under section 318(a) by or for a disqualified individual who receives (or is to receive) payments that would be parachute payments if the shareholder approval requirements described in paragraph (a) of this A-7 were not met. Likewise, stock is not counted as outstanding stock if the owner is considered under section 318(a) to own any part of the stock owned directly or indirectly by or for a disqualified individual described in the preceding sentence. However, if all persons who hold voting power in the corporation or the entity shareholder are disqualified individuals or related persons described in either of the two preceding sentences, then stock owned by such persons is counted as outstanding stock.

(d) To be adequate disclosure for purposes of paragraph (a)(2) of this A-7, disclosure must be full and truthful disclosure of the material facts and such additional information as is necessary to make the disclosure not materially misleading at the time the disclosure was made. An omitted fact is considered a material fact if there is a substantial likelihood that a reasonable shareholder would consider it important.

(e) The following examples illustrate the application of this A-7:

Example (1). Corporation S has two shareholders—Corporation P, which owns 76 percent of the stock of Corporation S, and A, an individual who owns the remaining 24 percent. No stock of

Corporation P is readily tradable on an established securities market (or otherwise). Stock of Corporation S represents a substantial portion of the assets of Corporation P All of the stock of Corporation S is sold to Corporation M. Contingent on the change in ownership of Corporation S, severance payments are made to the officers of Corporation S in excess of 3 times each officer's base amount. If the payments are approved by a separate vote of the persons who hold, immediately before the sale, more than 75 percent of the voting power of the outstanding stock of Corporation P and the disclosure rules of paragraph (a)(2) of this A-7 are compiled with, the shareholder approval requirements of this A-7 are met, and the payments are exempt from the definition of "parachute payment" pursuant to A-6 of this section.

Example (2). Corporation M is wholly owned by Partnership P, no interest in which is readily tradable on an established securities market (or otherwise). Stock of Corporation M represents a substantial portion of the assets of Partnership P. Partnership P has one general partner and 200 limited partners. None of the limited partners are entitled to vote on issues involving the management of the partnership investments. If the payments are approved by the general partner and the disclosure rules of paragraph (a)(2) of this A-7 are complied with, the shareholder approval requirements of this A-7 are met, and the payments are exempt from the definition of "parachute payment" pursuant to A-6 of this section.

Q-8: Which payments under a qualified plan are exempt from the definition of "parachute payment"?

A-8: The term "parachute payment" does not include any payment to or from—

(a) A plan described in section 401-(a) which includes a trust exempt from tax under section 501(a),

(b) An annuity plan described in section 403(a), or

(c) A simplified employee pension (as defined in section 408(k)).

Q-9: Which payments of reasonable compensation are exempt from the definition of "parachute payment"?

A-9: Except in the case of securities violation parachute payments, the term "parachute payment" does not include any payment (or portion thereof) which the taxpayer establishes by clear and convincing evidence is reasonable compensation for personal services to be rendered by the disqualified individual on or after the date of the change in ownership or control. See Q/A-38 through Q/A-44 for rules on determining amounts of reasonable compensation. See Q/A-37 for the definition and treatment of securities violation parachute payments.

Payor of Parachute Payments

Q-10: Who may be the payor of parachute payments?

A-10: Parachute payments within the meaning of Q/A-2 of this section may be paid directly or indirectly by the corporation referred to in paragraph (a)(3) of A-2 of this section, by a person acquiring ownership or effective control of that corporation or ownership of a substantial portion of that corporation's assets, or by any person whose relationship to such corporation or other person is such as to require attribution of stock ownership between the parties under section 318(a).

Payments in the Nature of Compensation

Q-11: What types of payments are in the nature of compensation?

A-11: (a) In general, for purposes of this section, all payments—in whatever form—are payments in the nature of compensation if they arise out of an employment relationship or are associated with the performance of services. For this purpose, the performance of services includes holding oneself out as available to perform services and refraining from performing services (such as under a covenant not to compete or similar arrangement). Payments in the nature of compensation include (but are not limited to) wages and salary, bonuses, severance pay, fringe benefits, and pension benefits and other deferred compensation (including any amount characterized by the parties as interest thereon). However, payments in the nature of compensation do not include attorney's fees or court costs paid or incurred in connection with the payment of any amount described in paragraph (a)(1), (2), and (3) of A-2 of this section.

(b) Transfers of property are treated as payments for purposes of this A-11. See Q/A-12 for rules on determining when such payments are considered made and the amount of such payments. See Q/A-13 for special rules on transfers of nonqualified stock options.

Q-12: If a property transfer to a disqualified individual is a payment in the nature of compensation, when is the payment considered made (or to be made), and how is the amount of the payment determined?

A-12: (a) Except as provided in this A-12 and A-13 of this section, a transfer of property is considered a payment made (or to be made) in the taxable year in which the property transferred is includible in the gross income of the disqualified individual under section 83 and the regulations thereunder. Thus, in general, such a payment is considered made (or to be made) when the property is transferred (as defined in §1.83-3(a)) to the disqualified individual and becomes substantially vested as defined in §1.83-3(b)) in such individual. In such case, the amount of the payment is determined under section 83 and the regulations thereunder. Thus, in general, the amount of the payment is equal to the excess of the fair market value of the transferred property (determined without regard to any lapse restriction, as defined in §1.83-3(i)) at the time that the property becomes substantially vested, over the amount (if any) paid for the property.

(b) An election made by a disqualified individual under section 83(b) with respect to transferred property will not apply for purposes of this A-12. Thus, even if such an election is made with respect to a property transfer that is a payment in the nature of compensation, the payment is generally considered made (or to be made) when the property is transferred to and becomes substantially vested in such individual.

(c) See Q/A-13 for rules on applying this A-12 to transfers of nonqualified stock options.

(d) *Example.* On January 1, 1986, Corporation M gives to A, a disqualified individual, in connection with his performance of services to Corporation M, a bonus of 100 shares of Corporation M stock. Under the terms of the bonus arrangement A is obligated to return the Corporation M stock to Corporation M unless the earnings of Corporation M double by January 1, 1989, or there is a change in ownership or control of Corporation M before that date. A's rights in the stock are treated as substantially nonvested (within the meaning of §1.83-3(b)) during that period because A's rights in the stock are subject to a substantial risk of forfeiture (within the meaning of §1.83-3(c)) and are nontransferable (within the meaning of §1.83-3(d)). On January 1, 1988, a change in the ownership of Corporation M occurs. On that day, the fair market value of the Corporation M stock is $250 per share. Since A's rights in the Corporation M stock become substantially vested (within the meaning of §1.83-3(b)) on that day, the payment is considered made on that day, and the amount of the payment for purposes of this sectio is equal to $25,000 (100 × $250). See Q/A-39 for rules relating to the reduction of the excess parachute payment by the portion of the payment which is established to be reasonable compensation for personal services actually rendered before the date of a change in ownership or control.

Q-13: How are nonqualified stock options treated?

A-13: (a) For purposes of this section, if an option to which section 421 (relating generally to certain qualified and other options) does not apply has an ascertainable fair market value (whether or not readily ascertainable as defined in §1.83-7(b)) at the time the option becomes substantially vested (as defined in §1.83-3(b), the option shall be treated as property that is transferred not later than the time at which the option becomes substantially vested. Thus, for purposes of this section, the vesting of such an option is treated as a payment in the nature of compensation. The value of an option with a readily ascertainable fair market value at the time the option vests shall be determined by applying the rules set forth in §1.83-7(b). The value of an option with an ascertainable fair market value at the time the option vests is determined under all the facts and circumstances in the particular case. Factors relevant to such a determination include, but are not limited to: (1) the difference between the option's exercise price and the value of the property subject to the option the time of vesting; (2) the probability of the value of such property increasing or decreasing; and (3) the length of the period during which the option can be exercised. See Q/A-33 for the treatment of options the vesting of which is contingent on a change in ownership or control and that do not have an ascertainable fair market value at the time of vesting.

(b) Any money or other property transferred to the disqualified individual upon the exercise, or as consideration upon the sale or other disposition, of an option described in paragraph (a) of this A-14 after the time such option vests is not treated as a payment in the nature of compensation to the disqualified individual under A-11 of this section. Nonetheless, the amount of the otherwise allowable deduction under section 162 or 212 with respect to such transfer shall be reduced by the amount of the payment described in paragraph (a) of this section treated as an excess parachute payment.

(c) (The issue of whether an option to which section 421 applies will be treated as a payment for purposes of this section at the time of grant or at a later time is reserved for future regulations.)

Q-14: Are payments in the nature of compensation reduced by consideration paid by the disqualified individual?

A-14: Yes. To the extent not otherwise taken into account under Q/A-12 and Q/A-13 of this section, the amount of any payment in the nature of compensation is reduced by the amount of any money or the fair market value of any property (owned by the disqualified individual without restriction) that is (or will be) transferred by the disqualified individual in exchange for the payment. For purposes of the preceding sentence, the fair market value of property is determined as of the date the property is transferred by the disqualified individual.

Disqualified Individuals

Q-15: Who is a "disqualified individual"?

A-15: For purposes of this section, an individual is a disqualified individual with respect to a corporation if, at any time during the "disqualified individual determination period" (as defined in Q/A-20 of this section), the individual is an employee or independent contractor of the corporation and is, with respect to the corporation—

(a) A shareholder (but see Q/A-17),

(b) An officer (see Q/A-18), or

(c) A highly-compensated individual (see Q/A-19).

Q-16: Is a personal service corporation treated as an individual?

A-16: (a) Yes. For purposes of this section, a personal service corporation (as defined in section 269A(b)(1)), or a noncorporate entity that would be a personal service corporation if it were a corporation, is treated as an individual.

(b) *Example.* Corporation N, a personal service corporation (as defined in section 269A(b)(1)), has a single individual as its sole shareholder and employee. Corporation N performs personal services for Corporation M as an independent contractor. The compensation paid to Corporation N by Corporation M puts Corporation N within the group of the highly-compensated individuals of Corporation M as determined under A-18 of this section. Hence, Corporation N is treated as a highly-compensated individual with respect to Corporation M.

Q-17: Are all shareholders of a corporation considered shareholders for purposes of paragraph (a) of A-15 of this section?

A-17: No. Only an individual who owns stock of a corporation having a fair market value that exceeds the lesser of $1 million, or 1 percent of the total fair market value of the outstanding shares of all classes of the corporation's stock, is treated as a disqualified individual with respect to the corporation by reason of stock ownership. An individual who owns a lesser amount of stock may, however, be a disqualified individual with respect to the corporation by reason of being an officer or highly-compensated individual with respect to the corporation. For purposes of determining the amount of stock owned by an individual, the constructive ownership rules of section 318(a) shall apply.

Q-18: Who is an officer?

A-18: (a) For purposes of this section, whether an individual is an officer with respect to a corporation is determined upon the basis of all the facts and circumstances in the particular case (such as the source of the individual's authority, the term for which the individual is elected or appointed, and the nature and extent of the individual's duties). Generally, the term "officer" means an administrative executive who is in regular and continued service. The term "officer" implies continuity of service and excludes those employed for a special and single transaction. An individual who merely has the title of officer but not the authority of an officer is not considered an officer for purposes of this section. Similarly, an individual who does not have the title of officer but has the authority of an officer is an officer for purposes of this section.

(b) An individual who is an officer with respect to any member of an affiliated group that is treated as one corporation pursuant to Q/A-46 of this section is treated as an officer of such one corporation.

(c) No more than 50 employees (or, if less, the greater of 3 employees, or 10 percent of the employees (rounded up to the nearest integer)) of the corporation (in the case of an affiliated group treated as one corporation, each member of the affiliated group) shall be treated as disqualified individuals with respect to a corporation by reason of being an officer of the corporation. For purposes of the preceding sentence, the number of employees of the corporation is the greatest number of employees the corporation has during the disqualified individual determination period (as defined in Q/A-20 of this section). If the number of officers of the corporation exceeds the number of employees who may be treated as officers under the first sentence of this paragraph (c), then the employees who are treated as officers for purposes of this section are the highest paid 50 employees (or, if less, the greater of 3 employees, or 10 percent of the employees (rounded up to the nearest integer)) of the corporation when ranked on the basis of compensation (as determined under Q/A-21 of this section) paid during the disqualified individual determination period.

Q-19: Who is a "highly-compensated individual"?

A-19: (a) For purposes of this section, a "highly- compensated individual" with respect to a corporation is any individual who is, or would be if the individual were an employee, a member of the group consisting of the lesser of (1) the highest paid 1 percent of the employees of the corporation (rounded up to the nearest integer), or (2) the highest paid

250 employees of the corporation, when ranked on the basis of compensation (as determined under Q/A-21 of this section) paid during the disqualified individual determination period (as defined in Q/A-20 of this section). However, no individual whose annualized compensation during the disqualified individual determination period is less than $75,000 will be treated as a highly-compensated individual.

(b) An individual who is not an employee of the corporation is not treated as a highly-compensated individual with respect to the corporation on account of compensation received for performing services (such as brokerage, legal, or investment banking services) in connection with a change in ownership or control of the corporation, if the services are performed in the ordinary course of the individual's trade or business and the individual performs similar services for a significant number of clients unrelated to the corporation.

(c) In determining the total number of employees of a corporation for purposes of this A-19, employees are not counted if they normally work less than 17 1/2 hours per week (as defined in section 414(q)(8)(B) and the regulations thereunder) or if they normally work during not more than 6 months during any year (as defined in section 414(q)(8)(C) and the regulations thereunder). However, an employee who is not counted for purposes of the preceding sentence may still be a highly-compensated individual.

Q-20: What is the "disqualified individual determination period"?

A-20: (a) The "disqualified individual determination period" is the portion of the year of the corporation ending on the date of the change in ownership or control of the corporation (the "change in ownership period") and the twelve month period immediately preceding such change in ownership period. For purpose of this A-20, a corporation may elect to use its taxable year or the calendar year. For this purpose, the taxable year of an affiliated group treated as one corporation pursuant to Q/A-46 of this section is the taxable year of the common parent.

(b) The provisions of this A-20 may be illustrated by the following examples:

Example (1). A change in ownership of Corporation M, a calendar year corporation, takes place on June 12, 1988. The disqualified individual determination period of Corporation M begins on January 1, 1987 and ends on June 12, 1988.

Example (2). Assume the same facts as example (1), except that Corporation M is a fiscal year taxpayer with a taxable year ending on May 31. Corporation M may elect as its disqualified individual determination period either the period beginning on January 1, 1987, and ending on June 12, 1988, or the period beginning on June 1, 1987, and ending on June 12, 1988.

Q-21: How is "compensation" defined?

A-21: (a) For purposes of this section, the term "compensation" is the compensation which was payable by the corporation with respect to which the change in ownership or control occurs ("changed corporation"), by a predecessor entity, or by a related entity. Such compensation shall be determined without regard to sections 125, 402(a)(8), and 402(h)(1)(B), and in the case of employer contributions made pursuant to a salary reduction agreement, without regard to section 403(b). Thus, for example, compensation includes elective or salary reduction contributions to a cafeteria plan, cash or deferred arrangement or tax-sheltered annuity.

(b) For purposes of this section, a "predecessor entity" is any entity which, as a result of a merger, consolidation, purchase or acquisition of property or stock, corporate separation, or other similar business transaction transfers some or all of its employees to the changed corporation or to a related entity or to a predecessor entity of the changed corporation. The term "related entity" includes: (1) all members of a controlled group of corporations (as defined in section 414(b)) that includes the changed corporation or a predecessor entity; (2) all trades or business (whether or not incorporated) that are under common control (as defined in section 414(c)) if such group includes the changed corporation or a predecessor entity; (3) all members of an affiliated service group (as defined in section 414(m)) that includes the changed corporation or a predecessor entity; and (4) any other entities required to be aggregated with the changed corporation or a predecessor entity pursuant to section 414(o) and the regulations thereunder (except leasing organizations as defined in section 414(n)).

(c) For purposes of Q/A-18 and Q/A-19 of this section, compensation that was contingent on the change in ownership or control and that was payable in the year of the change shall not be treated as compensation.

Contingent on Change in Ownership or Control

Q-22: When is a payment "contingent" on a change in ownership or control?

A-22: (a) In general, a payment is treated as "contingent" on a change in ownership or control if the payment would not, in fact, have been made had no change in ownership or control occurred. A payment generally is to be treated as one which would not, in fact, have been made in the absence of a change in ownership or control unless it is substantially certain, at the time of the change, that the payment would have been made whether or not the change occurred. (But see Q/A-23 of this section regarding payments under agreements entered into after a change in ownership or control.) Property that becomes substantially vested (as defined in §1.83-3(b)) as a result of a change in ownership or control will not be treated as a payment which was substantially certain to have been made whether or not the change occurred.

(b) A payment is also generally treated as contingent on a change in ownership or control if—

(1) The payment is contingent on an event that is closely associated with a change in ownership or control,

(2) A change in ownership or control actually occurs, and

(3) The event is materially related to the change in ownership or control.

For purposes of paragraph (b)(1) of this A-22, a payment is treated as contingent on an event that is closely associated with a change in ownership or control unless it is substantially certain, at the time of the event, that the payment would have been made whether or not the event occurred. An event is considered closely associated with a change in ownership or control if the event is of a type often preliminary or subsequent to, or otherwise closely associated with, a change in ownership or control. For example, the following events are considered closely associated with a change in the ownership or control of a corporation: the onset of a tender offer with respect to the corporation; a substantial increase in the market price of the corporation's stock that occurs within a short period (but only if such increase occurs prior to a change in ownership or control); the cessation of the listing of the corporation's stock on an established securities market; the acquisition of more than 5 percent of the corporation's stock by a person (or more than one person acting as a group) not in control of the corporation; the voluntary or involuntary termination of the disqualified individual's employment; and a significant reduction in the disqualified individual's job responsibilities. Whether other events will be treated as closely associated with a change in ownership or control will be based on all the facts and circumstances of the particular case. For purposes of paragraph (b)(3) of this A-22, an event will be presumed to be materially related to a change in ownership or control if the event occurs within the period beginning one year before and ending one year after the date of change in ownership or control. If such event occurs outside of the period beginning one year before and ending one year after the date of change in ownership or control, the event will be presumed not to be materially related to the change in ownership or control.

(c) A payment that would in fact have been made had no change in ownership or control occurred is treated as contingent on a change in ownership or control if the change accelerates the time at which the payment is made. Thus, for example, if a change in ownership or control accelerates the time of payment of vested deferred compensation, the payment may be treated as contingent on the change. See Q/A-24 regarding the portion of a payment that is so treated. See also Q/A-8 regarding the exemption for certain payments under qualified plans and Q/A-40 regarding treatment of a payment as reasonable compensation.

(d) A payment is treated as contingent on a change in ownership or control even if the employment or independent contractor relationship of the disqualified individual is not terminated (voluntarily or involuntarily) as a result of the change.

(e) The following examples illustrate the principles of this A-22:

Example (1). A contract between a corporation and A, a disqualified individual, provides that a payment will be made to A if his employment with the corporation is terminated at any time over the succeeding 3 years. Eighteen months later, a change in the ownership of the corporation occurs. Six months after the change in ownership, A's employment is terminated and the payment is made to A. It was not substantially certain, at the time of A's termination, that the payment would have been made had A's employment not been terminated. Termination of employment is considered closely associated with a change in ownership or control. Because the termination occurred within one year after the date of the change in ownership the termination of A's employment is presumed to be materially related to the change in ownership. If this presumption is not rebutted, the payment will be treated as contingent on the change in ownership.

Example (2). A contract between a corporation and a disqualified individual provides that a payment will be made to the individual upon the onset of a tender offer for shares of the corporation's stock. A tender offer is made on December 1, 1988, and the payment is made to the disqualified individual. Although the tender offer is unsuccessful, it leads to a negotiated merger with another entity on June 1, 1989, which results in a change in the ownership of the corporation. It was not substantially certain, at the time of the onset of the tender offer, that the payment would have been made had no tender offer taken place. The onset of a tender offer is considered closely associated with a change in ownership or control. Because the tender offer occurred within one year before the date of the change in ownership of the corporation, the onset of the tender offer is presumed to be materially related to the change in ownership. If this presumption is not rebutted, the payment will be treated as contingent on the change in ownership. If no change in ownership or control had occurred, the payment would not be treated as contingent on a change in ownership or control; however, the payment still could be a parachute payment under Q/A-37 of this section if the contract violated a generally enforced securities law or regulation.

Example (3). A contract between a corporation and a disqualified individual provides that a payment will be made to the individual if the corporation's level of product sales or profits reaches a specified level. At the time the contract was entered into, the parties had no reason to believe that such an increase in the corporation's level of product sales or profits would be preliminary or subsequent to, or otherwise closely associated with, a change in ownership or control of the corporation. Eighteen months later, a change in the ownership of the corporation occurs and within one year after the date of the change, the corporation's level of product sales or profits reaches the specified level. Under these facts and circumstances (and in the absence of contradictory evidence), the increase in product sales or profits of the corporation is not an event closely associated with the change in ownership or control of the corporation. Accordingly, even if the increase is materially related to the change, the payment will not be treated as contingent on a change in ownership or control.

Q-23: May a payment be treated as contingent on a change in ownership or control if the payment is made under an agreement entered into after the change?

A-23: (a) No. Payments are not treated as contingent on a change in ownership or control if they are made (or to be made) pursuant to an agreement entered into after the change. For this purpose, an agreement that is executed after a change in ownership or control, pursuant to a legally enforceable agreement that was entered into before the change, will be considered to have been entered into before the change. (See Q/A-9 regarding the exemption for reasonable compensation for services rendered on or after a change in ownership or control.)

(b) The following examples illustrate the principles of this A-23:

Example (1). Assume that a disqualified individual is an employee of a corporation. A change in control of the corporation occurs, and thereafter the individual enters into an employment agreement with the acquiring company. Since the agreement is entered into after the change in control occurs, payments to be made under agreement are not treated as contingent on the change.

Example (2). Assume the same facts as in example (1), except that the agreement between the disqualified individual and the acquiring company is executed after the change in control, pursuant to a legally enforceable agreement entered into before the change. Payments to be made under the agreement may be treated as contingent on the change in control pursuant to Q/A-22 of this section. However, see Q/A-9 regarding the exemption from the definition of parachute payment for certain amounts of reasonable compensation.

Q-24: If a payment is treated as contingent on a change in ownership or control, is the full amount of the payment so treated?

A-24: (a) Generally, yes. However, in certain circumstances, described in paragraphs (b) and (c) of this A-24, only a portion of the payment is treated as contingent on the change.

(b) This paragraph (b) applies if it is substantially certain, at the time of the change, that the payment would have been made whether or not the change occurred, but the payment is treated as contingent on the change solely because the change accelerates the time at which the payment is made. In such case, the portion of the payment that is treated as contingent on the change in ownership or control is the amount by which the amount of the accelerated payment exceeds the present value of the payment absent the acceleration. If the amount of such a payment absent the acceleration is not reasonably ascertainable, and the acceleration of the payment does not significantly increase the present value of the payment absent the acceleration, the present value of the payment absent the acceleration shall be treated as equal to the amount of the accelerated payment. For rules on determining present value, see paragraph (d) of this A-24, and Q/A-32 and Q/A-33.

(c) (1) This paragraph (c) applies in the case of a payment that is accelerated by a change in ownership or control and that was substantially certain, at the time of the change, to have been made without regard to the change if the disqualified individual had continued to perform services for the corporation for a specified period of time. In such case, the portion of the payment that is treated as contingent on the change in ownership or control is the lesser of—

(i) The amount of the accelerated payment; or

(ii) The amount by which the amount of the accelerated payment exceeds the present value of the payment that was expected to be made absent the acceleration (determined without regard to the risk of forfeiture for failure to continue to perform services), plus an amount, as determined in paragraph (c)-(2) of this A-24, to reflect the lapse of the obligation to continue to perform services.

If the value of the payment that was expected to be made absent the acceleration is not reasonably ascertainable, the future value of such payment shall be deemed to be equal to the amount of the accelerated payment.

(2) The amount reflecting the lapse of the obligation to continue to perform services (described in paragraph (c)(1)(ii) of this A-24) will depend on all of the facts and circumstances. In no event, however, shall such amount be less than 1 percent of the amount of the accelerated payment multiplied by the number of full months between the date that the individual's right to receive the payment is not subject to any requirement or condition which would be treated as resulting in a substantial risk of forfeiture (within the meaning of §1.83-3(c)) and the date that, absent the acceleration the individual's right to receive the payment would not have been subject to any requirement or condition which would be treated as resulting in a substantial risk of forfeiture.

(d) For purposes of this A-24, the present value of a payment is determined as of the date on which the accelerated payment is made.

(e) The following examples illustrate the principles of this A-24:

Example (1). A corporation and a disqualified individual enter into a contract providing that, if a change in the ownership or control of the corporation occurs, all of the nonforfeitable deferred compensation the individual has earned prior thereto will be paid immediately. The deferred compensation otherwise will be paid when the individual reaches age 60. A change in the ownership of the corporation occurs, and the deferred compensation is immediately paid. Since the payment would have been made in any event when the individual reached age 60, it is substantially certain, at the time of the change, that the payments would have been made whether or not the change occurred. The payment is treated as contingent on the change in ownership or control solely because the change accelerates the time at which the payments are made. Therefore, the portion of the payment treated as contingent on the change is the amount by which the amount of the accelerated payment (*i.e.*, the amount paid to the individual because of the change in ownership or control) exceeds the present value of the payment absent the acceleration (*i.e.*, the value of the deferred compensation at the time of the change in ownership or control, if the compensation had remained nonpayable until age 60).

Example (2). A corporation grants a stock appreciation right to a disqualified individual. After the stock appreciation right vests and becomes exercisable, a change in the ownership of the corporation occurs, and the individual exercises the right. Neither the granting nor the vesting of the stock appreciation right was treated as a payment in the nature of compensation. Even if the change in ownership accelerates the time at which the right is exercised, no portion of the payment received upon exercise of the right is treated as contingent on the change, since the amount of the accelerated payment does not exceed the present value of the payment absent the acceleration.

Example (3). As a result of a change in the effective control of a corporation, a disqualified individual with respect to the corporation receives payment of his vested account balance in a nonqualified individual account plan. Actual interest and other earnings on the plan assets are credited to each account as earned and before distribution. Investment of the plan assets is not restricted in such a manner as would prevent the earning of a market rate of return on the plan assets. The date on which the individual would have received his vested account balance absent the change in control is uncertain, and the rate of earnings on the plan assets is not fixed. Thus, the amount of the payment absent the acceleration is not reasonably ascertainable. Under these facts, acceleration of the payment does not significantly increase the present value of the payment absent the acceleration, and the present value of the payment absent the acceleration shall be treated as equal to the amount of the accelerated payment. Accordingly, no portion of the payment is treated as contingent on the change.

Example (4). As a result of a change in the effective control of a corporation, a disqualified individual with respect to the corporation receives payment of the individual's vested benefits under a nonqualified pension plan which the individual otherwise would have received upon retirement. The amount of the benefits is not actuarially reduced to reflect its earlier payment. The payment is treated as contingent on the change in control solely because the change accelerates the time at which the payment is made. Therefore, the portion of the payment treated as contingent on the change is the amount by which the amount of the accelerated payment exceeds the present value of the payment absent the acceleration.

Example (5). On January 15, 1986, a corporation and a disqualified individual enter into a contract providing for a cash payment of $500,000 to be made to the individual on January 15, 1991. The payment is to be forfeited by the individual if he does not remain employed by the corporation for the entire 5-year period. However, the full amount of the payment is to be made immediately upon a change in the ownership or control of the corporation during the 5-year period. On January 15, 1989, a change in the ownership of the corporation occurs and the full amount of the payment ($500,000) is made on that date to the individual. Since the payment would have been made in the absence of the change if the individual had continued to perform services for the corporation until the end of the five year period, it is substantially certain, at the time of the change, that the payment would have been made in the absence of the change if the individual had continued to perform services for the corporation for a specified period of time. Therefore, only a portion of the payment is treated as contingent on the change. The portion of the payment that is treated as contingent on the change is the amount by which the amount of the accelerated payment (*i.e.*, $500,000, the amount paid to the individual because of the change in ownership) exceeds the present value of the payment that was expected to have been made absent the acceleration (*i.e.*, $406,838, the present value on January 15, 1989, of a $500,000 payment on January 15, 1991), plus an amount reflecting the lapse of the obligation to continue to perform services. Such amount will depend on all the facts and circumstances but in no event will such amount be less than $115,000 (1% × 23 months × $500,000). Accordingly, the minimum amount of the payment treated as contingent on the change in ownership or control is $208,162 ([$500,000 -$406,838] + $115,000). This result is not changed if the individual actually remains employed until the end of the 5-year period.

Example (6). (i) On January 15, 1986, a corporation gives to a disqualified individual, in connection with his performance of services to the corporation, a bonus of 1,000 shares of the corporation's stock. Under the terms of the bonus arrangement, the individual is obligated to return the stock to the corporation if she terminates her employment for any reason prior to January 15, 1991. However, if there is a change in the ownership or effective control of the corporation prior to January 15, 1991, she ceases to be obligated to return the stock. The individual's rights in the stock are treated as substantially nonvested (within the meaning of §1.83-3(b)) during that period. On January 15, 1989, a change in the ownership of the corporation occurs. On that day, the fair market value of the stock is $500,000.

(ii) Since the stock would have become substantially vested in the individual in the absence of the change if she had continued to perform services for the corporation through January 15, 1991, it is substantially certain, at the time of the change, that the payment would have been made in the absence of the change if the individual had continued to perform services for the corporation for a specified period of time. Thus, only a portion of the payment is treated as contingent on the change in ownership or control. The portion of the payment that is treated as contingent on the change is the amount by which the amount of the accelerated payment on January 15, 1989 ($500,000), exceeds the present value of the payment that was expected to have been made on January 15, 1991, plus an amount reflecting the lapse of the obligation to continue to perform services. Assuming that, at the time of the change, it cannot be reasonably ascertained what the value of the stock would have been on January 15, 1991, the future value of such stock on January 15, 1991, is deemed to be $500,000, the amount of the accelerated payment. The present value on January 15, 1989, of a $500,000 payment to be made on January 15, 1991, is $406,838. Thus, the portion of the payment treated as contingent on the change is $93,162 ($500,000 − $406,838), plus an amount reflecting the lapse of the obligation to continue to perform services. Such amount will depend on all the facts and circumstances but in no event will such amount be less than $115,000 [1% × 23 months × $500,000].

Example (7). (i) On January 15, 1986, a corporation grants to a disqualified individual nonqualified stock options to purchase 30,000 shares of the corporation's stock. The options do not have a readily ascertainable fair market value at the time of grant. The options will be forfeited by the individual if he fails to perform personal services for the corporation until January 15, 1989. The options will, however, substantially vest in the individual at an earlier date if there is a change in ownership or control of the corporation. On January 16, 1988, a change in the ownership of the corporation occurs and the options become substantially vested in the individual. On January 16, 1988, the options have an ascertainable fair market value of $600,000.

(ii) At the time of the change, it is substantially certain that the payment of the options to purchase

30,000 shares would have been made in the absence of the change if the individual had continued to perform services for the corporation until January 15, 1989. Therefore, only a portion of the payment is treated as contingent on the change. The portion of the payment that is treated as contingent on the change is the amount by which the amount of the accelerated payment on January 16, 1988 ($600,000) exceeds the present value on January 16, 1988, of the payment that was expected to have been made on January 15, 1989, absent the acceleration, plus an amount reflecting the lapse of the obligation to continue to perform services. Assuming that, at the time of the change, it cannot be reasonably ascertained what the value of the options would have been on January 15, 1989, the value of such options on January 16, 1988, is deemed to be $600,000, the amount of the accelerated payment. The present value on January 16, 1988, of a $600,000 payment to be made on January 15, 1989, is $549,964.13. Thus, the portion of the payment treated as contingent on the change is $50,035.87 ($600,000 − $549,964.13), plus an amount reflecting the lapse of the obligation to continue to perform services. Such amount will depend on all the facts and circumstances but in no event will such amount be less than $66,000 (1% × 11 months × $600,000).

Example (8). (i) The facts are the same as in example (7), except that the options become substantially vested periodically (absent a change in ownership of control), with one-third of the options vesting on January 15, 1987, 1988, and 1989, respectively. Thus, options to purchase 20,000 shares vest independently of the January 16, 1988, change in ownership and the options to purchase the remaining 10,000 shares vest as a result of the change.

(ii) At the time of the change, it is substantially certain that the payment of the options to purchase 10,000 shares would have been made without regard to the change if the individual had continued to perform services for the corporation until January 15, 1989. Therefore, only a portion of the payment is treated as contingent on the change. The portion of the payment that is treated as contingent on the change is the amount by which the amount of the accelerated payment on January 16, 1988 ($200,000) exceeds the present value on January 16, 1988, of the payment that was expected to have been made on January 15, 1989, absent the acceleration, plus an amount reflecting the lapse of the obligation to continue to perform services. Assuming that, at the time of the change, it cannot be reasonably ascertained what the value of the options would have been on January 15, 1989, the value of such options on January 16, 1988, is deemed to be $200,000, the amount of the accelerated payment. The present value on January 16, 1988, of a $200,000 payment to be made on January 15, 1989, is $183,328.38. Thus, the portion of the payment treated as contingent on the change is $16,671.62 ($200,000 − $183,328.38), plus an amount reflecting the lapse of the obligation to continue to perform services. Such amount will depend on all the facts and circumstances but in no event will such amount be less than $22,000 (1% × 11 months × $200,000).

Example (9). Assume the same facts as in example (7), except that the option agreement provides that the options will vest either upon the corporation's level of profits reaching a specified level, or if earlier, on the date on which there is a change in ownership or control of the corporation. The corporation's level of profits do not reach the specified level prior to January 16, 1988. In such case, the full amount of the payment, $600,000, is treated as contingent on the change because it was not substantially certain, at the time of the change, that the payment would have been made in the absence of the change if the individual had continued to perform services for the corporation for a specified period of time. See Q/A-39 for rules relating to the reduction of the excess parachute payment by the portion of the payment which is established to be reasonable compensation for personal services actually rendered before the date of a change in ownership or control.

Presumption That Payment is Contingent on Change

Q-25: Is there a presumption that certain payments are contingent on a change in ownership or control?

A-25: Yes. For purposes of this section, any payment pursuant to—

(a) An agreement entered into within one year before the date of a change in ownership or control, or

(b) An amendment that modifies a previous agreement in any significant respect, if the amendment is made within one year before the date of a change in ownership or control,

is presumed to be contingent on such change unless the contrary is established by clear and convincing evidence. In the case of an amendment described in paragraph (b) of this A-25, only the portion of any payment that exceeds the amount of such payment that would have been made in the absence of the amendment is presumed, by reason of the amendment, to be contingent on the change in ownership or control.

Q-26: How may the presumption described in Q/A-25 of this section be rebutted?

A-26: (a) To rebut the presumption described in Q/A-25 of this section, the taxpayer must establish by clear and convincing evidence that the payment is not contingent on the change in ownership or control. Whether the payment is contingent on such change is determined on the basis of all the facts and circumstances of the particular case. Factors relevant to such a determination include, but are not limited to: (1) the content of the agreement or amendment; and (2) the circumstances surrounding the execution of the agreement or amendment, such as whether it was entered into at a time when a takeover attempt had commenced and the degree of likelihood that a change in ownership or control would actually occur.

(b) In the case of an agreement described in paragraph (a) of A-25 of this section, clear and convincing evidence that the agreement is one of the three following types will generally rebut the presumption that payments under the agreement are contingent on the change in ownership or control:

(1) A "nondiscriminatory employee plan or program" as defined in paragraph (c) of this A-26;

(2) A contract between a corporation and an individual that replaces a prior contract entered into by the same parties more than one year before the change in ownership or control, if the new contract does not provide for increased payments (apart from normal increases attributable to increased responsibilities or cost of living adjustments), accelerate the payment of amounts due at a future time, or modify (to the individual's benefit) the terms or conditions under which payments will be made; or

(3) A contract between a corporation and an individual who did not perform services for the corporation prior to the individual's taxable year in which the change in ownership or control occurs, if the contract does not provide for payments that are significantly different in amount, timing, terms, or conditions from those provided under contracts entered into by the corporation (other than contracts that themselves were entered into within one year before the change in ownership or control and in contemplation of the change) with individuals performing comparable services.

However, even if the presumption is rebutted with respect to an agreement, payments under the agreement still may be contingent on the change in ownership or control pursuant to Q/A-22 of this section.

(c) For purposes of this section, the term "nondiscriminatory employee plan or program" means: a group term life insurance plan that meets the requirements of section 79(d); an employee benefit plan that meets the requirements of section 89(d) and (e); a self insured medical reimbursement plan that meets the requirements of section 105(h); a qualified group legal services plan (within the meaning of section 120); a cafeteria plan (within the meaning of section 125); an educational assistance program (within the meaning of section 127); and a dependent care assistance program (within the meaning of section 129). Payments under certain other plans are exempt from the definition of "parachute payment" under Q/A-8 of this section.

(d) The following examples illustrate the application of the presumption:

Example (1). A corporation and a disqualified individual who is an employee of the corporation enter into an employment contract. The contract replaces a prior contract entered into by the same parties more than one year before the change and the new contract does not provide for any increased payments other than a cost of living adjustment, does not accelerate the payment of amounts due at a future time, and does not modify (to the individual's benefit) the terms or conditions under which payments will be made. Clear and convincing evidence of these facts rebuts the presumption described in A-25 of this section. However, payments under the contract still may be contingent on the change in ownership or control pursuant to Q/A-22 of this section.

Example (2). Assume the same facts as in example (1), except that the contract is entered into after a tender offer for the corporation's stock had commenced and it was likely that a change in ownership would occur and the contract provides for a substantial bonus payment to the individual upon his signing the contract. The individual has performed services for the corporation for many years, but previous employment contracts between the corporation and the individual did not provide for a similar signing bonus. One months after the contract is entered into, a change in the ownership of the corporation occurs. All payments under the contract are presumed to be contingent on the change in ownership even though the bonus payment would have been legally required even if no change had occurred. Clear and convincing evidence of these facts rebuts the presumption described in A-25 of this section with respect to all of the payments under the contract with the exception of the bonus payment (which is treated as contingent on the change). However, such payments under the contract still may be contingent on the change in ownership or control pursuant to Q/A-22 of this section.

Change in Ownership or Control

Q-27: When does a change in the ownership of a corporation occur?

A-27: (a) For purposes of this section, a change in the ownership or control of a corporation occurs on the date that any one person, or more than one person acting as a group, acquires ownership of stock of the corporation that, together with stock held by such person or group,possesses more than 50 percent of the total fair market value or total voting power of the stock of such corporation. However, if any one person, or more than one person acting as a group, is considered to own more than 50 percent of the total fair market value or total voting power of the stock of a corporation, the acquisition of additional stock by the same person or persons is not considered to cause a change in the ownership of the corporation (or to cause a change in the effective control of the corporation (within the meaning of Q/A-28 of this section)). An increase in the percentage of stock owned by any one person, or persons acting as a group, as a result of a transaction in which the corporation acquires its stock in exchange for property will be treated as an acquisition of stock for purposes of this section.

(b) For purposes of paragraph (a) of this A-27, persons will not be considered to be "acting as a group" merely because they happen to purchase or own stock of the same corporation at the same time, or as a result of the same public offering. However, persons will be considered to be "acting as a group" if they are owners of an entity that enters into a merger, consolidation, purchase or acquisition of stock, or similar business transaction with the corporation.

(c) For purposes of this A-27, section 318(a) shall apply in determining stock ownership.

(d) The following examples illustrate the principles of this A-27:

Example (1). Corporation M has owned stock having a fair market value equal to 19 percent of the value of the stock of Corporation N (an otherwise unrelated corporation) for many years prior to 1986. Corporation M acquires additional stock having a fair market value equal to 15 percent of the value of the stock of Corporation N on January 1, 1986, and an additional 18 percent on February 21, 1987. As of February 21, 1987, Corporation M has acquired stock having a fair market value greater than 50 percent of the value of the stock of Corporation N. Thus, a change in the ownership of Corporation N is considered to occur on February 21, 1987 (assuming that Corporation M did not have effective control of Corporation N immediately prior to the acquisition on that date).

Example (2). All of the corporation's stock is owned by the founders of the corporation. The board of directors of the corporation decides to offer shares of the corporation to the public. After the public offering, the founders of the corporation own a total of 40 percent of the corporation's stock, and members of the public own 60 percent. If no one person (or more than one person acting as a group) owns more than 50 percent of the corporation's stock (by value or voting power) after the public offering, there is no change in the ownership of the corporation.

Example (3). Corporation P merges into Corporation O (a previously unrelated corporation). In the merger, the shareholders of Corporation P receive Corporation O stock in exchange for their Corporation P stock. Immediately after the merger, the former shareholders of Corporation P own stock having a fair market value equal to 60 percent of the value of the stock of Corporation O, and the former shareholders of Corporation O own stock having a fair market value equal to 40 percent of the value of the stock of Corporation O. The former shareholders of Corporation P will be treated as "acting as a group" in their acquisition of Corporation O stock. Thus, a change in the ownership of Corporation O occurs on the date of the merger.

Example (4). A, an individual, owns stock having a fair market value equal to 20 percent of the value of the stock of Corporation Q. On January 1, 1987, Corporation Q acquires in a redemption for cash all of the stock held by shareholders other than A. Thus, A is left as the sole shareholder of Corporation Q. A change in ownership of Corporation Q is considered to occur on January 1, 1987 (assuming that A did not have effective control of Corporation Q immediately prior to the redemption).

Example (5). Assume the same facts as in example (4), except that A owns stock having a fair market value equal to 51 percent of the value of all the stock of Corporation Q immediately prior to the redemption. There is no change in the ownership of Corporation Q as a result of the redemption.

Q-28: When does a change in the effective control of a corporation occur?

A-28: (a) For purposes of this section, a change in the effective control of a corporation is presumed to occur on the date that either—

(1) Any one person, or more than one person acting as a group, acquires (or has acquired during the 12 month period ending on the date of the most recent acquisition by such person or persons) ownership of stock of the corporation possessing 20 percent or more of the total voting power of the stock of such corporation; or

(2) A majority of members of the corporation's board of directors is replaced during any 12-month period by directors whose appointment or election is not endorsed by a majority of the members of the corporation's board of directors prior to the date of the appointment or election.

This presumption may be rebutted by establishing that such acquisition or acquisitions of the corporation's stock, or such replacement of the majority of the members of the corporation's board of directors, does not transfer the power to control (directly or indirectly) the management and policies of the corporation from any one person (or more than one person acting as a group) to another person (or group). For purposes of this section, in the absence of an event described in paragraph (a)(1) or (2) of this A-28, a change in the effective control of a corporation is presumed not to have occurred.

(b) If any one person, or more than one person acting as a group, is considered to effectively control a corporation (within the meaning of this A-28), the acquisition of additional control of the corporation by the same person or persons is not considered to cause a change in the effective control of the corporation (or to cause a change in the ownership of the corporation within the meaning of Q/A-27 of this section).

(c) For purposes of this A-28, persons will not be considered to be "acting as a group" merely because they happen to purchase or own stock of the same corporation at the same time, or as a result of the same public offering. However, persons will be considered as "acting as a group" if they are owners of an entity that enters into a merger, consolidation, purchase or acquisition of stock, or similar business transaction with the corporation.

(d) Section 318(a) shall apply in determining stock ownership for purposes of this A-28.

(e) The following examples illustrate the principles of this A-28:

Example (1). Shareholder A acquired the following percentages of the voting stock of Corporation M (an otherwise unrelated corporation) on the following dates: 16 percent on January 1, 1985; 10 percent on January 10, 1986; 8 percent on February 10, 1986; 11 percent on March 1, 1987; and 8 percent on March 10, 1987. Thus, on March 10, 1987, A owns a total of 53 percent of M's voting stock. Since A did not acquire 20 percent or more of M's voting stock during any 12-month period, there is no presumption of a change in effective control pursuant to paragraph (a)(1) of this A-28. In addition, under these facts there is a presumption that no change in the effective control of Corporation M occurred. If this presumption is not rebutted (and thus no change in effective control of Corporation M is treated as occurring prior to March 10, 1987), a change in the ownership of Corporation M will be treated as having occurred on March 10, 1987 (pursuant to Q/A-27 of this section) since A had acquired more than 50 percent of Corporation M's voting stock as of that date.

Example (2). A minority group of shareholders of a corporation opposes the practices and policies of the corporation's current board of directors. A proxy contest ensues. The minority group presents its own slate of candidates for the board at the next annual meeting of the corporation's shareholders, and candidates of the minority group are elected to replace a majority of the current members of the board. A change in the effective control of the corporation is presumed to have occurred on the date the election of the new board of directors becomes effective.

Q-29: When does a change in the ownership of a substantial portion of a corporation's assets occur?

A-29: (a) For purposes of this section, a change in the ownership of a substantial portion of a corporation's assets occurs on the date that any one person, or more than one person acting as a group, acquires (or has acquired during the 12-month period ending on the date of the most recent acquisition by such person or persons) assets from the corporation that have a total fair market value equal to or more than one third of the total fair market value of all of the assets of the corporation immediately prior to such acquisition or acquisitions.

(b) A transfer of assets by a corporation is not treated as a change in the ownership of such assets if the assets are transferred to—

(1) A shareholder of the corporation (immediately before the asset transfer) in exchange for or with respect to its stock,

(2) An entity, 50 percent or more of the total value or voting power of which is owned, directly or indirectly, by the corporation,

(3) A person, or more than one person acting as a group, that owns, directly or indirectly, 50 percent or more of the total value or voting power of all the outstanding stock of the corporation, or

(4) An entity, at least 50 percent of the total value or voting power is owned, directly or indirectly, by a person described in paragraph (b)(3) of this A-29.

For purposes of this paragraph (b) (except as otherwise provided), a person's status is determined immediately after the transfer of the assets. For example, a transfer of assets pursuant to a complete liquidation of a corporation, a redemption of a shareholder's interest, or a transfer to a majority-owned subsidiary of the corporation is not treated as a change in the ownership of the assets of the transferor corporation.

(c) For purposes of this A-29, section 318(a) shall apply in determining stock ownership.

(d) The following examples illustrate the principles of this A-29:

Example (1). Corporation M acquires assets having a fair market value of $500,000 from Corporation N (an unrelated corporation) on January 1, 1986. The total fair market value of Corporation N's assets immediately prior to the acquisition was $3 million. Since the value of the assets acquired by Corporation M is less than one third of the fair market value of Corporation N's total assets immediately prior to the acquisition, the acquisition does not represent a change in the ownership of a substantial portion of Corporation N's assets.

Example (2). Assume the same facts as in example (1). Also assume that on November 1, 1986, Corporation M acquires from Corporation N additional assets having a fair market value of $700,000. Thus, Corporation M has acquired from Corporation N assets worth a total of $1.2 million during the 12-month period ending on November 1, 1986. Since $1.2 million is more than one third of the total fair market value of all of Corporation N's assets immediately prior to the earlier of these acquisitions ($3 million), a change in the ownership of a substantial portion of Corporation N's assets is considered to have occurred on November 1, 1986.

Example (3). All of the assets of Corporation P are transferred to Corporation O (an unrelated corporation). In exchange, the shareholders of Corporation P receive Corporation O stock. Immediately after the transfer, the former shareholders of Corporation P own 60 percent of the fair market value of the outstanding stock of Corporation O and the former shareholders of Corporation O own 40 percent of the fair market value of the outstanding stock of Corporation O. Because Corporation O is an entity more than 50 percent of the fair market value of the outstanding stock of which is owned by the former shareholders of Corporation P, the transfer of assets is not treated as a change in ownership of a substantial portion of the assets of Corporation P.

''Three Times Base Amount Test'' for Parachute Payments

Q-30: Are all payments that are in the nature of compensation, are made to a disqualified individual, and are contingent on a change in ownership or control, parachute payments?

A-30: (a) No. To determine whether such payments are parachute payments, they must be tested against the individual's ''base amount'' (as defined in Q/A-34 of this section). To do this, the aggregate present value of all payments in the nature of compensation that are made or to be made to (or for the benefit of) the same disqualified individual and are contingent on the change in ownership or control must be determined. If this aggregate present value equals or exceeds the amount equal to 3 times the individual's base amount, the payments are parachute payments. If this aggregate present value is less than the amount equal to 3 times the individual's base amount, no portion of the payments is a parachute payment. See Q/A-31, Q/A-32, and Q/A-33 for rules on determining present value. Parachute payments that are securities violation parachute payments are not included in the foregoing computation if they are not contingent on a change in ownership or control. See Q/A-37 for the definition and treatment of securities violation parachute payments.

(b) The following examples illustrate the principles of this A-30:

Example (1). A is a disqualified individual with respect to Corporation M. A's base amount is $100,000. Payments totalling $400,000 that are in the nature of compensation and contingent on a change in the ownership of Corporation M are made to A on the date of the change. The payments are parachute payments since they have an aggregate present value at least equal to 3 times A's base amount of $100,000 (3 × $100,000 = $300,000).

Example (2). Assume the same facts as in example (1), except that the payments contingent on the change in the ownership of Corporation M total $290,000. Since the payments do not have an aggregate present value at least equal to 3 times A's base amount, no portion of the payments is a parachute payment.

Q-31: As of what date is the present value of a payment determined?

A-31: Except as provided in this section, the present value of a payment is determined as of the date on which the change in ownership or control occurs, or, if a payment is made prior to such date, the date on which the payment is made.

Q-32: What discount rate is to be used to determine present value?

A-32: For purposes of this section, present value generally is determined by using a discount rate equal to 120 percent of the applicable Federal rate (determined under section 1274(d) and the regulations thereunder) compounded semiannually. The applicable Federal rate to be used for this purpose is the Federal rate that is in effect on the date as of which the present value is determined. See Q/As 24 and 31. However, for any payment, the corporation and the disqualified individual may elect to use the applicable Federal rate that is in effect on the date that the contract which provides for the payment is entered into, if such election is made in the contract.

Q-33: If the present value of a payment to be made in the future is contingent on an uncertain future event or condition, how is the present value of the payment determined?

A-33: (a) In certain cases, it may be necessary to apply the 3-times-base-amount test of Q/A-30 of this section or to allocate a portion of the base amount to a payment described in paragraph (a)-(1), (2), and (3) of A-2 of this section at a time when the aggregate present value of all such payments cannot be determined with certainty because the time, amount, or right to receive one or more such payments is contingent on the occurrence of an uncertain future event or condition. For example, a disqualified individual's right to receive a payment may be contingent on the involuntary termination of such individual's employment with the corporation. In such a case, a reasonable estimate of the time and amount of the future payment shall be made, and the present value of the payment will be determined on the basis of this estimate. For purposes of making this estimate, an uncertain future event or condition that may reduce the present value of a payment will be taken into account only if the possibility of the occurrence of the event or condition can be determined on the basis of generally accepted actuarial principles or can be otherwise estimated with reasonable accuracy.

(b) Whenever a payment described in paragraph (a) of this A-33 is actually made or becomes certain not to be made, the 3-times-base-amount test described in Q/A-30 of this section shall be reapplied (and the portion of the base amount allocated to previous payments shall be reallocated (if necessary) to such payments) to reflect the actual time and amount of the payment. Whenever the 3-times-base-amount test is applied (or whenever the base amount is allocated), the aggregate present value of the payments received or to be received by the disqualified individual is redetermined as of the date described in A-31 of this section, using the discount rate described in A-32 of this section. This redetermination may affect the amount of any excess parachute payment for a prior taxable year.

(c) The following examples illustrate the principles of this A-33:

Example (1). A, a disqualified individual with respect to Corporation M, has a base amount of $100,000. Under his employment agreement with Corporation M, A is entitled to receive a payment in the nature of compensation in the amount of $250,000 contingent on a change in the ownership of Corporation M. In addition, the agreement provides that if A's employment is terminated within 1 year after the change in ownership, A will receive an additional payment in the nature of compensation in the amount of $150,000, payable 1 year after the date of the change in ownership. A and Corporation M are calendar year taxpayers. A change in the ownership of Corporation M occurs and A receives the first payment of $250,000. At the time Corporation M files its income tax return for the year of the change in ownership, it reasonably estimates that there is a 50-percent probability that, as a result of the change, A's employment will be terminated within 1 year of the date of the change. For purposes of applying the 3-times-base-amount test (and if the first payment is determined to be a parachute payment, for purposes of allocating a portion of A's base amount to that payment), Corporation M shall assume that an additional payment of $75,000 (.5 × $150,000) will be made to A as a result of the change in ownership. The present value of the additional payment is determined under Q/A-31 and Q/A-32 of this section.

Example (2). B, a disqualified individual with respect to Corporation N, has a base amount of $100,000. Under her employment agreement with Corporation N, B is entitled to receive payments in the nature of compensation in the amount of $20,000 per month for a period of 24 months if B terminates employment with Corporation N as a result of a change in ownership of Corporation N. Such monthly payments are to be reduced by the amount of any compensation earned by B from unrelated employers during the 24-month period. B and Corporation N are calendar year taxpayers. On June 1, 1988, there is a change in the ownership of Corporation N. As a result of the change, B voluntarily terminates employment with Corporation N and begins to receive monthly payments under the agreement. Assume that the present value, determined as of June 1, 1988, of a stream of 24-monthly payments of $20,000, is $438,134. At the time Corporation N files its income tax return for 1988, it cannot be determined with reasonable accuracy whether B will earn any compensation from unrelated employers during the 24-month period. Accordingly, the present value of the payments to be received by B ($438,134) exceeds 3 times B's base amount ($300,000) and a portion of each of the 1988 payments will be treated as an excess parachute payment for the 1988 taxable year.

Example (3). Assume the same facts as in example (2), except that in April 1989 B becomes employed by an employer unrelated to Corporation N. At the time Corporation N files its income tax return for 1989, it has become certain that, due to the compensation earned by B from unrelated employers, the present value, determined as of June 1, 1988, of the stream of payments from Corporation N will not exceed $192,060. Because it has been redetermined that the present value of the payments received or to be received by B does not equal or exceed 3 times B's base amount, no portion of the payments made in 1988 or 1989 will be treated as excess parachute payments.

Q-34: What is the "base amount"?

A-34: (a) The base amount of a disqualified individual is the average annual compensation (as defined in Q/A-21 of this section) which was includible in the gross income of such individual for taxable years in the "base period" (or either was excludible from such gross income as "foreign earned income" within the meaning of section 911, or would have been includible in such gross income if such person had been a United States citizen or resident.) See Q/A-35 for the definition of "base period" and for examples of base amount computations.

(b) If the base period of a disqualified individual includes a short taxable year or less than all of a taxable year, compensation for such short or incomplete taxable year must be annualized before determining the average annual compensation for the base period. In annualizing compensation, the frequency with which payments are expected to be made over an annual period must be taken into account. Thus, any amount of compensation for such a short or incomplete taxable year that represents a payment that will not be made more often than once per year is not annualized.

(c) Because the base amount includes only compensation that is includible in gross income, the base amount does not include certain items that constitute parachute payments. For example, payments in the form of untaxed fringe benefits are not included in the base amount but may be treated as parachute payments.

Q-35: What is the "base period"?

A-35: (a) The "base period" of a disqualified individual is the most recent 5 taxable years of the individual ending before the date of the change in ownership or control. However, if the disqualified individual was not an employee or independent contractor of the corporation with respect to which the change in ownership or control occurs (or a predecessor entity or a related entity as defined in A-21 of this section) for this entire 5-year period, the individual's base period is the portion of such 5-year period during which the individual performed personal services for the corporation or predecessor entity or related entity.

(b) The following examples illustrate the principles of Q/A-34 of this section and this Q/A-35:

Example (1). A disqualified individual was employed by a corporation for 2 years and 4 months preceding his taxable year in which a change in ownership or control of the corporation occurs. The individual's includible compensation income from the corporation was $30,000 for the 4-month period, $120,000 for the first full year, and $150,000 for the second full year. The individual's base amount is

$$\$120,000 \left[\frac{(3 \times \$30,000) + \$120,000 + \$150,000}{3}\right].$$

Example (2). Assume the same facts as in example (1), except that the individual also received a $60,000 "sign-up" bonus when his employment with the corporation commenced at the beginning of the 4-month period. The individual's base amount is $140,000

$$\left[\frac{[\$60,000 + (3 \times \$30,000)) + \$120,000 + \$150,000]}{3}\right].$$

Since the bonus will not be paid more often than once per year, the amount of the bonus is not increased in annualizing the individual's compensation for the 4-month period.

Q-36: How is the base amount determined in the case of a disqualified individual who did not perform services for the corporation (or a predecessor entity or a related entity as defined in A-21 of this section), prior to the individual's taxable year in which the change in ownership or control occurs?

A-36: (a) In such a case, the individual's base amount is the annualized compensation (as defined in Q/A-21 of this section) which—

(1) Was includible in the individual's gross income for that portion, prior to such change, of the individual's taxable year in which the change occurred (or either was excludible from such gross income as "foreign earned income" within the meaning of section 911, or would have includible in such gross income if such person had been a United States citizen or resident),

(2) Was not contingent on the change in ownership or control, and

(3) Was not a securities violation parachute payment.

(b) The following examples illustrate the principles of this A-36:

Example (1). On January 1, 1986, A, an individual whose taxable year is the calendar year, enters into a 4-year employment contract with Corporation M as an officer of the corporation. A has not previously performed services for Corporation M (or any predecessor entity or related entity as defined in A-21 of this section). Under the employment contract, A is to receive an annual salary of $120,000 for each of the 4 years that he remains employed by Corporation M with any remaining unpaid balance to be paid immediately in the event that A's employment is terminated without cause. On July 1, 1986, after A has received compensation of $60,000, a change in the ownership of Corporation M occurs. Because of the change, A's employment is terminated without cause, and he receives a payment of $420,000. It is established by clear and convincing evidence that the $60,000 in compensation is not contingent on the change in ownership or control, but the presumption of Q/A-25 of this section is not rebutted with respect to the $420,000 payment. Thus, the payment of $420,000 is treated as contingent on the change in ownership of Corporation M. In this case, A's base amount is $120,000 (2 × $60,000). Since the present value of the payment which is contingent on the change in ownership of Corporation M ($420,000) is more than 3 times A's base amount of $120,000 (3 × $120,000 = $360,000), the payment is a parachute payment.

Example (2). Assume the same facts as in example (1), except that A also receives a "sign-up" bonus of $50,000 from Corporation M on January 1, 1986. It is established by clear and convincing evidence that the bonus is not contingent on the change in ownership. When the change in ownership occurs on July 1, 1986, A has received compensation of $110,000 (the $50,000 bonus plus $60,000 in salary). In this case, A's base amount is $170,000 [$50,000 + (2 × $60,000)]. Since the $50,000 bonus will not be paid more than once per year, the amount of the bonus is not increased in annualizing A's compensation. The present value of the potential parachute payment ($420,000) is less than 3 times A's base amount of $170,000 (3 × $170,000 = $510,000), and therefore no portion of the payment is a parachute payment.

Securities Violation Parachute Payments

Q-37: Must a payment be contingent on a change in ownership or control in order to be a parachute payment?

A-37: (a) No. The term "parachute payment" also includes any payment (other than a payment exempted under Q/A-6 or Q/A-8 of this section) that is in the nature of compensation and is to (or for the benefit of) a disqualified individual, if such payment is made or to be made—

(1) Pursuant to an agreement that violates any generally enforced Federal or State securities laws or regulations, and

(2) In connection with a potential or actual change in ownership or control. A violation is not taken into account under paragraph (a)(1) of this A-37 if it is merely technical in character or is not materially prejudicial to shareholders or potential shareholders. Moreover, a violation will be presumed not to exist unless the existence of the violation has been determined or admitted in a civil or criminal action (or an administrative action by a regulatory body charged with enforcing the particular securities law or regulation) which has been resolved by adjudication or consent. Parachute payments described in this A-37 are referred to in this section as "securities violation parachute payments."

(b) Securities violation parachute payments that are not contingent on a change in ownership or control within the meaning of Q/A-22 of this section are not taken into account in applying the 3-times-base-amount test of Q/A-30 of this section. Such payments are considered parachute payments regardless of whether such test is met with respect to the disqualified individual. Moreover, the amount of a securities violation parachute payment treated as an excess parachute payment shall not be reduced by the portion of such payment that is reasonable compensation for personal services actually rendered before the date of a change in ownership or control if such payment is not contingent on such change. Likewise, the amount of a securities violation parachute payment shall include the portion of such payment that is reasonable compensation for personal services to be rendered on or after the date of a change in ownership or control if such payment is not contingent on such change.

(c) The rules in paragraph (b) of this A-37 also apply to securities violation parachute payments that are contingent on a change in ownership or control if the application of these rules results in greater total excess parachute payments with respect to the disqualified individual than would result if the payments were treated simply as payments contingent on a change in ownership or control (and hence were taken into account in applying the 3-times-base-amount test and were reduced by, or did not include, any applicable amount of reasonable compensation).

(d) The following examples illustrate the principles of this A-37:

Example (1). A, a disqualified individual with respect to Corporation M, receives two payments in the nature of compensation that are contingent on a change in the ownership or control of Corporation M. The present value of the first payment is equal to A's base amount and is not a securities violation parachute payment. The present value of the second payment is equal to 1.5 times A's base amount and is a securities violation parachute payment. Neither payment includes any reasonable compensation. If the second payment is treated simply as a payment contingent on a change in ownership or control, the amount of A's total excess parachute payments is zero because the aggregate present value of the payments does not equal or exceed 3 times A's base amount. If the second payment is treated as a securities violation parachute payment subject to the rules of paragraph (b) of this A-37, the amount of A's total excess parachute payments is 0.5 times A's base amount. Thus, the second payment is treated as a securities violation parachute payment.

Example (2). Assume the same facts as in example (1), except that the present value of the first payment is equal to 2 times A's base amount. If the second payment is treated simply as a payment contingent on a change in ownership or control, the total present value of the payments is 3.5 times A's base amount, and the amount of A's total excess parachute payments is 2.5 times A's base amount. If the second payment is treated as a securities violation parachute payment, the amount of A's total excess parachute payments is 0.5 times A's base amount. Thus, the second payment is treated simply as a payment contingent on a change in ownership or control.

Example (3). B, a disqualified individual with respect to Corporation N, receives two payments in the nature of compensation that are contingent on a change in the control of Corporation N. The present value of the first payment is equal to 4 times B's base amount and is a securities violation parachute payment. The present value of the second payment is equal to 2 times B's base amount and is not a securities violation parachute payment. B establishes by clear and convincing evidence that the entire amount of the first payment is reasonable compensation for personal services to be rendered after the change in control. If the first payment is treated simply as a payment contingent on a change in ownership or control, it is exempt from the definition of "parachute payment" pursuant to Q/A-9 of this section. Thus, the amount of B's total excess parachute payment is zero because the present value of the second payment does not equal or exceed three times B's base amount. However, if the first payment is treated as a securities violation parachute payment, the amount of B's total excess parachute payments is 3 times B's base amount. Thus, the first payment is treated as a securities violation parachute payment.

Example (4). Assume the same facts as in example (3), except that B does not receive the second payment and B establishes by clear and convincing evidence that the first payment is reasonable compensation for services actually rendered before the change in the control of Corporation N. If the payment is treated simply as a payment contingent on a change in ownership or control, the amount of B's excess parachute payment is zero because the amount treated as an excess parachute payment is reduced by the amount that B establishes as reasonable compensation. However, if the payment is treated as a securities violation parachute payment, the amount of B's excess parachute payment is 3 times B's base amount. Thus, the payment is treated as a securities violation parachute payment.

Computation and Reduction of Excess Parachute Payments

Q-38: How is the amount of an excess parachute payment computed?

A-38: (a) The amount of an excess parachute payment is the excess of the amount of any parachute payment over the portion of the disqualified individual's base amount that is allocated to such payment. For this purpose, the portion of the base amount allocated to any parachute payment is the amount that bears the same ratio to the base amount as the present value of such parachute payment bears to the aggregate present value of all parachute payments made or to be made to (or for the benefit of) the same disqualified individual. Thus, the portion of the base amount allocated to any parachute payment is determined by multiplying the base amount by a fraction, the numerator of which is the present value of such parachute payment and the denominator of which is the aggregate present value of all such payments. See Q/A-31, Q/A-32, and Q/A-33 for rules on determining present value and Q/A-34 for the definition of "base amount".

(b) *Example.* An individual with a base amount of $100,000 is entitled to receive two parachute payments, one of $200,000 and the other of $400,000. The $200,000 payment is made at the time of the change in ownership or control, and the $400,000 payment is to be made at a future date. The present value of the $400,000 payment is $300,000 on the date of the change in ownership or control. The portions of the base amount allocated to these payments are $40,000 ([$200,000/$500,000] × $100,000) and $60,000 ([$300,000/$500,000] × $100,000), respectively. Thus, the amount of the first excess parachute payment is $160,000 ($200,000 − $40,000) and that of the second is $340,000 ($400,000 − $60,000).

Q-39: May the amount of an excess parachute payment be reduced by reasonable compensation for personal services actually rendered before the change in ownership or control?

A-39: (a) Generally, yes. Except in the case of payments treated as securities violation parachute payments, the amount of an excess parachute payment is reduced by any portion of the payment that the taxpayer establishes by clear and convincing evidence is reasonable compensation for personal services actually rendered by the disqualified individual before the date of the change in ownership or control. Services reasonably compensated for by payments that are not parachute payments (either because the payments are not contingent on a change in ownership or control and are not securities violation parachute payments, or because the payments are made pursuant to a contract entered into before June 15, 1984, which has not been renewed, or amended or supplemented in significant relevant respect after June 14, 1984) are not taken into account for this purpose. The portion of any parachute payment that is established as reasonable compensation is first reduced by the portion of the disqualified individual's base amount that is allocated to such parachute payment; any remaining portion of the parachute payment established as reasonable compensation then reduces the excess parachute payment.

(b) Reasonable compensation for personal services to be rendered by the disqualified individual on or after the date of the change in ownership or control is exempt from the definition of "parachute payment" pursuant to Q/A-9 of this section. For rules on determining amounts of reasonable compensation, see Q/A-40 through Q/A-43.

(c) The following examples illustrate the principles of this A-39:

Example (1). Assume that a parachute payment of $600,000 is made to a disqualified individual, and the portion of the individual's base amount that is allocated to the parachute payment is $100,000. Also assume that $300,000 of the $600,000 parachute payment is established as reasonable compensation for personal services actually rendered by the disqualified individual before the date of the change in ownership or control. Before the reasonable compensation is taken into account, the amount of the excess parachute payment is $500,000 ($600,000 − $100,000). In reducing the excess parachute payment by reasonable compensation, the portion of the parachute payment that is established as reasonable compensation ($300,000) is first reduced by the portion of the disqualified individual's base amount that is allocated to the parachute payment ($100,000), and the remainder ($200,000) then reduces the excess parachute payment. Thus, in this case, the excess parachute payment of $500,000 is reduced by $200,000 of reasonable compensation.

Example (2). Assume the same facts as in example (1), except that the full amount of the $600,000 parachute payment is established as reasonable compensation. In this case, the excess parachute payment of $500,000 is reduced to zero by $500,000 of reasonable compensation. As a result, no portion of any deduction for the payment is disallowed by section 280G, and no portion of the payment is subject to the 20-percent excise tax of section 4999.

Determination of Reasonable Compensation

Q-40: How is it determined whether payments are reasonable compensation?

A-40: In general, whether payments are reasonable compensation for personal services actually rendered, or to be rendered, by the disqualified individual is determined on the basis of all the facts and circumstances of the particular case. Factors relevant to such a determination include, but are not limited to, the following:

(a) The nature of the services rendered or to be rendered;

(b) The individual's historic compensation for performing such services; and

(c) The compensation of individuals performing comparable services in situations where the compensation is not contingent on a change in ownership or control.

Q-41: Is any particular type of evidence generally considered clear and convincing evidence of reasonable compensation for personal services?

A-41: Yes. A showing that payments are made under a nondiscriminatory employee plan or program (as defined in

Q/A-26 of this section) generally is considered to be clear and convincing evidence that the payments are reasonable compensation. This is true whether the personal services for which the payments are made are actually rendered before, or to be rendered on or after, the date of the change in ownership or control. Q/A-46 of this section (relating to the treatment of an affiliated group as one corporation) does not apply for purposes of this A-41. No determination of reasonable compensation is needed in order for payments under qualified plans to be exempt from the definition of "parachute payment" under Q/A-8 of this section.

Q-42: Is any particular type of evidence generally considered clear and convincing evidence of reasonable compensation for personal services to be rendered on or after the date of a change in ownership or control?

A-42: (a) Yes. If payments are made or to be made to (or on behalf of) a disqualified individual for personal services to be rendered on or after the date of a change in ownership or control, a showing that—

(1) The payments were made or are to be made only for the period the individual actually performs such personal services, and

(2) The individual's annual compensation for such services is not significantly greater than such individual's annual compensation prior to the change in ownership or control, apart from normal increase attributable to increased responsibilities or cost of living adjustments (or is not significantly greater than the annual compensation customarily paid by the employer or by comparable employers to persons performing comparable services),

generally is considered to be clear and convincing evidence that the payments are reasonable compensation for services to be rendered on or after the date of change in ownership or control. However, except as provided in paragraph (b) of this A-42, such clear and convincing evidence will not exist if the individual does not, in fact, perform the services.

(b) If the employment of a disqualified individual is involuntarily terminated before the end of a contract term and the individual is paid damages for the breach of the contract, a showing of the following factors generally is considered clear and convincing evidence that the payment is reasonable compensation for personal services to be rendered on or after the date of change in ownership or control:

(1) The contract was not entered into, amended, or renewed in contemplation of the change in ownership or control;

(2) The compensation the individual would have received under the contract would qualify as reasonable compensation under section 162;

(3) The damages do not exceed the present value (determined as of the date of receipt) of the compensation the individual would have received under the contract if the individual had continued to perform services for the employer until the end of the contract term;

(4) The damages are received because an offer to provide personal services was made by the disqualified individual but was rejected by the employer; and

(5) The damages are reduced by mitigation. Mitigation will be treated as occurring when such damages are reduced (or any payment of such damages is returned) to the extent of the disqualified individual's earned income (within the meaning of section 911(d)(2)(A)) during the remainder of the period in which the contract would have been in effect. See Q/A-44 for rules regarding damages for a failure to make severance payments.

(c) The following examples illustrate the principles of this A-42:

Example (1). A, a disqualified individual, has a three-year employment contract with Corporation M, a publicly traded corporation. Under this contract, A is to receive a salary for $100,000 for the first year of the contract and, for each succeeding year, an annual salary that is 10 percent higher than his prior year's salary. During the third year of the contract, Corporation N acquires all the stock of Corporation M. Prior to the change in ownership, Corporation N arranges to retain A's services by entering into an employment contract with him that is essentially the same as A's contract with Corporation M. Under the new contract, Corporation N is to fulfill Corporation M's obligations for the third year of the old contract, and, for each of the succeeding years, pay A an annual salary that is 10 percent higher than his prior year's salary. Amounts are payable under the new contract only for the portion of the contract term during which A remains employed by Corporation N. A showing of the facts described above (and in the absence of contradictory evidence) is regarded as clear and convincing evidence that all payments under the new contract are reasonable compensation for personal services to be rendered on or after the date of the change in ownership. Therefore, the payments under this agreement are exempt from the definition of "parachute payment" pursuant to Q/A-9 of this section.

Example (2). Assume the same facts as in example (1), except that the employment contract with Corporation N does not provide that amounts are payable under the contract only for the portion of the term for which A remains employed by Corporation N. Shortly after the change in ownership, and despite A's request to remain employed by Corporation N, A's employment with Corporation N is involuntarily terminated. Shortly thereafter, A obtains employment with Corporation O. A commences a civil action against Corporation N, alleging breach of the employment contract. In settlement of the litigation, A receives an amount equal to the present value of the compensation A would have received under the contract with Corporation N, reduced by the amount of compensation A otherwise receives from Corporation O during the period that the contract would have been in effect. A showing of the facts described above (and in the absence of contradictory evidence) is regarded as clear and convincing evidence that the amount A receives as damages is reasonable compensation for personal services to be rendered on or after the date of the change in ownership. Therefore, the amount received by A is exempt from the definition of "parachute payment" pursuant to Q/A-9 of this section.

Q-43: Is any particular type of payment generally considered reasonable compensation for personal services actually rendered before the date of a change in ownership or control?

A-43: (a) Yes. Payments of compensation earned before the date of a change in ownership or control generally are considered reasonable compensation for personal services actually rendered before the date of a change in ownership or control if they qualify as reasonable compensation under section 162.

Q-44: May severance payments be treated as reasonable compensation?

A-44: No. Severance payments are not treated as reasonable compensation for personal services actually rendered before, or to rendered on or after, the date of a change in ownership or control. Moreover, any damages paid for a failure to make severance payments are not treated as reasonable compensation for personal services actually rendered before, or to be rendered on or after, the date of such change. For purposes of this section, the term "severance payment" means any payment that is made to (or for the benefit of) a disqualified individual on account of the termination of such individual's employment prior to the end of a contract term, but shall not include any payment that otherwise would be made to (or for the benefit of) such individual upon the termination of such individual's employment, whenever occurring.

Miscellaneous Rules

Q-45: How is the term "corporation" defined?

A-45: For purposes of this section, the term "corporation" has the meaning prescribed by section 7701(a)(3) and shall include a publicly traded partnership treated as a corporation under section 7704(a).

Q-46: How is an affiliated group treated?

A-46: For purposes of this section, and except as otherwise provided in this section, all members of the same affiliated group (as defined in section 1504, determined without regard to section 1504(b)) are treated as one corporation. Rules affected by this treatment of an affiliated group include (but are not limited to) rules relating to exempt payments of certain corporations (Q/A-6, Q/A-7 (except as provided therein)), payor of parachute payments (Q/A-10), disqualified individuals (Q/A-15 through Q/A-21 (except as provided therein)), rebuttal of the presumption that payments are contingent on a change (Q/A-26 except as provide therein), change in ownership or control (Q/A-27, 28, 29), and reasonable compensation (Q/A-42, Q/A-43, and 44).

Effective Date

Q-47: What is the general effective date of section 280G and this section?

A-47: In general, section 280G and this section apply to payments under agreements entered into or renewed after June 14, 1984. Any agreement that is entered into before June 15, 1984, and is renewed after June 14, 1984, is to be treated as a new contract entered into on the day the renewal takes effect. (See Q/A-48 regarding application of section 280G and this section with respect to contracts entered into on or before June 14, 1984, and amended or supplemented after that date.)

Q-48: How is a contract that is cancellable at will treated for purposes of the effective date of section 280G and this section?

A-48: (a) For this purpose, a contract that is terminable or cancellable unconditionally at will by either party to the contract without the consent of the other, or by both parties to the contract, is treated as a new contract entered into on the date any such termination or cancellation, if made, would be effective. However, a contract is not treated as so terminable or cancellable if it can be terminated or cancelled only by terminating the employment relationship or independent contractor relationship of the disqualified individual.

(b) The following examples illustrate the principles of this A-48:

Example (1). Before June 15, 1984, a corporation and a disqualified individual enter into a contract providing for payments to the individual contingent on a change in the ownership or control of the corporation. The corporation may cancel the contract unconditionally at will by giving 3 months notice. Thus, the earliest date that any such cancellation after June 14, 1984, could be effective is September 15, 1984. The contract is treated as a new contract entered into on September 15, 1984, whether or not it is in fact cancelled. Therefore, section 280G and this section apply to all payments made or to be made under the contract in taxable years of the individual that end on or after September 15, 1984.

Example (2). On January 1, 1984, a corporation and a disqualified individual enter into a contract providing for payments to the individual contingent on a change in the ownership or control of the corporation. The corporation has a right to terminate the employment of the individual with or without cause, and the individual has the right to cease working for the corporation; otherwise, the contract is not terminable by either party. Since the contract is terminable only by terminating the employment relationship between the parties, it is not treated as terminable at will. Thus, since the contract was entered into on or before June 14, 1984, no payments under the contract are subject to section 280G or this section.

Q-49: Do section 280G and this section apply to payments under some agreements entered into on or before June 14, 1984, that are not renewed after this date?

A-49: Yes. Section 280G and this section apply to payments under a contract entered into on or before June 14, 1984, if the contract is amended or supplemented after June 14, 1984, in significant relevant respect. For this purpose, a "supplement" to a contract is defined as a new contract entered into after June 14, 1984, that affects the trigger, amount, or time of receipt of a payment under an existing contract.

Q-50: Under what circumstances is a contract considered to be amended or supplemented in significant relevant respect?

A-50: Except as otherwise provided in Q/A-51 of this section, a contract is considered to be amended or supplemented in significant relevant respect if provisions for payments contingent on a change in ownership or control ("parachute provisions"), or provisions in the nature of parachute provisions, are added to the contract, or are amended or supplemented to provide significant additional benefits to the disqualified individual. Thus, for example, a contract generally is treated as amended or supplemented in significant relevant respect if it is amended or supplemented:

(a) To add or modify, to the disqualified individual's benefit, a change in ownership or control trigger;

(b) To increase amounts payable that are contingent on a change in ownership or control (or, where payment is to be made under a formula, to modify the formula to the disqualified individual's advantage); or

(c) To accelerate, in the event of a change in ownership or control, the payment of amounts otherwise payable at a later date.

For purposes of this A-50, a payment will not be treated as being accelerated in the event of a change in ownership or control if the acceleration does not increase the present value of the payment.

Q-51: Will normal adjustments in an employment contract cause the contract to be treated as amended or supplemented in significant relevant respect?

A-51: No. A contract entered into on or before June 14, 1984, will not be treated as amended or supplemented in significant relevant respect merely by reason of normal adjustments in the terms of employment relationship or independent contractor relationship of the disqualified individual. Whether an adjustment in the terms of such a relationship is considered normal for this purpose depends on all of the facts and circumstances of the particular case. Relevant factors include, but are not limited to, the following: (a) the length of time between the adjustment and the change in ownership or control; (b) the extent to which the corporation, at the time of the adjustment, viewed itself as a likely takeover candidate; (c) a comparison of the adjustment with historical practices of the corporation; (d) the extent of overlap between the group receiving the benefits of the adjustment and those members of that group who are the beneficiaries of pre-June 15, 1984, parachute contracts; and (e) the size of the adjustment, both in absolute terms and in comparison with the benefits provided to other members of the group receiving the benefits of the adjustment.

Q-52: What are some examples illustrating the principles of Q/A-49, Q/A-50, and Q/A-51 of this section?

A-52: The following examples illustrate these principles:

Example (1). Corporation M grants a nonqualified stock option to a disqualified individual before June 15, 1984. After June 14, 1984, at a time when the option is currently vested and exercisable by the individual regardless of whether a change in ownership or control occurs, Corporation M amends the option to permit the individual to surrender it for cash or other property equal to the fair market value of the stock that would have been received if the option had been exercised (minus the exercise price of the option). Since the individual could have exercised the option and then sold the stock received upon the exercise, the amendment does not provide significant additional benefits to the individual. Hence, the amendment does not cause payments under the option to become subject to section 280G and this section.

Example (2). Corporation N and A, a disqualified individual, enter into an employment contract before June 15, 1984, that provides for a payment, contingent on a change in the ownership or control of Corporation N, equal to 4 times A's base amount. After June 14, 1984, and at a time when Corporation N did not view itself as a likely takeover candidate, Corporation N increases A's annual compensation by 25 percent to reflect additional managerial responsibilities. Such increase is consistent with the historical practices of Corporation N. Although the amount payable to A contingent on a change in ownership is increased, the employment contract is not treated as amended in significant relevant respect because, under these facts (and in the absence of contrary evidence), the amendment to the contract is treated as a normal adjustment in the terms of the employment relationship.

Example (3). Before June 15, 1984, Corporation O enters into contracts with disqualified individuals A, B, and C, providing for payments contingent on a change in the ownership of Corporation O equal to 4 times each individual's base amount. After June 14, 1984, Corporation O, consistent with its historical practices, grants identical nonvested stock options to numerous disqualified individuals, including A, B, and C. All of these new options provide that the vesting of all such options will be accelerated if a change in the ownership or control of Corporation O occurs. Section 280G and this section apply to payments under the options granted after June 14, 1984. However, the granting of these options does not cause the contracts that were entered into before June 15, 1984, to be treated as amended or supplemented in significant relevant respect because, under these facts (and in the absence of contrary evidence), the granting of options is treated as a normal adjustment in the terms of the employment relationship.

Lawrence B. Gibbs,
Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on May 4, 1989, 8:45 a.m., and published in the issue of the Federal Register for May 5, 1989, 54 F.R. 19390 as corrected by 54 F.R. 25879 and further corrected by 54 F.R. 29061)

Notice of Proposed Rulemaking

Treatment of Partnership Liabilities; Allocations Attributable to Nonrecourse Liabilities

PS-229-84

AGENCY: Internal Revenue Service, Treasury.

ACTION: Notice of proposed rulemaking by cross-reference to temporary regulations.

SUMMARY: In *** [T.D. 8237, page 180, this Bulletin], the Internal Revenue Service is issuing final and temporary regulations concerning the treatment of partnership liabilities and the allocation of deductions attributable to nonrecourse debt. The temporary regulations reflect changes to the applicable tax law made by section 79 of the Tax Reform Act of 1984. The text of the temporary regulations also serves as the comment document for this notice of proposed rulemaking.

DATES: Written comments and requests for a public hearing must be delivered or mailed by March 30, 1989.

ADDRESS: Send comments and requests for a public hearing to: Internal Revenue Service, Attn: CC:CORP:T:R (PS-229-84), Room 4429, Washington, D.C. 20224.

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 1980 (44 U.S.C. 3504(h)). Comments on the collections of information should be sent to the Office of Management and Budget, Paperwork Reduction Project, Washington, D.C. 20503, with copies to the Internal Revenue Service, Attn: IRS Reports Clearance Officer TR:FP, Washington, D.C. 20224.

The collections of information in this regulation are in §§1.752-4T(c) and 1.704-1T(b)(4)(iv)(*m*)(2). This information is required by the Internal Revenue Service to administer sections 752 and 704(b). The respondents are partnerships who wish to make the elections under §§1.752-4T(c) and 1.704-1T(b)(4)(iv)-(*m*)(2).

These estimates are an approximation of the average time expected to be necessary for a collection of information. They are based on such information as is available to the Internal Revenue Service. Individual respondents may require greater or less time, depending on their particular circumstances.

Estimated total annual reporting burden: 417 hrs.

The estimated annual burden per respondent varies from 3 minutes to 8 minutes, depending on individual circumstances, with an estimated average of 5 minutes.

Estimated number of respondents: 5,000

Estimated annual frequency of responses: 1

Background

The temporary regulations in [T.D. 8237, page 180, this Bulletin] amend the Income Tax Regulations (26 CFR Part 1) under sections 752 and 704(b) of the Internal Revenue Code of 1986.

For the text of the temporary regulations, see T.D. 8237 [page 180] ***. The preamble to the temporary regulations explains the amendments to the regulations.

Special Analyses

These rules are not major rules as defined in Executive Order 12291. Therefore, a Regulatory Impact Analysis is not required. A general notice of proposed rulemaking is not required by 5 U.S.C. §553 for interpretative regulations. Therefore, these rules do not constitute regulations subject to the Regulatory Flexibility Act (5 U.S.C. Chapter 6) and a Regulatory Flexibility Analysis is not required.

Comments and Request for a Public Hearing

Before adopting these proposed regulations, consideration will be given to any written comments that are submitted (preferably a signed original) to the Internal Revenue Service. All comments will be available for public inspection and copying in their entirety. A public hearing will be scheduled and held upon written request by any person who submits written comments on the proposed rules. Notice of the time and place for the hearing will be published in the Federal Register.

Lawrence B. Gibbs,
Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on December 29, 1988, 8:45 a.m., and published in the issue of the Federal Register for December 30, 1988, 53 F.R. 53174)

Notice of Proposed Rulemaking

Limitations on Passive Activity Losses and Credits— Definition of Activity

PS-001-89

AGENCY: Internal Revenue Service, Treasury.

ACTION: Notice of proposed rulemaking by cross-reference to temporary regulations.

SUMMARY: In * * * [T.D. 8253, page 121, this Bulletin], the Internal Revenue Service is issuing temporary regulations relating to the definition of "activity" for purposes of applying the limitations on passive activity losses and passive activity credits. The text of those temporary regulations also serves as the comment document for this notice of proposed rulemaking.

DATES: These regulations are proposed to be effective for taxable years beginning after December 31, 1986. Comments and requests for a public hearing must be delivered or mailed by August 31, 1989.

ADDRESS: Send comments and requests for a public hearing to: Internal Revenue Service, 1111 Constitution Avenue, N.W., Room 4429, Washington, D.C. 20224 (Attn: CC:CORP:T:R (PS-001-89)).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

This notice of proposed rulemaking contains requirements for collecting information, which have been submitted to the Office of Management and Budget for review under the Paperwork Reduction Act of 1980 (44 U.S.C. 3504 (h)). Comments on the requirements should be sent to the Office of Management Budget, Paperwork Reduction Project, Washington, D.C. 20503, with copies to the Internal Revenue Service, Attn: IRS Reports Clearance Officer TR:FP, Washington, D.C. 20224.

The collections of information in this regulation are in §1.469-4T(k) and (o). The Internal Revenue Service requires this information to identify certain undertakings that taxpayers elect to treat as separate activities and to ascertain that taxpayers have made proper, timely elections. This information will be used to verify that taxpayers have accounted for their interests in the separate activities as section 469 requires The likely respondents are individuals, farms, and businesses.

These estimates are an approximation of the average time expected to be necessary for a collection of information. They are based on such information as is available to the Internal Revenue Service. Individual respondents may require more or less time, depending on their circumstances.

The estimated figures below represent only the estimated time for the physical preparation of any writing requirement that may be imposed by §1.469-4T(k) or (o). They do not represent an estimation of the actual time for making the decisions, judgments, computations, and studies that may be necessary to satisfy the requirements of section 469 or to determine whether an election should be made.

Estimated total annual reporting burden: 3,000 hours.

Estimated annual burden per respondent for making a written election varies from 5 minutes to 15 minutes, depending on individual circumstances, with an estimated average of 6 minutes.

Estimated number of respondents: 30,000.

Estimated annual frequency of responses: once (for each of two possible elections).

Submission to Small Business Administration

Pursuant to section 7805(f) of the Code, the rules proposed in this document will be submitted to the Administrator of the Small Business Administration for comment on their impact on small business.

Background

The temporary regulations in * * * [T.D. 8253, page 121, this Bulletin] add rules under §1.469-4T to Title 26 of the Code of Federal Regulations. Section 1.469-4T defines the term "activity" for purposes of applying the limitations on passive activity losses and passive activity credits. The temporary regulations also amend certain provisions of previously issued temporary regulations under section 469 (53 FR 5686, February 25, 1988 (T.D. 8175)[1988-1 C.B. 191]).

The temporary regulations reflect the amendment of the Internal Revenue Code by sections 501 and 502 of the Tax Reform Act of 1986 (Pub. L. 99-514) [1986-3 C.B. (Vol. 1) 1, 150, 158], section 10212 of the Revenue Act of 1987 (Pub. L. 100-203), and sections 1005(a) and 2004(g) of the Technical and Miscellaneous Revenue Act of 1988 (Pub. L. 100-647). This document proposes to adopt the temporary regulations as final regulations. Accordingly, the text of the temporary regulations serves as the comment document for this notice of proposed rulemaking. In addition, the preamble to the temporary regulations explains the proposed and temporary rules.

For the text of the temporary regulations, see T.D. 8253, [page 121, this Bulletin].

Special Analyses

These proposed rules are not major rules as defined in Executive Order 12291. Therefore, a Regulatory Impact Analysis is not required.

Comments and Requests for a Public Hearing

Before these proposed regulations are adopted, consideration will be given to any written comments that are submitted (preferably a signed original and seven copies) to the Internal Revenue Service. All comments will be available for public inspection and copying. A public hearing will be scheduled and held upon written request by any person who submits written comments on the proposed rules. Notice of the time and place for the hearing will be published in the Federal Register.

List of Subjects

26 CFR 1.441-1 1.483-2

Income taxes, Accounting, Deferred compensation plans.

26 CFR Part 602

OMB control numbers under the Paperwork Reduction Act.

Lawrence B. Gibbs,
Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on May 11, 1989, 8:45 a.m., and published in the issue of the Federal Register for May 12, 1989, 54 F.R. 20606)

Notice of Proposed Rulemaking

Research and Experimental Expenditures

PS-002-89

AGENCY: Internal Revenue Service, Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document revises and supersedes the amendments to the regulations proposed in 1983 under section 174 of the Internal Revenue Code. These proposed amendments primarily relate to the definition of "research and experimental expenditures" and the application of section 174 to computer software development costs. The proposed amendments will provide taxpayers with guidance on the type of expenditures that will qualify as "research and experimental expenditures" for purposes of section 41 and section 174 of the Code.

DATES: These amendments are proposed to be effective, for purposes of both section 41 and section 174, for taxable years beginning after the date the amendments become final regulations by publication of a Treasury decision in the Federal Register. Written comments and requests for a public hearing must be delivered or mailed by July 17, 1989.

ADDRESS: Send comments and requests for a public hearing to: Internal Revenue Service, Attn: CC:CORP:T:R (PS-002-89), Room 4429, Washington, D.C. 20224.

SUPPLEMENTARY INFORMATION:

Submission to Small Business Administration

Pursuant to section 7805(f) of the Code, the rules proposed in this document will be submitted to the Administrator of the Small Business Administration for comment on their impact on small business.

Background

On January 21, 1983, the Federal Register published (48 FR 2790) [LR-236-81, 1983-1 C.B. 1003] proposed amendments to the Income Tax Regulations (26 CFR Part 1) relating to the credit for increasing research activities and the treatment of "research and experimental expenditures" under section 174 of the Internal Revenue Code. A large number of comments were received and a public hearing was held on April 14, 1983.

This document proposes a more extensive set of amendments to the regulations under section 174 than those proposed in 1983. These regulations are proposed to clarify the definition of "research and experimental expenditures" undersection 174, and to provide guidance on the application of section 174 to the costs of developing computer software.

Explanation of Provisions

Section 1.174-2 of the regulations as proposed in 1983 included extensive clarifications of the regulations under section 174, including a clarification of the treatment of computer software.

Section 1.174-2(a)(3) of the 1983 proposed regulations provided that the costs of developing computer software are not "research or experimental expenditures" within the meaning of section 174 unless the computer software is new or significantly improved. The 1983 proposed regulations also provided that such term does not include costs paid or incurred for the development of software the operational feasibility of which is not seriously in doubt. A large number of comments were received that were critical of the proposed computer software provisions on the basis that the proposed regulations treated computer software differently from other products. On January 26, 1987, the Service announced in Notice 87-12 (1987-1 C.B. 432) that final regulations under section 174 would clarify that software development costs qualify as research expenses under the same standards as apply to the costs of developing other products or processes. The regulations proposed by this document revise and supersede the 1983 proposed amendments to the regulations.

These regulations contain a number of examples clarifying the application of section 174 to software development costs. The Service currently is studying the continuing validity of Rev. Proc. 69-21 (1969-2 C.B. 303) in light of the enactment of section 263A of the Code. Taxpayers are invited to comment on the proper treatment of computer software that does not qualify for section 174 treatment. Any change in the tax treatment of computer software will be prospective.

Section 1.174-2(a)(1)(iv) of the 1983 proposed regulations provided in part that the term "research or experimental expenditures" does not include the routine or periodic alteration or improvement of existing products, commercial existing products, commercial production lines, or other ongoing operations. A number of commentators suggested that the proposed regulations could be read to require a significant improvement for an activity to qualify under section 174. They suggested that such a reading would be overly restrictive because research and development activities may in many instances be part of an evolutionary process involving a series of minor improvements that, when taken together over a period of time, lead to a significantly improved product. The regulations proposed by this document do not include the reference to "routine" or "periodic" improvements. However, expenditures incurred after the point that a product or property (or component of the product or property) meets its basic design specifications related to function and performance level generally will qualify as research or experimental expenditures only if the expenditures relate to modifications to the basic design specifications for the purpose of curing significant defects in design, obtaining significant cost reductions or achieving significantly enhanced function or performance level. The regulations proposed by this document also modify the proposed regulations in certain other aspects.

Regulatory Impact Analysis

These proposed rules are not major rules as defined in Executive Order 12291. Therefore, a Regulatory Impact Analysis is not required.

Comments and Requests for a Public Hearing

Before adopting these proposed regulations, consideration will be given to any written comments that are submitted to the Internal Revenue Service. All comments will be available for public inspection and copying. A public hearing will be held upon written request to the Internal Revenue Service by any person who also submits written comments. If a public hearing is held, notice of the time and place will be published in the Federal Register.

List of Subjects

26 CFR 1.61-1 through 1.281-4

Income taxes, Taxable income, Deductions, Exemptions.

Proposed Amendments to the Regulations

The proposed amendments to 26 CFR Chapter I, Part 1 are as follows:

PART 1—[AMENDED]

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

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

Par. 2. Section 1.174-2 is amended as follows:

1. Paragraph (a)(1) of §1.174-2 is revised to read as set forth below.

2. Paragraph (a)(2) is redesignated as paragraph (a)(7).

3. Paragraph (a)(3) is redesignated as paragraph (a)(8) and is amended by removing "subparagraph (2)" and adding in its place "paragraph (a)(7)".

4. New paragraphs (a)(2), (3), (4), (5) and (6) are added to read as set forth below.

§1.174-2 Definition of research and experimental expenditures.

(a) *In general.* (1) The term "research or experimental expenditures," as used in section 174, means expenditures incurred in connection with the taxpayer's trade or business which represent research and development costs in the experimental or laboratory sense. The term includes generally all such experimental or laboratory costs incident to the development or improvement of an experimental or pilot model, a plant process, a product, a formula, an invention, or a similar property. It includes research or experimentation aimed at the discovery of new knowledge and research or experimentation searching for new applications of either research or experimentation findings or other knowledge. However, not all of the expenditures incident to developing or improving a product or property will qualify as research or experimental expenditures within the meaning of section 174. Expenditures incurred after the point that the product or property (or component of the product or property) meets its basic design specifications related to function and performance level generally will not qualify as research or experimental expenditures under section 174 unless the expenditures relate to modifications to the basic design specifications for the purpose of curing significant defects in design, obtaining significant cost reductions or achieving significantly enhanced function or performance level.

(2) The following examples illustrate the application of the principles contained in paragraph (a) (1) of this section.

Example (1). Company B, a manufacturing company, decided to develop and market a new type of kitchen appliance. Company B incurred $500x of expenses relating to developing the basic performance and functional design specifications and constructing a prototype of the appliance based on these specifications. After B developed the product to the point where it met its basic design specifications, B incurred $250x of additional expenditures, including expenditures for minor modifications of the product to facilitate the manufacturing process, writing and printing an owner's manual, designing the case to contain the appliance, and performing quality control testing and market research. The $500x of expenses incurred to develop the appliance to meet its basic design specifications qualifies as research and experimental expenditures within the meaning of section 174. The $250x expended by B after the proposed product achieved its basic design specifications does not qualify as research or experimental expenditures within the meaning of section 174.

Example (2). Assume the same facts as in example (1) except that after the appliance has been fully developed and marketed, B discovers that the vibration level of the appliance could be reduced substantially and its useful life substantially extended by altering the basic design specifications. The costs incurred by B to alter the basic design specifications to reduce the vibration level and extend the useful life of the appliance are research or experimental expenditures within the meaning of section 174 because they relate to a modification of the basic design specifications of a component of a product.

(3) The term "research or experimental expenditure" does not include any cost incurred in connection with the following activities unless the expenditures relating to such activities separately qualify under section 174—

(i) Efficiency surveys or management studies;

(ii) Consumer surveys, market development, or market testing (including market research, advertising, or promotions);

(iii) The routine or ordinary testing or inspection of materials or products for quality control;

(iv) Activities relating to management functions or techniques developed primarily for internal use of the taxpayer in its trade or business and not generally intended for sale to customers;

(v) Activities not directed at the functional aspects of a product including expenses relating to style, taste, cosmetic, or seasonal design factors;

(vi) Activities relating to the implementation of commercial production;

(vii) The construction of duplicate prototypes used for market testing purposes or held for sale;

(viii) The adaptation of an existing capability to a particular requirement or customer's need;

(ix) Routine data collections;

(x) The acquisition of another person's patent, model, or production process; or

(xi) Literary, historical, or similar projects.

However, the term includes the costs of obtaining a patent, such as attorneys' fees expended in making and perfecting a patent application. See section 263A and the regulations thereunder for cost capitalization rules that apply to expenditures paid or incurred for research in connection with literary, historical or similar projects involving the production of property, including the production of films, sound recordings, video tapes, books, or similar properties.

(4) The following examples illustrate the application of the principles contained in paragraph (a)(3) of this section.

Example (1). M Corporation, a textile manufacturer, develops a new synthetic fiber for use in a variety of applications. After extensive testing, the corporation decides that fabric made of the new fiber meets its basic design specifications and is ready for production. After initial marketing of the fabric, the corporation discovers that flaws exist in a significant percentage of the marketed fabric. The corporation determines that the flaws can be eliminated by adjusting the weaving machines so as to slightly loosen the weave of the fabric. Section 1.174-2(a)(3)(vi) provides that the term "research and experimental expenditures" does not include activities relating to the implementation of commercial production unless such expenditures separately qualify under section 174. Since the expenses of modifying the production line were incurred implementing commercial production specifications and did not relate to modifications of the basic design specifications of the fabric, such expenses do not constitute section 174 expenses.

Example (2). O Corporation, a manufacturer of perfume, decides to create a new perfume to sell to teenage girls. In laboratory tests, O Corporation developed a variety of scents, evaluating the odor of each scent, as well as its physical properties, such as whether it causes an allergic reaction. After this laboratory testing yielded several satisfactory alternatives which met O Corporation's basic design specifications, the corporation conducted consumer surveys to determine the preferences of potential customers. Based on information from this consumer survey, O Corporation selected one scent to market as a new perfume. Under §1.174-2(a)(1), the term "research and experimental expenditures" means "research and development costs in the experimental and laboratory sense." Paragraph (a)(3)(v) of this section further provides that the term does not include "activities not directed at the functional aspects of a product including expenses relating to style, taste, cosmetic, or seasonal design factors." Although the expenditure relates to a consumer taste, the costs of developing the basic scent of the perfume will separately qualify under section 174 if they are research and experimental expenditures within the meaning of section 174. The costs of developing alternative perfumes to market to teenagers, however, do not constitute research or experimental expenditures under section 174 because the alternatives do not alter the basic design specifications of the perfume. However, the costs relating to the functional aspects of perfume, such as whether it causes an allergic reaction on certain persons, may qualify as section 174 expenses. Finally, the costs of conducting surveys to determine customer preferences with respect to the alternative perfumes do not constitute section 174 expenses because of the exclusion for consumer surveys or market testing activities.

Example (3). The facts are the same as in example (2), except that after the perfume was in production, O Corporation continued to test each batch of perfume to determine whether that batch is allergenic. The cost of performing such tests relate to quality control and do not constitute research or experimental expenditures under section 174.

Example (4). P Corporation, manufacturer of automobiles, decides to redesign the body of one of its existing models. This process typically involves a series of steps. Initially, the corporation's designers, working with certain basic design specifications, develop several alternative styles. From these alternative designs, the corporation's management will select one design which will then be tested by the corporation's engineers for a variety of functional specifications, including its aerodynamic efficiency and safety. Section 1.174-2(a)(3)(v) provides that section 174 does not include activities relating to the nonfunctional aspects of a product. Therefore, the costs of developing alternative designs for P corporation's new model do not constitute research or experimental expenditures under section 174. However, the costs relating to the aerodynamic testing and safety may constitute research or experimental expenditures under section 174.

Example (5). In 1987, S, a company that publishes general reference books for use by the general public, decides to publish textbooks for use in high schools throughout the country. To develop each textbook, S incurs expenses to develop the theme and topic of the textbook, obtain manuscripts from authors, edit the author's submission and obtain illustrations for the textbook. None of these expenses qualifies as research or experimental expenditures under section 174 by virtue of the exclusion for "literary, historical, or similar projects," and because they do not separately qualify as research and experimental expenditures within the meaning of section 174.

Example (6). G is a designer and manufacturer of specialized computer chips that will perform certain functions on a customer-designed hardware system in accordance with a customer's specifications. Each chip is custom-designed, through a process of experimentation, for a customer's specific order at G's risk. Each chip has a different basic design specification. The costs of designing and developing each chip are research and experimental expenditures within the meaning of section 174, even though the chips are intended for a specific customer because each chip has different basic design specifications.

Example (7). R, which is in the business of making cranes to be used for building construction, uses the same type of parts for each crane it manufactures. R designs and manufactures each crane in different configurations depending on the type of building being constructed, the situation of the building on the building site, and the distances between the site and the nearest streets. However, the cranes do not have different basic design specifications. The costs of designing and manufacturing the cranes are not research or experimental expenditures within the meaning of section 174 because they are costs of adapting an existing capability to a particular requirement or customer's need.

Example (8). B, a small manufacturer, develops a new employee training program for its business to conform to recent changes in management science. The costs of developing the employee training program do not qualify as research or experimentation because of the exclusion for management functions or techniques.

Example (9). C, a biotechnology firm, developed a new drug that substantially lowers blood pressure. Prior to marketing the drug, C incurs costs to test the product and obtain FDA approval of the drug. The costs incurred by C to develop, test, and receive government approval of the drug are research and experimental expenditures within the meaning of section 174.

Example (10). D, a manufacturer of tires, develops a new tire that is more puncture-resistant than any tire it has previously developed and marketed. Prior to production of the new tire, D constructs a number of duplicate prototypes for use in several different safety tests. After the safety tests are completed, D constructs additional duplicate prototypes to offer to car dealers for testing by their customers. D subsequently sold some of the tires that were used for safety or market testing. The costs of manufacturing the duplicate prototypes that were used for safety testing and were not held for sale to customers qualify for section 174 treatment. The costs relating to constructing the duplicate prototypes for market testing or sale to customers, however, do not qualify under section 174 because of the exclusion for duplicate prototypes. In addition, none of the costs of market testing qualifies under section 174 because of exclusion for market testing activities.

(5) The costs of developing computer software qualify as research or experimental expenditures within the meaning of section 174 under the same rules that apply to other products or properties.

(6) The following examples illustrate the application of the principles contained in paragraph (a)(5) of this section.

Example (1). F, a company in the business of developing software for sale to the public, intends to develop a new type of database management system for microcomputers. The new program will be different from any other product existing in the market and will contain new features and capabilities that previously were only available on programs designed for mainframe computers. Due to the differences between types of computers, F cannot use its existing technology for mainframe computers to produce database systems for microcomputers. To begin development of the program, F develops a detailed program design of the new program describing its functions and performance levels. Upon completion of the program design, F begins coding and testing the program as it is developed. After F had expended $500x, the program meets the basic design specifications. F then incurs $250x to prepare the program for market, including debugging, performing minor modifications to facilitate the manufacturing of the program, producing multiple copies of the software to send to outside consulting firms for further testing, and writing the documentation for users. The $500x expended to develop the program to meet its basic design specifications qualifies as a research or experimental expenditure within the meaning of section 174. The $250x expended after the program meets its basic design specifications does not qualify as a research or experimental expenditure.

Example (2). Assume the same facts as in example (1), except that two years after marketing the database management system, a number of B's customers reported errors that caused the system to shut down after extensive use. B recalled each system from its customers and replaced it with a system that the customers could use on a temporary basis. During this period, B's engineers conducted research to discover the source of the error. After months of research, B's engineers discovered a defect in the design of the system and redesigned the system to eliminate the problem. The expenses incurred to discover and correct the error are research and experimental expenditures within the meaning of section 174 because they relate to modifications to the basic design specifications for the purposes of curing significant defects in the original design of the product.

Example (3). D, a company in the business of developing software for sale to the public, currently markets a program that is used to analyze information derived from orbiting satellites. The existing software has been designed to operate on a specific computer system and with a specific operating system. Recent advances in satellite technology have changed the amount, type, and format of the data that is transmitted by satellites. These advances in satellite technology require a change in the design of the program to achieve an increase in processing rate, improvements in data handling capabilities, and a change in functional specifications to analyze the new data transmitted by satellites. Since the changes to be made to the existing software involve modifications to the performance levels and functions of the software, the costs incurred in connection with the development of the modifications to the basic design specifications of the software qualify as research or experimental expenditures within the meaning of section 174.

Example (4). E, a company in the business of developing software for sale to the public, currently markets a word processing program. The program entitled "Writer 1.0" has been marketed to the public for one year. Based on comments received from customers of the program, E decided to make changes to the program. Generally, these improvements involve adding some additional commands to the program. On completion of the changes, all new copies of the program delivered to customers contain the changes and are entitled "Writer 1.1." Previous customers of "Writer 1.0" are offered the opportunity to obtain copies of "Writer 1.1" for a nominal charge. Since the changes made to the existing software did not modify the basic design specifications relating to performance levels and functions of the software, the costs incurred in connection with the modifications to the program do not qualify as research or experimental expenditures within the meaning of section 174.

Example (5). C, a developer of software, develops and sells an inventory control software system. B, a customer of C, offers to buy C's software system but requires modification of the system to meet B's warehouse and distribution needs. Subsequently, C modifies the inventory software to expand the number of data fields and to design a custom data input screen. These changes to the software do not alter the basic design specifications of the software. C's expenditures to modify the software system do not qualify as research or experimental expenditures within the meaning of section 174 because they relate to the adaptation of an existing product to a particular customer's need.

Example (6). G, a manufacturing company, develops software that automatically prepares financial data and analysis for inclusion in the annual report to shareholders. The costs of developing the software system are not research and experimental expenditures because the software relates to internal management functions or techniques, and because they do not separately qualify as research and experimental expenditures within the meaning of section 174.

Example (7). K, a manufacturer of machine equipment, intends to automate its manufacturing process more fully. To this end, it begins development of an automated sorting system that will sort and test to determine whether components to be used in assembly of its products meet specifications. As part of the development of the new system, software is developed that will operate the sorting system. The software is developed by employees of K, written using standard computer programming language, and is not available for sale in the market. Although the software relates to the implementation of commercial production, the development of the software separately qualifies under section 174 because it relates to the development of a new plant process.

Example (8). C, publishing company, publishes a number of reference books including an encyclopedia. Due to the growing number of home computers, C decided that additional sales could be generated for the encyclopedia if it were published in electronic format. Therefore, C had the text of the encyclopedia coded onto data disks that can be read by personal home computers. The editorial content of the encyclopedia on the data disks is the same as the published edition. The costs of transferring the editorial content of the encyclopedia to the electronic media do not qualify as research or experimental expenditures within the meaning of section 174 because they were incurred in connection with development of a literary product, and because they do not separately qualify as research and experimental expenditures within the meaning of section 174.

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Lawrence B. Gibbs,
Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on May 16, 1989, 8:45 a.m., and published in the issue of the Federal Register for May 17, 1989, 54 F.R. 21224)

Announcement of the Disbarment, Suspension, or Consent to Voluntary Suspension of Attorneys, Certified Public Accountants, Enrolled Agents and Enrolled Actuaries from Practice Before the Internal Revenue Service

Under 31 Code of Federal Regulations, Part 10, an attorney, certified public accountant, enrolled agent or enrolled actuary, in order to avoid the institution or conclusion of a proceeding for his disbarment or suspension from practice before the Internal Revenue Service, may offer his consent to suspension from such practice. The Director of Practice, in his discretion, may suspend an attorney, certified public accountant, enrolled agent or enrolled actuary in accordance with the consent offered.

Attorneys, certified public accountants, enrolled agents, and enrolled actuaries are prohibited in any Internal Revenue Service matter from directly or indirectly employing, accepting assistance from, being employed by, or sharing fees with, any practitioner disbarred or under suspension 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 the 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 later 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
Geffner, Donald F.	Miami, FL	Attorney	Indefinite from October 27, 1988
Green, Dennis L.	Riverside, CA	Certified Public Accountant	Indefinite from October 27, 1988
Hammond, Allen	Irvine, CA	Certified Public Accountant	Indefinite from October 27, 1988
Johnson, M.B.	Little Rock, AR	Certified Public Accountant	Definite from October 7, 1988 to October 7, 1989
Burton, Melvin M., Jr.	Washington, DC	Attorney	Indefinite from Dec. 15, 1988
Fullmer, Ernest M., Jr.	Spokane, WA	Enrolled Agent	Indefinite from Dec. 6, 1988
Golletz, Victor H.	Country Club Hills, IL	Enrolled Agent	Indefinite from Dec. 16, 1988
Berman, Chester N.	Marietta, GA	Enrolled Agent	Indefinite from Jan. 1, 1989
Van Natter, James H.	Seattle, WA	Certified Public Accountant	Indefinite from Jan. 11, 1989
Brock, Charles Randall	Middletown, CT	Attorney	Indefinite from Feb. 21, 1989
Garavaglia, Michael J.	Vero Beach, FL	Attorney	Indefinite from Feb. 1, 1989
Hutchinson, Jr., Robert H.	Columbia, KY	Attorney	Definite from Jan. 24, 1989 to Jan. 23, 1990
Levy, Stanley	Philadelphia, PA	Certified Public Accountant	Indefinite from Jan. 31, 1989
Spina, Joseph P.	Miami, FL	Certified Public Accountant	Indefinite from Feb. 7, 1989
Van Miegham, Daniel J.	Santa Monica, CA	Enrolled Actuary	6 Months from March 1, 1989
DeMassa, Philip A.	San Diego, CA	Attorney	Indefinite from April 13, 1989

The following individual has entered a consent resignation from enrollment to practice before the Internal Revenue Service:

Name	Address	Status	Effective Date
Hailey, Louis	Jena, LA	Enrolled Agent	October 4, 1988

After due notice and opportunity for hearing, the following individual has been suspended from further practice before the Internal Revenue Service:

Name	Address	Designation	Date of Suspension
Wagner, Darrell E.	Canby, OR	Enrolled Agent	Indefinite from Nov. 6, 1988

Under Section 330, Title 31 of the United States Code (1970 ed), 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 in the names and addresses of practitioners who have been suspended from each 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 for each attorney, certified public accountant, enrolled agent or enrolled actuary so suspended or disbarred and will be consolidated and published in the Cumulative Bulletin.

After due notice and opportunity for hearing before an administrative law judge, the following individuals have been disbarred from further practice before the Internal Revenue Service:

Name	Address	Designation	Date of Disbarment
Tedder, David L.	Beaufort, SC	Attorney	November 4, 1988
Bace, William C.	Baltimore, MD	Attorney	December 31, 1988
Judge, John E.	Redondo Beach, CA	Certified Public Accountant/Attorney	December 8, 1988
Padgett, Steven E.	Linton, IN	Certified Public Accountant	December 8, 1988
Wollarb, James E.	St. Louis, MO	Attorney	December 8, 1988
Keeney, Theodore M.	Kahului, HA	Attorney	March 27, 1989
Moore, Earcel, Jr.	London, KY	Certified Public Accountant	March 27, 1989

After due notice and hearing before an administrative law judge, the following individual has been suspended from further practice before the Internal Revenue Service.

Name	Address	Designation	Date of Suspension
Alexander, Harry T.	Washington, DC	Attorney	December 31, 1988

The abbreviation and number in parentheses following the index entry refer to the specific item; numbers following the parentheses refer to 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 TAXES

ESTATE & GIFT TAXES ADMINISTRATIVE

ESTATE & GIFT TAXES—Continued
ADMINISTRATIVE—Continued

ESTATE TAX

EXCISE TAXES

EXCISE TAXES—Continued

INCOME TAX